

# The real and hidden costs of Russia's foreign policy

by Stanislav Secieru

Russia is set to hold presidential elections on 18 March 2018, and Vladimir Putin has expressed his intention to run for another term. His high approval ratings, the vast administrative resources at his disposal and the non-competitive political environment in Russia make the outcome a foregone conclusion. However, if the election result is predictable, it is still unclear what direction the country will take afterwards. In recent years, Russia has resorted more and more frequently to military force to advance its foreign policy objectives. This overreliance on force, however, came with a price tag attached. In this context, it is useful to explore whether Russia's foreign policy will take a softer and more economic-oriented turn after the elections. Alternatively, if Russia continues down the same path, which factors will be responsible?

## The perils of economic slowdown

There is a powerful nexus between foreign and domestic policies in Russia: Moscow's assertive foreign policy during Putin's third term amplified the leadership's popularity at home. Therefore, any serious attempt to forecast how Russia will approach the world after its presidential elections has to keep in mind the potential impact of both external and internal stimuli.

One way to anticipate Russia's next moves is to look at how economic developments may play out. The mounting costs of the country's assertive foreign policy and economic structural malaises might compel the government to pivot away from geopolitics and back to economics. Several factors support this line of reasoning. Russia's Reserve Fund, which contained \$87 billion in 2014, dried up entirely in 2017, for instance. This is partially the effect of Ukraine-related sanctions: besides eating into reserves, the International Monetary Fund (IMF) estimates that the restrictive measures, combined with the partial food embargo Moscow enacted in response, cost Russia 1-1.5% of its GDP per year. According to the former minister of finance Aleksey Kudrin, exorbitant military spending shaves off another 0.3% of annual economic growth. Geopolitical risks and the volatile business climate in Russia also altered capital flow dynamics, from a net inflow (\$79 billion between 2000-2007) to a massive net outflow (\$646 billion during the period 2008-2016).<sup>1</sup> These factors, in combination with low oil prices, slashed average economic growth rates from 7% (2000-2007) to a mere 0.9% (2008-2016).

Arguably, if Russia does not alter its current course, it will have fewer resources for the upkeep and modernisation of its armed forces, the principal tool Moscow relies upon to uphold its great power status.

To prevent this hard power erosion, Russia needs to repair its damaged economic base. Deep reforms might be the answer. This move would have to be accompanied by foreign policy adjustments to soften economic sanctions, diminish tensions with leading global economies and improve access to international capital markets.

If implemented, the reorientation will not be guided exclusively by hard power imperatives. Russia's muscular foreign policy not only drains the state's coffers, but it impoverishes its citizens, too. Since the annexation of Crimea, real disposable incomes in Russia have fallen continuously, dropping to 2007 levels. The number of people living in poverty jumped significantly from 15.5 million in 2013 to over 20 million in 2017 – the highest level since 2006.<sup>2</sup> If this trend is not stopped, the cultivation of 'traditional values' and foreign policy adventures may not be enough to distract people from the decline in living standards. In order to ensure social peace, Russia therefore has to jump-start its economy and strike a better balance between investments in the defence sector and allocations which foster human capital.

## Hopeful signs

A number of developments hint that major reforms are possibly in the pipeline. Several high-ranking officials and advisers (Aleksey Kudrin among them) were asked by the president to produce economic development programmes for the period 2018-2025. This call for an economic blueprint was accompanied by the rotation of civil servant cadres in the presidential administration and government. The inflow of young technocrats into Russia's bureaucratic machine seems to be a move in preparation for enacting reforms. Vladimir Putin also announced moderate cuts in the defence budget and called on the defence industry to increase the production of civilian goods as the amount of state orders is set to dwindle. To improve the demographic situation, the government decided to extend the decade-old birth stimulus programme to 2021, to introduce new payments for first-born children (starting in 2018) and to launch favourable mortgage programmes for families with two or more children. The reform of the fiscal and pension systems is also under consideration.

Perhaps the transition towards a less combative foreign policy is in the making, too. The Kremlin's offer to beef up the OSCE mission in Donbas with lightly armed UN guards might be interpreted as a first attempt at the economisation of Russia's foreign policy. If it manages to effectively extricate itself from Donbas, Russia will be able to free itself from the financial burden of sustaining the separatist republics

and may see the sectoral sanctions applied by the EU loosened or removed. In Syria, after securing the survival of its client regime with military means, Russia announced a reduction of its troop presence in the country. Now, Moscow might consider a more inclusive diplomatic approach in order to achieve a sustainable political solution. The Trump-Putin joint statement on Syria from last November could be read in this way. Moreover, progress in Syria and Ukraine may help Moscow to (re)build bridges with the US administration and indirectly soften US sanctions put in place in response to Russia's meddling in the 2016 presidential elections.

## But collapse is not around the corner

At first glance, the economic arguments to conduct reforms look compelling. But the incentives are not as strong as they may initially appear. Last year, Russia's economy emerged out of recession (with growth estimated at 1.5%) and is set to grow at a slow pace until 2019.<sup>3</sup> These rates will still be below the level of world economic growth, but should be enough to meet social obligations and freeze the fall in citizens' real disposable incomes. The goal is not to dramatically improve the situation, but to help citizens muddle through. The indexing of pensions of non-working pensioners above the rate of inflation and a pledge to raise the minimum wage demonstrate the government's drive to help the 20 million people still in poverty (which in 2017 was half the record-high level of 42 million in 2000).

This macroeconomic stabilisation and the consolidation of the country's financial reserves does not bode well for reformers. Inflation in Russia dropped to 2.5% in 2017, the lowest level in post-Soviet history. While the Reserve Fund was depleted and liquidated, Russia's other sovereign fund, the National Wealth Fund, was worth \$66 billion as of February 2018, equal to 3.8% of GDP.<sup>4</sup> The ministry of finance expects additional revenues in 2018 to be worth 3% of GDP, if the oil price stays at \$60 per barrel.<sup>5</sup> This, in turn, could allow the country to run a budget surplus for the first time since 2011. The deal with the Organisation of the Petroleum Exporting Countries (OPEC) on reducing oil production, valid until the end of 2018, renders this scenario plausible.

Furthermore, Vladimir Putin has a habit of requesting economic programmes ahead of elections. The rate of implementation is, however, rather low. The Center of Strategic Research in Moscow estimates that only 29% of measures listed in the previous 'Strategy 2020' have been carried out. As long as the current model, backed by a prudent macro-economic policy, ensures social peace and helps preserve power, there

is no urgent need for the leadership to push for drastic changes.

## Political straitjacket

Predictions based on pure economic logic not only overestimate the potential impact of any financial losses, they also overlook the political determinants which shape policymakers' choices. The economy does not exist in a vacuum; it is shaped by the political context, and the perceptions and power imperatives of those in charge. This is especially the case in Russia, where the political agenda often trumps the economic one. When looking through the power prism of the Russian leadership, major economic reforms are politically undesirable for two reasons.

First, reforms will clash with the entrenched vested interests in and linked to the government, and risk upsetting the balance of power by intensifying conflicts between competing political clans. As a result, reforms would increase the president's workload as the mediator and arbiter of disputes. Thus, any serious attempt by the newly-appointed technocrats to conduct reforms will be met with severe political push-back. Even if a particular reform is sanctioned by the president, there is no guarantee that the reformer(s) will not be sacrificed at a later date: the former economic development minister, Alexey Ulyukaev, was sentenced to eight years in jail late last year, for instance. The threat of imprisonment will therefore always loom large when reform-minded technocrats consider steps forward.

Second, reforms might be socially destabilising, and the Kremlin evaluates reforms against a 'do-not-rock-the-boat' benchmark. On the one hand, the Russian administration is concerned with the potential losers of such reforms: the 2005 protests over the government's attempt to monetise benefits are deeply ingrained in the memory of policymakers (and it probably also explains the delay in the reform of the pension system). On the other hand, the Kremlin is preoccupied with the potential winners of any reforms.

The ascendance of an independent middle-class, concentrated in urban centres, is perceived as detrimental for the political system. This social group formed the backbone of 2011-2012 anti-government protests and may challenge the authorities again in future. The Kremlin therefore has no interest in economic reforms that would empower these self-sustaining, politically active, and 'disloyal' elements of society. This also partially explains why the administration favours increasing role of the state in the economy (state-owned companies account for 70% of the Russian market).<sup>6</sup>

## Sticking to its guns

Russia is a predominantly geopolitical, rather than a commercial power. As such, it is more driven by the security agenda than by a money-making philosophy. The policy towards Ukraine is symbolic of this: although Russia claimed that the Deep and Comprehensive Free Trade Agreement (DCFTA) between Ukraine and the EU would negatively impact its trade with Kyiv, it was the annexation of Crimea and the war in eastern Ukraine which left bilateral commercial relations in tatters.

Following the power-maximisation logic, the Kremlin will still be tempted to rely on a militarised foreign policy after the elections. First, despite the economic costs, opinion polls reveal that Russians consider the country's foreign policy and the reform of the army as President Putin's main achievements by far. Thus, it is logical that the president will exploit what people regard as success stories while blaming third parties (bureaucrats, regional authorities, external powers, etc.) for his failures. There is public appetite for more assertive behaviour: 66% of Russians believe that the country has enemies overseas.<sup>7</sup>

Second, although the military investments take time to bear fruit, they eventually yield long-term dividends. Regardless of whether the announced defence budget cuts turn out to be real or not (17.6% of total budget expenditures in 2018 remain classified),<sup>8</sup> Russia's armed forces have (re)gained capabilities over the last decade to the extent that the army is now able to effectively wield military power in the neighbourhood and has the potential to act as a security spoiler overseas for some years to come. Even if Russia's hard power is again eroded due to the economic slowdown, the process will be gradual.

Third, the Russian administration measures not only the economic cost of a forceful foreign policy, but also political costs of concessions. The concern widely shared by Moscow's decision-makers is that any concessions made will be interpreted as a sign of weakness which, in turn, will invite a long list of demands from the EU and US. Moreover, it is feared that concessions could nullify the advantages and leverage Russia has gained over the last years, something which the Kremlin is not prepared to give up easily. The conflict in Donbas is just one case in point.

In spite of the proposal to deploy a UN mission to parts of Donbas (which will not curb Russia's ability to use force in the conflict area), Russia continues to integrate the separatist republics into its economic space and maintains a heavy military footprint in the region. These actions might appear counterintuitive, but understanding the difference between a

speculative investor and a strategic one helps to explain Russia's approach. Rather than searching for short-term profits, Russia seeks to carve out a share of the market to the extent that it can shape the rules of the game for other players. Therefore, while some regard Donbas as an increasingly toxic liability for Russia, the Kremlin sees it as a long-term (bearable) investment in a multi-purpose lever which can be exploited in Ukraine and beyond. This logic also applies to Russia's presence in Transnistria, South Ossetia and Abkhazia for over two decades. And contrary to official statements about a troop drawdown, the same reasoning lies behind Russia's military deployments in Syria.

## The shapers of Russia's future

Real life rarely unfolds along the lines of imaged scenarios, and unexpected twists in Russian politics and economics cannot be ruled out. However, the interplay between three main trends will be decisive for the country's trajectory. As Russian domestic and foreign policy is very much an elite-driven affair, all three trends are intimately linked to the ruling elites' expectations, aspirations, and fears.

The first trend is a powerful resistance to change. Russia survived the double shock of sanctions and low oil prices without making serious concessions on the foreign policy front. From the point of view of the Kremlin, why should an economic model which proved to be so resilient be scrapped? In addition, there is concern in Moscow that destabilising economic reforms will expose Russia to the influence of external actors, something which could spell the end of the country as a great independent power. According to the narrative of the governing elites, this is precisely what triggered the collapse of the Soviet Union. Accordingly, weak political leadership enfeebled by reforms is perceived as more threatening for Russia's future than a near-stagnating economy under a strong ruler. That said, this aversion to reform does not imply a linear evolution in the years to come. Russia might carry out limited reforms with the aim of fine-tuning the existing system, rather than attempting to create a new one altogether. The inflow of young technocrats may therefore be designed to make the system more functional, not to spearhead a new major leap forward.

The second trend is an inflated sense of self-confidence after the perceived foreign policy victories scored in Ukraine and Syria. That Moscow thinks it managed to outsmart far superior economic and military powers only adds to this sense of achievement. Force-backed diplomacy is therefore considered more efficient than economic statecraft-backed foreign

policy. And although Russia's muscular foreign policy does not rule out 'peace' proposals, these are only to be made from positions of strength and are designed to convert military wins into political (and sometimes financial) dividends. The Kremlin's efforts to sideline the Geneva process while building parallel platforms of dialogue on Syria (in Astana and Sochi) and simultaneously vying for lucrative contracts in the country showcases this approach.

The third trend is growing insecurity among elites. This anxiety stems from the uncertainty surrounding the power transition due in 2024, when the last constitutionally-allowed term of Vladimir Putin expires. For two decades, Russia has not experienced a genuine succession of power and there are no institutionalised and tested mechanisms to ensure a peaceful transition. Even if the outgoing president decides to stay after 2024 (as some observers predict), the question of life after the aging Putin will cast a long shadow over the political scene in Russia. In particular, the matter of how to safeguard the immense wealth accumulated by elites (through both legal and illegal means) since 2000 will be one of the defining features which will shape the outcome of the transition of power.

What might come out of this mix after the elections is not a softening of Russia's stance on international matters, but a more risk-prone foreign policy with potentially far-reaching consequences for Europe and its eastern neighbours. Therefore, perhaps the major challenge facing the EU in the years to come will be how to manage and minimise the effects of contentious disputes with Russia, as the latter slowly nears the end of an era.

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