Russia's Tense Year Ahead

by Ekaterina Zolotova - December 30, 2024

The Russian economy will be bad in 2025, at least according to Russian citizens. A newly published **poll** conducted by Levada suggests that nearly two-thirds of Russians think 2025 will be "tense" for the economy, and nearly 60 percent believe it will be "tense" for Russian politics. Their concerns aren't without merit. Russia enters this year with a host of unresolved problems that will be extremely difficult to solve.

The biggest of these is that the Russian government is still struggling to enact the structural changes needed to ease the pressure brought on by international sanctions. When the sanctions first took effect, some hoped that Russia would be able to, say, transition from a resource-dependent economy to one producing semi-finished and finished goods. Doing so would be beneficial in its own right, but it would also give Moscow a much-needed alternative to easily targeted energy exports. But that hasn't happened; Russia still plays the role of resource provider, and China, India and the European Union still play the role of buyer, directly or indirectly. Though the share of oil and gas revenue in the Russian budget has decreased, estimates suggest it will still account for just over 27 percent in 2025. Crucially, the reductions owe less to diversifying production than they do to increases in tax rates. (A progressive personal income tax scheme came into force on Jan. 1.)

Meanwhile, Russia has not yet built an effective industrial sector, so it continues to rely on imports, especially in the electronics sector and high technology. Even relatively successful industrial activities such as military production have been goosed by defense contracts; civilian industrial activity still wants for development, having struggled with supply chain issues and a diversified supplier base and, in some cases, having failed to meet domestic demand. The shortages in supply and in human and raw resources owe almost entirely to international sanctions. Thus, much of Russia's economic activity relies on what the federal budget can allocate for things like construction, production and social security.

This means that the process by which the Kremlin spends its money is even more politicized than usual. Moscow spends almost 33 percent of its budget on defense expenditures, but some 85 percent of those expenditures are classified. The upcoming budget is already factoring in a deficit, so non-defense spending is at risk of more cuts. That's not to say the Kremlin has no desire to spend more on, for example, improving technological industrial capacity, but it is to say that, the constraints being what they are, Moscow is unlikely to meet the civilian sector's needs. This is especially so in light of the external affairs Russia must continue to try to manage, including the Ukraine conflict, tensions in the Middle East and border instability in the Caucasus.

Put simply, there is only so much wiggle room in the budget, and any unforeseen development will only make matters worse. For example, drone raids from Ukraine are becoming more frequent, are flying farther into Russian territory, and are beginning to inflict damage on civilian targets. Countering them requires additional modernization and widespread deployment of air defense systems. Another example involves so-called acts of God: Unpredictable weather conditions recently caused two oil tankers to crash in the Black Sea, and apparently it was difficult to find the means to respond quickly. Not only did Russia lose some oil, but it was out the additional funds needed to clean up the mess.

Even so, the biggest thing bedeviling the Russian budget is the war in Ukraine. Moscow has repeatedly indicated that it is ready to begin negotiations, and some officials even suggest that talks could take place in 2025 after Donald Trump returns to the U.S. presidency. But even if that happens, it won't solve Russia's economic problems overnight. A ceasefire won't immediately lift economic sanctions, restore trade flows, or return Western technologies and investments. Nor would it achieve the stated goals of the war in Ukraine that the Kremlin formulated in 2022 (denazification and demilitarization). The Kremlin may welcome a reprieve in fighting and in certain types of military spending, but right or wrong, it believes a future conflict with NATO is a real possibility, so don't expect it to fundamentally halt defense development or manufacturing.

This explains some of the "tension" Russian citizens feel toward the economy, driven as it is by inflation and the inconsistency between the central bank and the legislative branch on how to lower it. The measures applied by the central bank – high interest rates – have created discontent among some lawmakers in the ruling party, who prefer to focus on ways to increase supply. On Dec. 20, the bank surprised many by leaving the interest rate at 21 percent, instilling some confidence in investors, businesses and the ruble. But disagreements remain between the Kremlin and the central bank, and though the bank has conceded much already, there's no guarantee that it won't raise rates again if inflation persists. (And there is evidence to suggest it will. In December, annual inflation increased to roughly 16 percent, and there remains an imbalance of supply and demand in goods and services, labor and capital.) Nor is there any certainty in the stability of existing trade relations, which depend on (insufficient) long-term contacts with Asia-Pacific countries and on unstable energy prices.

Russia enters 2025 with an unbalanced economy, where growth is achieved in oil and gas and in domestic demand spurred by social payments, government orders and high wages in the military sector, and where trade flows to new partners have yet to be fully established. Focusing on the military sector may work for now, but without significant growth in the civilian sector, Russia may find even bigger problems down the line.

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