RUSSIAN ECONOMY FEELS THE BITE OF ATTRITION

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On February 1, the European Council unanimously approved the 50 billion euro aid package to Ukraine.

Although this package will not alter the course of the battles for Avdiivka or Kupyansk as it does not include funding for armor or ammunition, it will deliver a boost to Ukraine's struggling economy. In a long war of attrition, economic performance has a decisive impact.

Russia's economy got a boost last year from the massive increase in military expenditures. However, even if this volume of funding is sustained this year, the economy's limits of growth have already been reached.

The Russian military-industrial complex has reached its peak performance, a level significantly higher than many experts had assumed possible. This level of performance, however, is still insufficient to cover the needs of those on active duty (Riddle, January 17).

Official economic data from Russia is scarce and doctored, but the available figures unmistakably point to a stagnation in industrial production for the last two quarters (Re:Russia, February 7).

The large-scale illicit import of artillery shells from North Korea provides proof of insufficient domestic production, which depends on the expanding and illicit import of nitrocellulose (also known as guncotton, an explosive agent) from Türkiye and China (Current time, February 6;Moscow times, January 31).

The heavy priority placed on resource allocation in the Russian defense industry has caused contractions in other sectors, particularly in consumer goods production (Nezavisimaya gazeta, February 8). The illicit import of crucial technologies and microchips is still oriented primarily toward military needs.

At the same time, critical industrial sectors such as civilian aircraft production cannot deliver on the politically prescribed plans (Nezavisimaya gazeta, February 7). The volume of domestic air travel has recovered to the pre-pandemic level, but the frequency of technical failures pushes the limits of acceptable risks (Novaya gazeta Europe, February 8).

Another underfunded sector is communal infrastructure, and the incessant news about freezing cities in Russia adds to the downtrodden tone of public opinion (Levada.ru, February 2).

The Kremlin policy of completely funding every war-related expense inevitably generates inflationary pressure. To counter it, the Central Bank of the Russian Federation has *kept the key interest rate at 16 percent* (Nezavisimaya gazeta, February 8). Many “patriotic” commentators are eager to condemn this credit tightening as a suffocating investment (TopWar.ru, February 8).

The government ministers and economists, who have escaped the many cadre purges since the start of the war, counter these accusations by demonstrating the financial system’s stability (RBC.ru, February 8). The budget deficit is estimated to be manageable. Still, these calculations are based on unrealistic expectations of high revenues and even more dubious provisions for reducing military expenditures in 2025–2026 (Tinkoff Journal, February 8).

Over-taxation causes underinvestment in the development of productive assets and the economization of industrial maintenance. This results in technical failures, such as the gas pipeline explosion in the Perm region on February 8 (Permnews.ru, February 9).

Recognizing this vulnerability, the Ukrainian Defense Intelligence has launched a series of long-distance drone strikes on Russian oil refineries, some of them hundreds of miles away from the border, like in Volgograd or Yaroslavl (The Insider, February 7). Most of these attacks have a low impact, but every disruption cuts the profit margin of petroleum exports (BFM.ru, February 6).

The primary source of budget revenue in the Russian Federation comes from the energy sector. The government seeks to increase this revenue by raising taxes, even on the coal industry, which is not very cost-effective even if exports hold steady (Kommersant, February 9).

The loss of the profitable European market has severely affected the Russian gas industry. At the same time, plans for expanding liquid natural gas production have been delayed as the Novatek projects on Yamal and Gydan struggle to circumvent sanctions (see EDM, January 9[1],[2],January 24;Kommersant, February 8).

The oil industry generates the bulk of economic revenue in the Russian Federation, and the volume has remained well below budget forecasts as both production and export prices remain stagnant (Neftegaz.ru, January 27).

The only hope of rescue for the Russian energy complex would be a new spike in oil prices. Still, the indifference in the world market to the risks of maritime traffic in the Red Sea, much to Moscow's disappointment, illustrates the robustness of the declining trend in oil prices (Forbes.ru, February 7).

Stagnation in China's economy is the primary driver of this trend.

Russian proposals to build new gas pipelines jointly find the usual "maybe-later" response in Beijing (Moscow times, February 6). China is keen to increase exports to Russia but is wary of not breaching the sanctions regime. *A recent shock for Moscow was the enforcement of a ban on all financial transactions with Russian clients by several Chinese banks* (Vedomosti, February 7).

Several Turkish banks have also introduced similar restrictions. Desperate diplomatic persuasion from Russia has yielded only a partial softening of the ban, allowing payments for consumer goods exported from Türikye (IStories, February 5;RIA-Novosti, February 9).

Russia is increasingly dependent upon Türkiye to facilitate its energy exports. Moscow has sought to turn this weakness into strength by tempting Ankara with a proposal for a "gas hub" (Moscow times, February 1).

Moscow has also refrained from venting its irritation with such Turkish actions as mine-clearing (jointly with Bulgaria and Romania) the maritime corridor from Odesa and building a plant near Kyiv for constructing Bayraktar drones (RBC.ru, February 6).

Russian President Vladimir Putin hoped to smooth these disagreements with a visit to Ankara and to resume a dialogue with Turkish President Recep Tayyip Erdogan. Still, compromises have proven hard to reach, and the visit has been postponed (Kommersant, February 8).

Loopholes in the sanctions against Russia are progressively getting covered, creating more difficulties for the Russian economy. Each new Russian scheme for circumventing restrictions involves extra costs and relies on more middlemen of low repute.

The economic model based on the high-value export of hydrocarbons and channeling revenues into the military-industrial complex, which depends on the import of critical components and technologies, is resulting in diminishing returns and accelerating breakdowns.

Ukraine is struggling with a formidable and ruthless enemy. The approval of the military aid package by the US Congress is crucial for keeping Kyiv in the fight for months to come.

In the interim, however, Ukraine's victory will be determined by the economic ties and integration with Europe, which possesses industrial, technological, and scientific capabilities far superior to those that Russia can mobilize or purchase. Only a fraction of Europe's power needs to be deployed to decide the outcome of the confrontation unleashed by Putin.

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