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Research Report

Macroeconomic policies in Russia 1995-2025 – from barter arrangements to an emerging war economy

BOFIT Policy Brief, No. 13/2025

Provided in Cooperation with:

Bank of Finland, Helsinki

Suggested Citation: Solanko, Laura (2025) : Macroeconomic policies in Russia 1995-2025 – from barter arrangements to an emerging war economy, BOFIT Policy Brief, No. 13/2025, Bank of Finland, Bank of Finland Institute for Emerging Economies (BOFIT), Helsinki, <https://nbn-resolving.de/urn:nbn:fi-fe2025090594609>

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BOFIT Policy Brief

13 • 2025

Laura Solanko

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BOFIT

THE BANK OF FINLAND
INSTITUTE FOR
EMERGING ECONOMIES

BOFIT Policy Brief
Editor-in-Chief Sanna Kurronen

BOFIT Policy Brief 13/2025
5 September 2025

Laura Solanko:
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emerging war economy

ISSN 2342-205X, online

The opinions expressed in this paper are those of the authors and do not
necessarily reflect the views of the Bank of Finland.

Bank of Finland
Helsinki 2025

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Laura Solanko

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Abstract

This paper provides an overview of the major changes in Russia’s macroeconomic policies since the early 1990s. For decades, the quest for economic stability and security have been leading principles of Russian macroeconomic policies. To understand the genesis of these macroeconomic policy choices the paper first provides a chronology of macroeconomic policies from the early 1990’s to the aftermath of the global pandemic thirty years later. The second part describes how since the full-scale invasion on Ukraine, Western economic sanctions and the emerging war economy have fundamentally changed Russia’s policy choices in fiscal and monetary policies as well as in Russia’s trade relations.

Keywords: Russia, fiscal policy, monetary policy

JEL: O10, P20

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This is an updated version of Solanko, L. “Economic Policies and Russia’s Global Economic Integration” (pp. 225–246). In S. A. Wengle (Ed.), *Russian Politics Today: Stability and Fragility* © Cambridge University Press & Assessment 2023, reproduced with permission.

1. Introduction

Russia's economy is dependent on global markets. Trade in goods and services and access to global financial markets are crucially important for the country's welfare. This is not unusual for upper-middle income countries, but Russia is more vulnerable to swings in the global markets than an average economy. Crude oil, oil products and natural gas constitute well over half of the value of Russian exports and bring about a fifth of public sector revenues. Any abrupt changes in revenue streams generated by hydrocarbon exports have immediate effects in domestic financial markets, the external value of the Russian ruble and Russian government revenues. Since early 1990's, sudden drops in global oil prices have exposed Russia's macroeconomic weaknesses and led to recurring financial crisis. Managing these vulnerabilities is a key challenge for the Russian government. The bitter experiences of economic transformation in the 1990's further heightened demands for a stable and predictable macroeconomic environment. As a consequence, under President Putin, the quest for stability and economic security became leading principles of Russian economic policies.

Russia's fiscal and monetary policies have indeed changed dramatically since the collapse of Soviet Union. First the oftentimes chaotic liberalization, privatization and decentralization of the early 1990s ended in a major fiscal failure. Russia defaulted on its sovereign debt in August 1998, which forced the government to cut spending and to balance the budget. In the years that followed, tax reforms and increasing oil prices helped in balancing the budget and then paying back most of the remaining public debt. Tight fiscal and monetary policies and especially avoidance of government debt became the guiding principles of economic policy. As the state got the upper hand in the battle for economic power by the early 2000s, high oil and gas export proceeds increased government revenues and boosted both the newly created stabilization fund and the central bank's international reserves.

Even as foreign trade was liberalized, Russian exports remained dominated by hydrocarbons and other unprocessed raw materials. To maintain macroeconomic stability, Russian governments have neglected necessary structural reforms and favored selective implementation of rigid rules over flexibility and innovation. Where

formal institutions are weak, *de facto* implementation of laws and regulations tends to create opportunities for rent-seeking, corruption, state capture and tight links between business oligarchs and politicians. This has further hindered private investments and diversification away from hydrocarbons.

The ill-fated three-week special military operation, which turned out to be a full-scale, prolonged military invasion of Ukraine, has resulted in major overhaul of the country's economic policies. Immediately after February 22, 2022, Russian central bank had to abandon free capital mobility and severely limit all foreign currency operations to limit the damage caused by the first wave of Western sanctions. Ruble convertibility was gone almost overnight.

It became clear very soon that the invasion was a military failure, and Russian armed forces would require huge increases in both material and personnel to achieve the stated goals. This in turn necessitated continuous increases in both direct and indirect military spending. As the war became the main economic policy priority, the tight fiscal policy was soon abandoned. Various rounds of further Western sanctions have restricted Russia's income from raw material exports and severely limited Russia's options to import foreign technologies. This has made financing the ever-increasing public expenditure more difficult and increased the need for government support, especially in military industries. By early 2025, about two thirds of the liquid part of the stabilization fund had been used to finance the budget deficits.

Wars also tend to increase the role of the state in an economy. This is certainly true for Russia, where state-owned or state-controlled corporations typically control not only military industries but much of energy, finance and transportation sectors. The boom in war-related sectors has increased the importance of sectors characterized by state-ownership, close links between the state, the *siloviki* and the businesses, poor transparency, and corrupt practices.

2. How stability and sovereignty became the cornerstones of Russian macroeconomic policies

2.1. Setting the stage: 1991–1998

The first decade of the economic transformation from the Soviet planned economy to what turned out to be a poorly functioning market economy was devastating for all countries of the former Soviet Union and formerly socialist Central Europe. The early years of price liberalization, privatization and the collapse of old networks were especially destructive in Russia, where the legacies of planned economy were much longer.

The standard prescription of reforms for Post-Soviet economies in the late 1980s and early 1990s was a long list of liberalization, privatization, stabilization and structural reforms, a canon known as the Washington Consensus. In Russia, price liberalization and privatization were pushed ahead relatively swiftly by Yeltsin's team of liberal reformers, a policy that was later labeled “shock therapy”. Benefits of Russia's liberal reforms, however, were hampered by the government's failure to pursue fiscal and financial stability early on. The government continued to pay e.g. large enterprise subsidies but failed to collect taxes finance the outlays. The government therefore resorted to the central bank and monetary financing of the deficits. As expected, the resulting increases in money supply led to hyperinflation and collapsing external value of the ruble. One consequence of this was the emergence of barter trade in Russia, an inherently inefficient means of economic transactions.

Unable to balance expenditures and revenues, Russia generated sizable federal budget deficits for much of the nineties. By the mid-1990s, Russian securities markets started to emerge, and an increasing share of budget deficit could be financed by government bonds. The new means of deficit financing allowed the government to reduce its dependence on central bank financing, thereby giving the central bank some room to conduct monetary policy. But issuing government bonds also allowed the government to avoid the inherently unpleasant decisions to cut public spending.

Foreign trade was gradually liberalized, and many export tariffs were lowered substantially in 1992-1995. Even if imports remained subject to various tariffs, in general, the quality and variety of Russian products was far behind of what was available in global markets. Russians thus imported both consumption and investment goods as a first step to increase economic well-being.

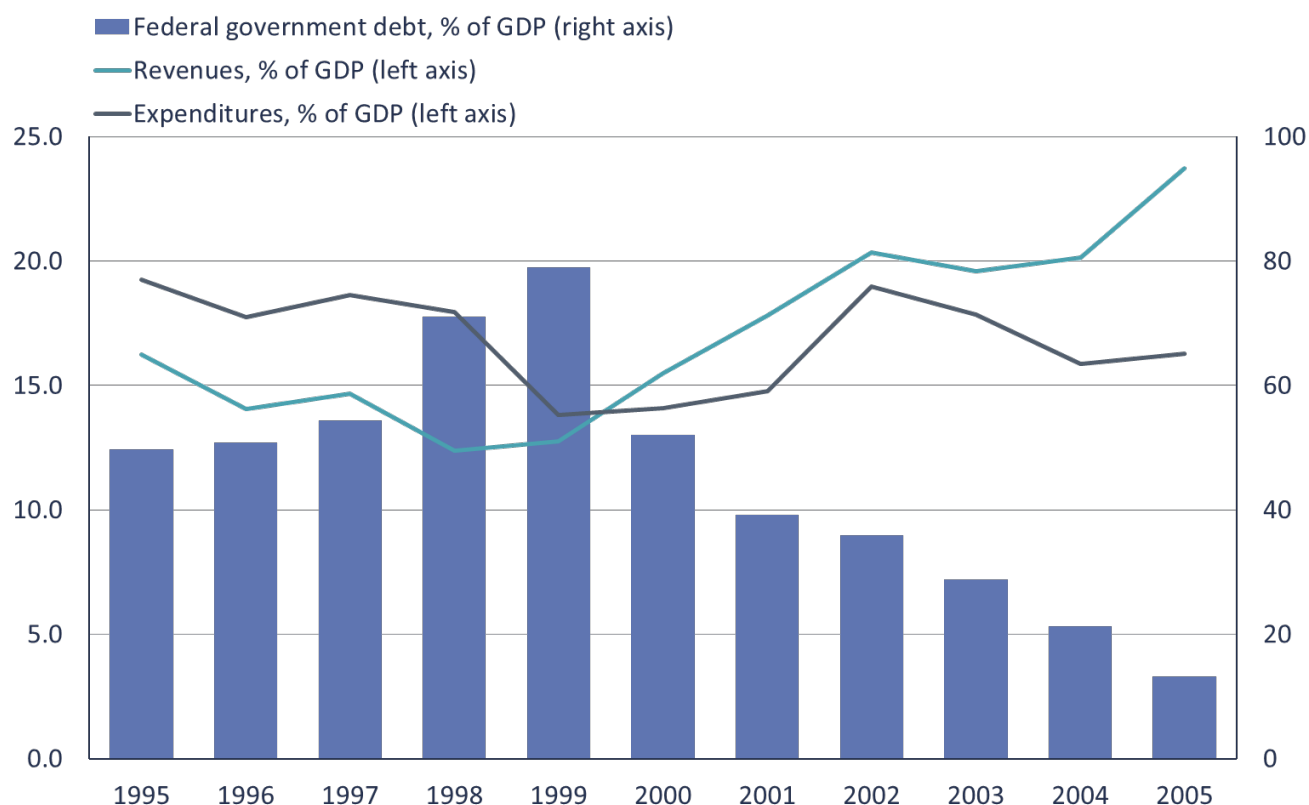
Import of foreign capital was welcomed and the government bond market was opened to foreign investors in early 1996. Very high yields and the fixed ruble exchange rate made the short-term government bonds known as GKO highly attractive for anyone with a fair dose of risk appetite and access to global money markets. As the Asian financial crisis hit global financial markets in 1998, Russia's mounting short-term debt became a signal of looming disaster. Foreign investors began to withdraw their bets from emerging markets, including Russia. To make matters worse, falling oil price increased federal budget deficits. A classical financial crisis was in the making. In August 1998 the authorities had no other choice than to devalue the ruble, declare default on ruble-denominated debt and force a moratorium on all foreign debt payments. The fragile macroeconomic stabilization achieved in 1997 was wiped out almost overnight. Russian GDP decreased by five percent in 1998 and inflation peaked at over 100 percent.

The Russian crisis of 1998 came to symbolize the perils of rapid financial liberalization and loose fiscal policies. Left with no other choice, Russian decision-makers finally had to take fiscal consolidation seriously. During a financial crisis the only way to do that was to drastically cut expenditure, in particular the complex and opaque web of enterprise subsidies. General government expenditure (federal, regional and local budgets combined) was cut by a whopping 10 percentage points from 36 percent GDP in 1997 to 26 percent of a much smaller GDP in 1999. The fiscal deficits that seemed impossible to limit in the early years of transition had all but disappeared by the end of 1999. At the same time, the state and large state-owned companies started to decline payments in barter, encouraging re-monetization of the Russian economy. In a few years, barter transactions disappeared almost completely, greatly improving economic efficiency.

After immediate macroeconomic stability was achieved, the new economic policy team nominated by President Putin finally embarked on major economic reforms in late 2000. The team led by Finance Minister Aleksei Kudrin put forward a new Tax Code, a major Land Reform Code, new Labor Code and numerous improvements to banking sector legislation. Several tax rates were cut significantly, tax bases unified, and many tax breaks and some regulatory loopholes were abolished. Most importantly, a strict oil taxation regime was put in place. Oil companies had typically been able to minimize their tax payments by using barter payments, transfer pricing and on- and offshore tax havens. As Russian corporate accounting on profit and loss statements were notoriously unreliable, the new oil taxation was based on physical quantities produced and exported. Mineral extraction tax became an ad valorem tax calculated based on Urals crude price, not on domestic prices. These reforms aimed to decrease tax avoidance and thereby increase government revenue. On most accounts, they succeeded.

Overall, the experience of an extremely violent financial crisis created an economic policy consensus on necessity to maintain budget balance. This consensus included a shared mistrust of foreign borrowing by the sovereign. Never again should sovereign Russia be left at the mercy of international financial markets. Very cautious and conservative fiscal policy soon became the only game in town. Importantly, apart from the 90-day moratorium, no major capital controls were put in place. Russia remained highly dollarized and private sector foreign funding was not seen as a threat to stability. Therefore, the new policy consensus did not entail economic isolationism. Policymakers wanted to see Russia joining the global economy, but on more cautious terms. The financial crisis also led to improvements in risk management practices by the commercial banks and in some improvements in banking supervision.

Figure 1: Central government revenue and debt in 1995–2005



Source: BOFIT Russia Statistics.

3. The great economic boom and the bust 1999–2009

In the 1990s, oil prices rarely exceeded 20 USD per barrel and during the 1998 crisis crude prices temporarily dropped below 10 USD. Oil prices started to recover in the early 2000's. The major Russian export variety, Urals crude oil traded at around 23 dollars per barrel in 2001-2002, but the price more than doubled to 50 USD in 2005. Due to the new oil tax regime, Russian government was exceptionally well placed to benefit from the boom in global trade. Federal budget revenues that equaled 15 percent of GDP in 2000 had grown to 24 percent of GDP in 2005, and the federal budget was running a surplus of seven percent of GDP.

The next big economic policy discussion was about how best to use the surpluses. The fiscally conservative strategy championed by the finance minister Alexey Kudrin and the economy minister German Gref implied it would be best to use the funds to pay back public debt and store the rest into a sovereign fund.

Thanks to this policy choice and rapid increase in global oil prices, Russia repaid all remaining Soviet-era public debt by August 2006. By the end of 2006, the newly created Stabilization Fund ballooned to 90 billion US dollars. If in 1998 Russia was a textbook example of irresponsible fiscal management, in 2006 it started to look like a model student.

Successful macroeconomic stabilization, better legal frameworks, maturing of the structural transformation of the 1990s and a favorable external environment supported economic growth in Russia. On average, between 2000 and 2007 Russian GDP grew by seven percent annually. This unprecedented pace of economic growth rapidly created wealth. The number of billionaires more than doubled and real incomes increased for almost everyone. This was not left unnoticed by international investors. Global foreign direct investment inflows increased in four consecutive years and reached record levels in 2007. Whereas sovereign foreign borrowing was nonexistent, private sector foreign debt started to accumulate. Large Russian companies successfully raised funding in international capital markets.

The piecemeal liberalization of capital account continued and most remaining restrictions on financial flows were lifted in 2007. The exchange rate, meanwhile, remained tightly managed. The central bank had a dual mandate of promoting stable exchange rates and moderate inflation, but the former policy goal was much more important. As inflation in Russia remained above the levels in the US, the ruble continued to appreciate in real terms, making imports increasingly attractive.

Many aspects of Russia's legal and regulatory framework were improved. But Russia's economy remained plagued by weak rule of law, corruption and a cumbersome bureaucracy. As the state gained upper hand in the internal battles for power and money, all major reforms stalled. After the arrest of Michal Khodorkovsky, once Russia's richest man, the famously powerful oligarchs learned their lesson and avoided openly criticizing any government policies. The unprecedented economic boom made neglecting these issues all too easy.

In 2008, Russia's economy was once again threatened by global financial instability, this time originating in the collapse of the US sub-prime mortgage markets. In late 2008 global investors rushed to move their liquid assets to safe heavens

from emerging markets, causing havoc also in Russian markets. And as the period of global economic boom ended abruptly, global raw material prices duly collapsed. A global crisis once again hit the Russian economy.

This time, however, Russian state finances were in much better shape than in 1998 and the government did not hesitate to use the spending powers at hand. Despite powerful fiscal and monetary policy support, the Russian GDP shrank by a whopping eight percent in 2009, more than in any other large economy of the G20 group. This underlined how vulnerable the Russian economy is to abrupt changes in global commodities and financial markets.

To limit this vulnerability, diversification the economy away from hydrocarbons would be required. This in turn would call for bold and inherently risky reforms to limit opportunities for corruption and to encourage private competition. But as quest for stability once again took precedence over structural reforms, macroeconomic policies reverted back to balancing the budget. The opportunity for much needed change was wasted.

4. Stability and stagnation, Russia's lost decade of 2010–2021

Oil prices recovered quickly in the early 2010's, which meant that Russia could once again delay necessary structural reforms and fall back on hydrocarbon revenues. For a short while, it seemed that increasing global oil prices and macroeconomic stability would support growth and provide reasonable economic growth. Yet, it soon became clear that stability alone is not sufficient to promote prosperity. Increasing domestic political repression following the 2011-2012 election cycle stalled growth in private investments. Russia's illegal annexation of Crimea and military incursion in Eastern Ukraine in 2014 resulted in the EU, US and UK imposing targeted sanctions on Russia's financial sector and oil & gas exploration. The sanctions and macroeconomic uncertainty increased urgency of import-substitution, reshaped foreign trade and hampered economic growth.

As a result, in 2012-2020, Russian GDP grew by a meagre one percent annually, and household disposable real incomes stayed below their peak of 2013 till

the end of the decade. Russia's economy became more self-sustained in a few narrow fields, but it remained critically dependent on raw material exports.

4.1. A sovereign payment system emerges

Following the stepwise devaluation of the ruble in early 2009, stability of the ruble exchange rate remained the key policy objective for the Central Bank of Russia (CBR). To maintain the ruble rate within a pre-determined band, the central bank actively intervened in the foreign exchange markets. The policy decision to follow international best practices and move to freely floating exchange rate and full inflation targeting was taken early on, and the preparations were well underway when oil prices again started to fall in summer 2014. The CBR relaxed its mechanism for steering the exchange rate and began cautiously to increase the main monetary policy rate. Unsurprisingly, when oil prices continued to fall and tighter Western sanctions on Russia were imposed, the value of the ruble duly collapsed. Finally, in mid-December 2014, the ruble was allowed to float freely and the key policy rate was more than doubled to 17 percent. With a bit of help from a looming economic crisis, Russia had resolutely switched to a new monetary policy regime of inflation targeting. The central bank no longer had a target for nominal exchange rate, and instead the four percent inflation target was taken seriously.

As expected, the floating exchange rate has helped to make the economy a bit less vulnerable to external shocks. When oil prices rise (or fall) ruble tends to appreciate (or depreciate), making export revenues less volatile in ruble terms. This in turn translates into less volatile oil tax revenues in the federal budget. Inflation in 2016-2020 was, on average, quite close to the four percent target level, a remarkable achievement given Russia's past inflation history.

The Western sanctions imposed in 2014 effectively curtailed the largest Russian banks and energy companies from access to the EU and the US financial markets. This caused a forced deleveraging of private sector foreign debt. More significantly, US sanctions caused VISA and Mastercard to block services to customers in sanctioned Russian banks. This was a serious challenge, given these two payment operators jointly accounted for almost all domestic cashless payments in Russia at the time. To sanction-proof domestic transactions, the central bank fast-tracked its

development of a sovereign payment system and a fully Russian payment card. Building parallel systems is expensive, and initially largest banks were reluctant to join the new arrangements. However, given direct orders by the central bank, the Russian payment card was swiftly and widely adopted.

4.2. Fiscal policies focused on stability

As an oil exporting country, Russia's revenue structure is tilted towards taxes and fees on oil production and exports. Discussions on various ways to smooth government consumption over time have always been at the very core of Russian economic policy discussions. After various attempts, the most recent oil price rule was finally adopted in 2017. The rule states that oil and gas revenues that accrue to the federal budget when oil prices are above a pre-determined level are to be saved in the stabilization fund, now renamed National Welfare Fund.

The Fund was originally set up as a buffer to support the federal budget in times of oil price shocks. Over time, however, as the political clout of the fiscally conservative camp around the former Finance Minister Kudrin waned, its assets were used to support the pension fund and to prop up large domestic companies. As a result, the share of assets invested in highly liquid USD and Euro denominated assets declined. When geopolitical tensions increased, Russia decided to divest remaining USD by end-2021. This soon turned out to be a very wise move.

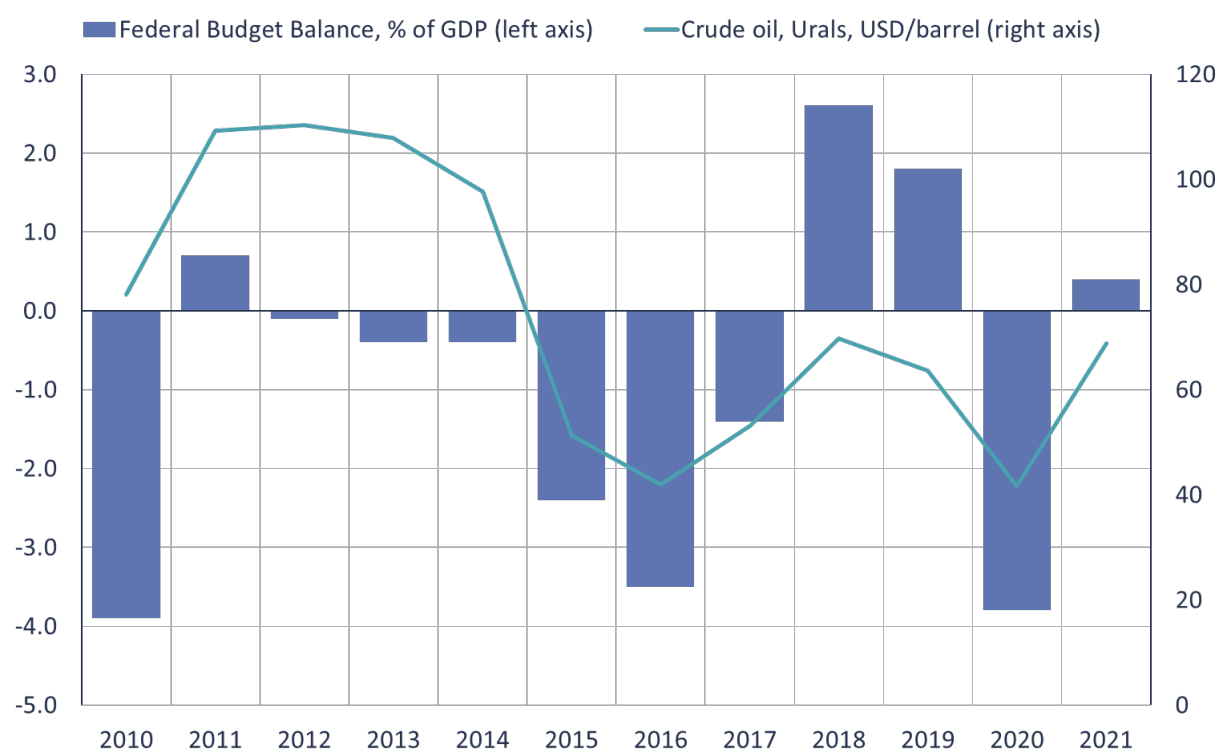
On the expenditure side, the single largest expenditure item in the Russian consolidated budget was social security. That is true for many economies globally, but in Russia cash payments to pensioners alone equaled almost a quarter of total expenditure. Russia's low birth rates and increasing life expectancy threaten to increase this share further.

The second largest public expenditure item was always the combined national defence, internal security and public order. Assessing the true extent of Russian military expenditure is a tedious task, as some expenditure items categorized as internal security, education, housing services and national economy are in fact directly linked to the Armed Forces. Moreover, part of these funds has been classified secret in the Russian budget laws, making it impossible to assess their real

uses. The Stockholm Peace Research Institute (SIPRI) estimated Russian military expenditure at slightly above four percent of GDP in 2020, among the highest in the world.

When the next global shock hit Russian economy in 2020 in the form of covid-19 pandemic, fiscal policy was again loosened temporarily. As was typical during the oil-price linked crisis of 1998, 2009 and 2014, the corporate sector was supported heavily via subsidized lending programs. In 2020, however, significant fiscal support was directed to also Russian households and the small and medium sized enterprises (SME) sector. Social stability was supported by temporary hikes in unemployment benefits, restrictions on layoffs, reduction in SME tax burden and cheap mortgages throughout 2020.

Figure 2: Russian federal government budget deficit, % of GDP & average annual Urals crude oil price in 2010–2021.



Source: BOFIT Russia Statistics.

4.3. Protectionism on the rise

Free movement of capital remained a largely uncontested policy choice in Russia. Free movement of goods and services, however, has always garnered less political support. After the 2009 economic shock, Russia's trade policies turned increasingly protectionist. Two key policy objectives – a pivot to the East and import-substitution - shaped Russian trade policies and foreign economic relations. These objectives became more urgent when relations with many Western countries deteriorated in 2014, but neither was a direct consequence of Western sanctions or Russia's military operations in Eastern Ukraine.

Traditionally, Russia's conception of economic globalization was defined by increasing trade links and cross-border finance with the economies in the Western hemisphere, with the European Union (EU) countries in particular. This was natural for several reasons, not least because Russia's existing export infrastructure connects Russia to Eastern and Western Europe, and many firms in these economies were eager to enter the Russian markets. The mood started to change after the Global Financial Crisis.

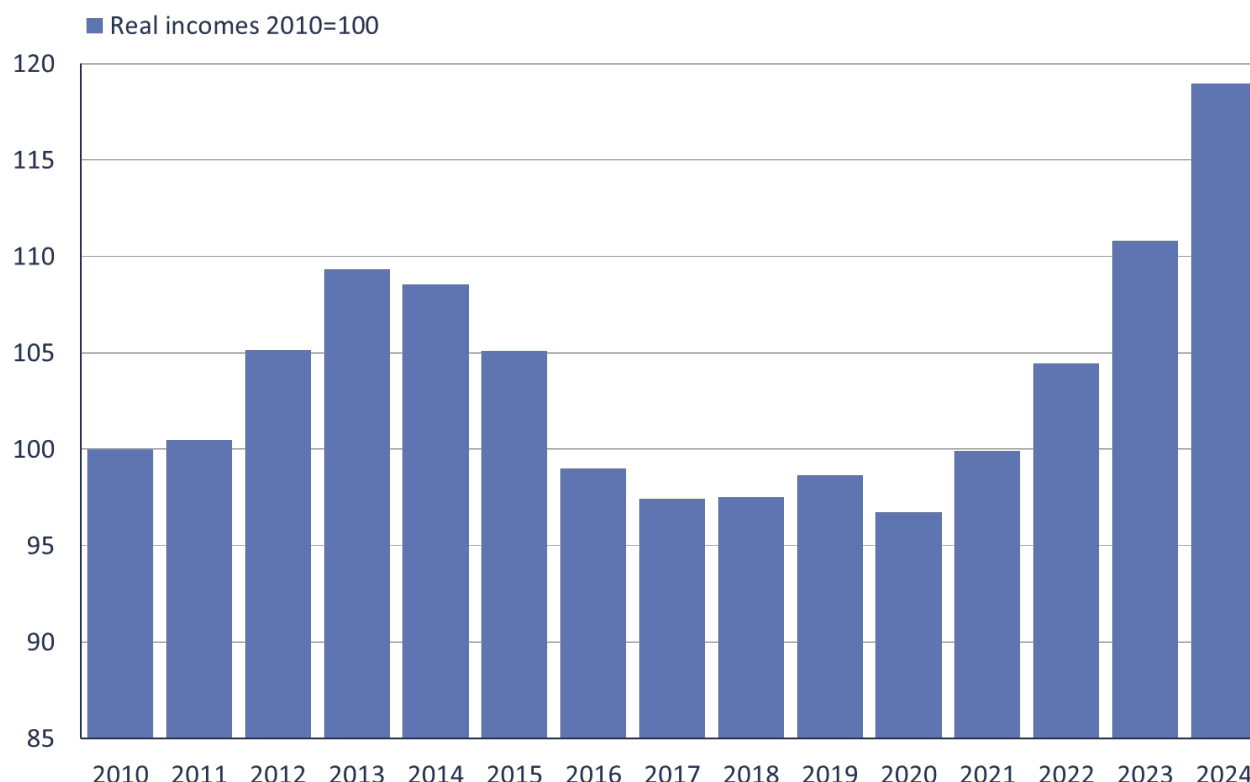
President Putin first outlined Russia's "Pivot to the East" in 2009. At the time the "Pivot" simply acknowledged the new realities of the global economy. Growth in energy demand was to be found mainly in Asia, China in particular. Opening new oil and gas export routes to the East required developing new production areas in Eastern Siberia and building two vast pipeline systems across thousands of kilometres. An oil pipeline with a connection to China was commissioned in 2009-2012 and a natural gas pipeline to China in late 2019. Due to the new pipelines, China became one of Russia's main trading partners, leading to a significant diversification of Russia's oil and gas export markets. Simultaneously, growth in exports to China only increased Russia's dependence on hydrocarbons.

Russia's illegal annexation of Crimea and its actions in Eastern Ukraine in 2014 caused the EU, the US, and their allies to impose economic and political sanctions against Russia. Initially, the restrictive measures were relatively mild, but since July 2014, a broad set of sectoral economic sanctions on Russia were imposed. Russia's immediate response was to seek closer cooperation with China and to broaden the existing import-substitution policies.

Import substitution, that is, favoring domestic goods at the expense of imported ones, stems partly from the desire to diversify the economy away from oil and gas. Blocking imports should direct demand towards domestic goods and thereby help in reviving non-oil and gas sectors. This is a potentially very costly way to support domestic producers. As dependence on imported goods was increasingly framed as a potential threat to economic sovereignty and security, costs could be ignored. High-profile import substitution programs soon became the primary tool to increase Russia's economic sovereignty. In most sectors, the results were disappointing (Simola 2024).

Even where import restrictions are successful in reviving domestic production, they are likely to create a deadweight loss on the economy. Russia's ban on food imports is a prime example. In line with Russia's Food Security Doctrine of 2010 and in response to Western economic sanctions, import of many fruits, milk and meat products was severely restricted in 2014. Consequently, food prices increased, and the selection of goods offered shrank, decreasing Russian consumer welfare. Import bans and subsidies increased profitability of Russian agribusinesses, but corporate benefits did not outweigh the loss of Russian consumers (Volchkova and Kuznetsova, 2019). Building a home-grown industry by restricting imports is a risky strategy that is unlikely to increase welfare for all. In Russia, these policies contributed to the decade-long stagnation in real incomes of Russian households.

Figure 3: Real disposable income index 2010–2021.



Source: Rosstat, BOFIT. Real Disposable Income measures per capita incomes adjusted for inflation and taxes. In Russia, the level of real disposable incomes achieved in late 2013 was only reached again at the end of 2022.

Over time, Russia's pivot to the East and closer cooperation with China came to also align more closely with Russia's broader foreign policy goals of breaking US hegemony and the creation of a multipolar world order. China and Russia increased their cooperation on many fronts, including the defence sphere. Both countries also shared doubts about the dollar's preeminent status in global trade finance. This resulted in increased use of the yuan in bilateral trade, and an increased share of yuan in CBR foreign exchange reserves. By the end of 2021, CBR held 17 % (105 bn USD out of total 630) of its reserves in Chinese yuan, one third of total global reserve assets held in yuan.

5. Invasion of Ukraine transforms the economy

A large-scale war inevitably changes the economy and society even if actual fighting takes place outside of a country's borders. In Russia, since the full-scale invasion of Ukraine in 2022, fiscal prudence has been replaced by continuous increases in government spending, CBR has resorted to capital controls to maintain financial stability and the role of the state in the economy has increased in multiple ways. An economic boom in sectors linked to the war has created labor shortages and resulted in stubbornly high inflation rates in all sectors of the economy.

5.1. Fiscal and monetary policies overhauled

At the end of 2021, Russia had low public debt, broadly balanced budget and a sizable stabilization fund (National Welfare Fund, NWF). During the three years of full-scale war in Ukraine all of these have started to erode. Government spending has increased steeply, with new spending mainly targeting military, internal security and war-related branches of the economy. In real terms, public spending grew at an average pace of 4 % a year in 2022-2024. For comparison, between 2011- 2019 government spending grew by 0.5 % annually. With spending focused on war, a declining share is available for other purposes such as social services, education and healthcare.

Western sanctions have reduced Russia's oil export prices and consequently reduced federal oil tax revenues. Therefore, increased spending has been mainly financed with higher taxes on domestic corporates and increased VAT revenues - but also budget deficits have grown. In just three years, two thirds of liquid NWF assets have been spent to cover the federal budget deficit. The remaining deficits have been funded by domestic borrowing. The outstanding stock of government bonds increased by over 40 % between 2022 and 2024, with domestic banks swallowing most of the issues. However, Russian government debt remains at a very modest level by international standards and therefore the interest expenses have been manageable.

Western sanctions seriously limited central bank's monetary policy tools and reduced the scope of its operating environment. Because of the sanctions imposed in

February 2022, the central bank lost access to a large part of its foreign currency reserves. Without this possibility, the CBR was reduced to defending financial stability through the imposition of capital controls and ending the free convertibility of the ruble. Large export firms were ordered to repatriate most of their foreign-currency export earnings into rubles and exports of capital to “unfriendly” (i.e. sanctions coalition) countries were banned.

Government measures to boost military production and to support economic activity have made it difficult to control inflation by traditional monetary policy tools. Government spending directly pushes up prices on many goods, while urgency in fulfilling public procurement orders and military recruitments make labor shortages worse and push wages up in all sectors. Moreover, the government has awarded generous loan subsidy programs for household mortgages and for multiple industrial sectors. These fixed-rate schemes support bank lending irrespective of very high market interest rates.

Foreign currencies, particularly the US dollar, had always been significant as a means of payment, store of value and unit of account in Russia. Most wealthy Russians maintained convertible dollar and euro deposit accounts in both domestic and international banks. The multitude of sanctions imposed on Russian financial sector and Russian policies of banning the use of “unfriendly” currencies forced Russians to give up use of the dollar and euro in many contexts. Foreign-currency bank loans have been changed to ruble-denominated ones, and the share of Chinese yuan as an invoicing currency has skyrocketed. In cross-border transfers and foreign trade transactions Russians have had to resort to complex and costly arrangements to circumvent sanctions.

While sanctions seem to reinforce Russia’s stated policy goal to move away from dollar-based trade, such a shift does not come without risks. Currently the only alternative, the yuan, is not a free-floating currency and not fully convertible. Reduced financial system efficiency is part of the price the current regime has to bear for its imperialistic ambitions and sanction avoidance.

5.2. Increased government presence and militarization of the economy

Wars typically increase government spending and the role of the state in an economy, and Russia is no exception to the rule. Warfare requires both material and manpower, and these resources must be directed from their civilian uses to the battlefields. So far Russia has mainly relied on increasing monetary bonuses, pre-payments on government procurement and subsidized bank lending to shift labor and production to serve military needs. But all this needs also the use of administrative resources, increasing control over production and fulfilling regional quotas for voluntary military recruits. Space for private economic initiative tends to shrink.

The increasing role of war-related branches is already visible in Russian economic statistics. In 2022-2024 manufacturing production at war-related branches grew briskly while output in other sectors remained essentially flat. A similar picture emerges when looking at data on fixed investments or bank lending by sectors of the economy. Sectors directly supporting the war effort have been growing very fast, while the rest of the economy grows at a very modest pace. This structural shift will shape the Russian economy far into the future, as the booming sectors are precisely the ones with a large state footprint, wide-spread state ownership, low transparency, and terrible track record on corruption.

As the war drags on, the importance of controlling the media space has increased in Russia. As people may be jailed for a social media post, criticizing any government policies has become potentially lethal. Government control on the information space extends also to education, culture and academic research, further restricting opportunities for new innovations outside the military industries.

New policy priorities naturally create new interest groups. Well-connected businessmen have benefitted from the withdrawal of many Western companies, and potential return of former competitors is now viewed with great suspicion. The powerful domestic producers have no interest in allowing international competition in their home market. These wishes of the business lobbies resonate well within the Kremlin, reinforcing the protectionist rhetoric. The war effort requires constantly rewarding the loyal supporters and punishing the less loyal ones. In 2022-2024 over 500 corporates had their Russian assets expropriated and, in most cases, handed to

new owners. (Djankov and Golovchenko, 2025). This process has further eroded private property rights.

5.3. Sanctions reshaped foreign economic relations

Initially the US, EU, UK and several other Western countries imposed economic sanctions on Russia following the illegal annexation of Crimea in 2014, with some of the restrictions further tightened in 2016-2018 as a response to Russian malign activities in Western countries. These restrictive measures limited access to international capital markets for some large Russian financial institutions and corporations, banned exports of military goods to Russia and restricted access to services and technology used in hard-to-recover hydrocarbon exploration activities. Even if initially these measures caused a serious shock to the Russian economy, a semblance of normalcy soon returned.

The unprovoked full-scale invasion of Ukraine in February 2022, however, pushed the sanctioning coalition to impose radically wider sanctions on Russian state institutions and private sector actors alike. One set of sanctions aimed to restrict Russian exports, thereby making funding the invasion more difficult. For example, the sanctioning countries banned imports of maritime Russian oil and oil products, hard coal, aluminum, steel and wood. These measures forced Russian state and Russian companies to rapidly look for alternative export markets. To lure new customers and to compensate for the sanctions-related uncertainties, Russian oil companies were forced to offer sizable discounts on their products. As a result, especially China, India and Turkey emerged as the new export destinations replacing the EU. As most EU countries radically cut their pipeline natural gas imports from Russia, state-owned Gazprom lost its main export market. As new pipelines take years to build, Russia's pipeline gas exports will remain subdued at least for the near future.

Another set of sanctions restricted the type of goods Western companies are allowed to provide to their Russian customers. The restricted items range from military and dual-use goods and financial services to various luxury goods. These sanctions forced Russian customers to find alternative suppliers outside of the sanctioning coalition. As some high technology components essential in military production

are only produced by Western companies, the increasing demand for imports also resulted in increased efforts to circumvent the sanctions. As a result, the geography of Russia's foreign trade changed, making Russia extremely dependent on Chinese imports. Increasing difficulties in arranging sanctioned imports, using chains of shell companies and enduring long delays in payments results in increased costs of imports. In 2024 Russia's imports declined, even if reported GDP grew briskly.

To ensure vital imports and to safeguard goodwill of the new import customers, Russia has been forced to promote economic relations with a group of "friendly" countries. First and foremost, this means economic partnership with China. Russia's invasion of Ukraine and the resulting sanctions have given China the upper hand in bilateral negotiations. Imports from China became vitally important for Russian military industries, at the end of 2024 Chinese alternatives or imports via China accounted for 80 % of all imports of high priority battlefield items. Chinese yuan has gained prominence as the invoicing currency of Russia's foreign trade while the central bank's currency operations are limited to Chinese yuan. But even Chinese companies are extremely careful not to trade with sanctioned entities or directly engage in sanctioned activities. This has pushed Russia to build economic and military cooperation with pariah states like North Korea and Iran.

Even as many Western companies have withdrawn from the Russian market, no large investors from other countries have been willing to fill in the void. This is not entirely surprising, since the business environment has become more unpredictable, property rights less secure and estimates about the potential growth rate declined to about 1% - 1.5 % annually. A war of aggression with all its consequences has profoundly transformed the Russian economy. Tight fiscal policies have been abandoned, and stubbornly high inflation poses a serious challenge for maintaining macroeconomic stability. Uncertainty of future policy moves has multiplied.

6. Concluding remarks

Russian economy and economic policymaking have changed dramatically from the chaotic years of the early 1990s. The policy consensus that emerged in the late 1990s greatly improved fiscal and financial stability in the country and helped the government to build sizable fiscal buffers. In this sense, Russia in the early 2000's was a textbook example of prudent fiscal policies. The move to inflation targeting in 2014 did help in bringing down stubbornly high inflation, thereby making the domestic economic environment more stable and predictable. Russia's global economic integration deepened remarkably in the 2000s, and Russian corporations benefited from increased funding opportunities provided by the global financial markets.

Better macroeconomic policies brought economic stability, but conservative fiscal and monetary policies were not enough to promote private investments or to insulate Russian economy from external volatility. Global oil prices collapsed again in 2008, 2014 and 2020, causing severe recessions for the Russian economy. In 2010-2020 Russian GDP grew on average by one percent annually, compared to 2.4 percent globally. Economic growth was especially disappointing compared to what was hoped for. As the quest for stability took precedence, market-enhancing reforms were abandoned. Towards the end of 2010's, Russia's macroeconomic policies were subordinated to national security concerns.

With the invasion of Ukraine, macroeconomic policymaking switched to a war mode. Supporting the military immediately became the main economic policy target, and the principles of balanced budget and free capital movements were at least temporarily removed from the agenda. Wars also tend to increase the role of the state in an economy. This is certainly true for Russia, where state-owned or state-controlled corporations typically control not only military industries but much of energy, finance and transportation sectors. The boom in war-related sectors has increased the importance of sectors characterized by state-ownership, close links between the state, the *siloviki* and the businesses, poor transparency, and corrupt practices. Since 2022 government control in all areas of the Russian economy and society has increased, ranging from technical details of government procurement to private social media posts of Russian individuals.

The costs of the war – in material and human terms – have strained Russia’s stabilization fund and fueled stubborn inflation. In the longer term, declining working-age population and the ongoing structural transformation of the Russian economy will lead to lower potential growth rates. Once the war-related fiscal expansion is over, Russia’s poor growth prospects and deterioration in the business climate (e.g. weakened property rights) will make returning to pre-war growth levels very challenging.

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