BLOG

Military dominance increases imbalances in the Russian economy

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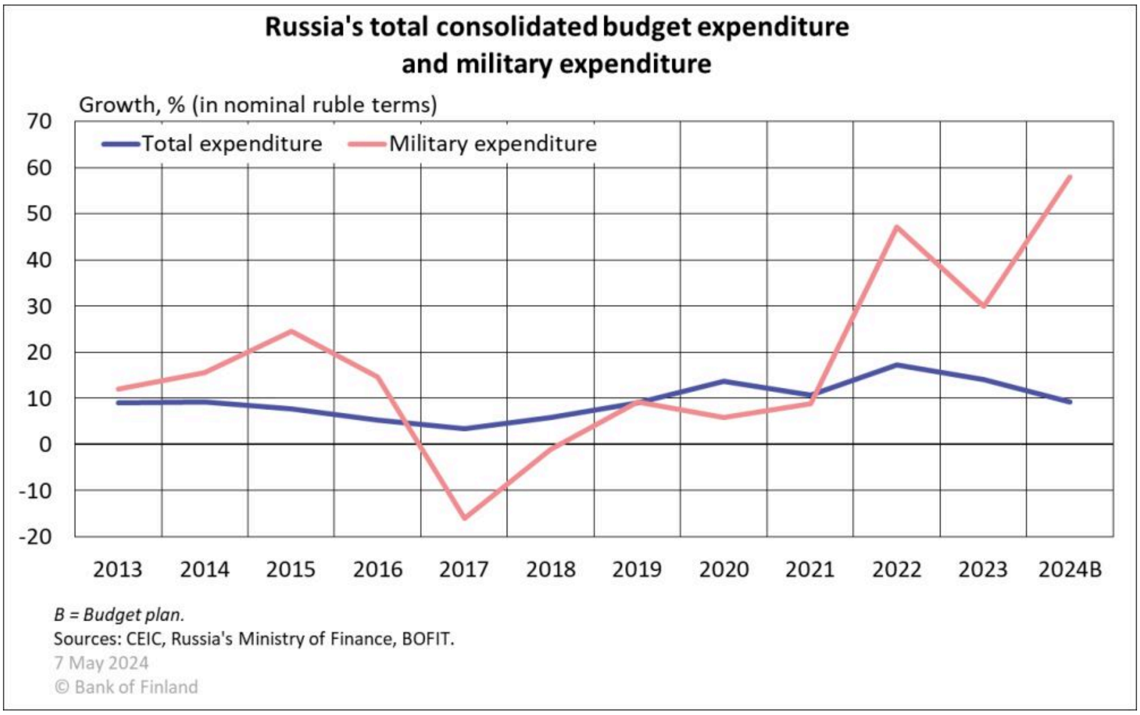
Russia's full-blown war in Ukraine has already continued for more than two years. Russian economy has shifted towards a war mode, with military efforts the main priority also in the economic policy agenda. Government spending has sharply increased, leading to budget deficits and accelerating inflation. Financial and material resources focused on war-related sectors suck resources from other parts of the economy. Russia's output has grown in recent months, but the military production's dominance is increasing economic imbalances and eroding Russia's longer term growth potential.

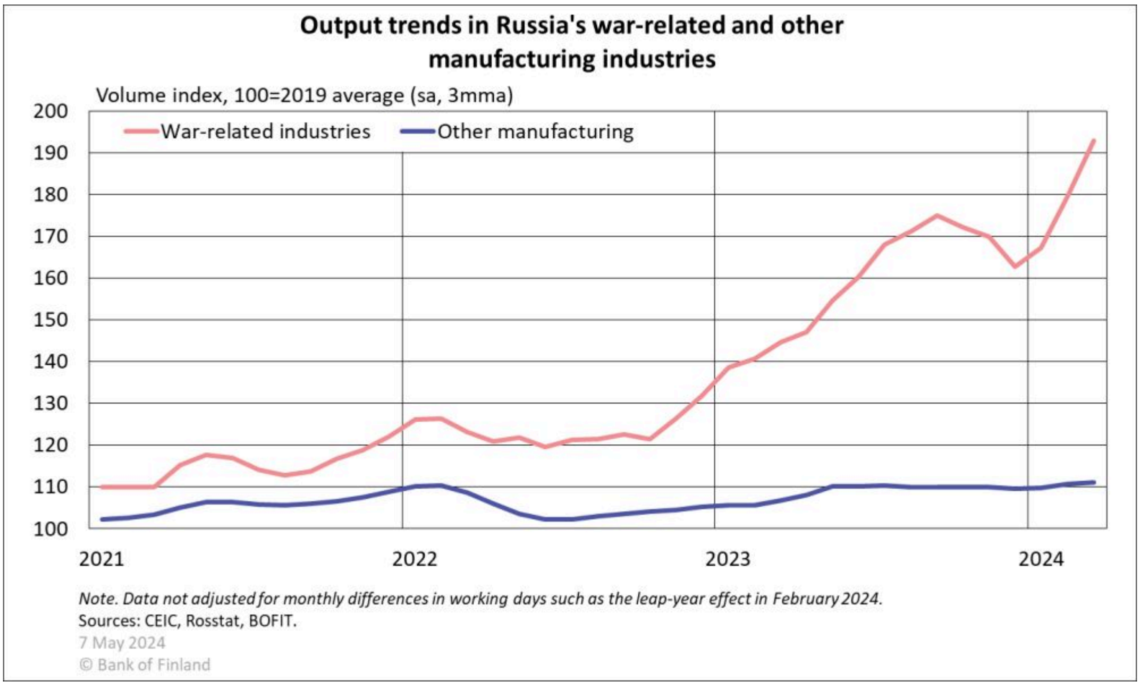
Russian government spending soared after the invasion of Ukraine. In 2022–2023, Russia's consolidated budget expenditure (which includes the federal budget, regional budgets and extra-budgetary funds) increased on average by 15 % a year in nominal terms. The current budget plan expects further rapid growth in spending. Russia has ceased to publish detailed information on realized budget spending, but the Stockholm International Peace Research Institute (SIPRI),[1] for example, estimates that Russia's military spending (in nominal ruble terms) rose by nearly 40 % a year during 2022–2023. Growth in military spending this year is set to outpace overall spending growth by an even larger margin as government funds continue to be redirected to supporting the war effort (Figure 1).

Chart 1.



Russia’s focus on the war is clearly visible in the manufacturing sector. While output in industries associated with the military industry increased sharply over the past two years, [2] output in other manufacturing industries (in aggregate) largely remained flat (Figure 2). Supported by increased government outlays, war-related industries continued to gather steam in the first months of this year. In January-March 2024, the average output of war-related industries was more than 50 % higher than in the months preceding Russia’s invasion. Output in other manufacturing industries was up by a mere 0.5 %.

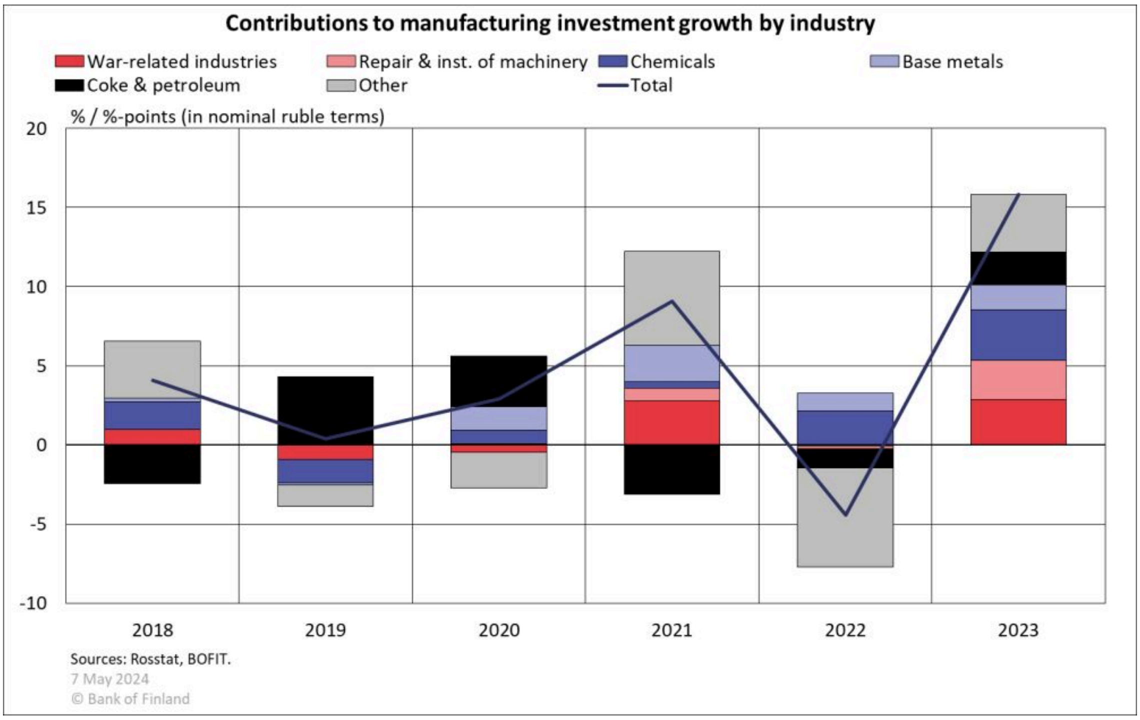
Chart 2.



The supply side of the economy already struggles to keep up with higher government spending and sharp increases in subsidized credit. Labor shortages have become a chronic problem and capacity utilization is historically high for many industries. Sanctions have restricted Russia's access to imported inputs and increased their costs. [3] As war-related industries sponge up resources from other sectors, problems are even more severe in these parts of the economy.

Investment in fixed assets has increased exceptionally fast over the past two years – nearly 8 % on average compared to a mere 0.2 % a year on average in 2011–2019. Notably, fixed investment has largely been geared towards supporting the war efforts in recent years. [4] In 2022, for example, the focus was on construction of infrastructure serving the war efforts in regions bordering Ukraine and military industry production hubs. Last year more investment was directed to manufacturing, particularly war-related industries as well as repair of machinery – similarly to 2021 (Figure 3). Other industries contributing to manufacturing investment growth in 2023 can also support the war effort, e.g. manufacturing of chemical products and base metals. At this point, it appears Russia remains primarily focused on securing the future production capacity and transport infrastructure needed by the military. Other investment remains further in the doldrums.

Chart 3.



Inflation has accelerated sharply in Russia in past months. Demand growth has outpaced production capacity of the economy and sanctions have further added to price pressure through supply problems, ruble depreciation and higher import prices. Rosstat figures show consumer prices in Russia were up 8 % y/y in March. The Central Bank of Russia hiked its key rate by 8.5 percentage points during the second half of last year to 16 % and has kept the rate since unchanged at this level (the highest since the CBR's emergency measures to stabilize financial markets in spring 2022). Some alternative measures suggest that the inflation for specific goods is higher than the aggregate measure for consumer prices. For example, Russian research company Romir's price index based on the purchases of Russian households suggests that the annual price increase of everyday goods reached 19 % in March.

The strong focus on war-related production has aggravated imbalances in the Russian economy. These effects are most pronounced in consumer-related sectors denied output growth by military industries gobbling up financial and productive resources. Despite massive investment needs in other parts of the economy and society, Russia's future growth potential and living conditions are eroded by government spending and investment focused on war-related production and infrastructure.

Key words

economy, Russia, Ukraine