

## Revising Russia's Economic Model

### THE SHIFT FROM DEVELOPMENT TO GEOPOLITICS

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In July 2015, Finland denied entry to several Russian parliamentary deputies, including the chair of the State Duma, who planned to participate in an OSCE Parliamentary Assembly in Helsinki. These politicians were on the list of individuals under sanction by the European Union due to their role in the annexation of Crimea. In response, Nikolai Patrushev, secretary of Russia's Federal Security Council and former head of the FSB, proposed an asymmetric penalty for Finland. He suggested a ban on the export of Russian wood to Finland, arguing that it would cause serious economic harm. However, the impact on Finland would be negligible since wood from Russia accounts for only 10 percent of Finnish forestry imports and the supply is easily replaceable with wood from domestic or Baltic producers. By contrast, Russian forestry would suffer about a \$584 million loss in revenues from such a ban ([based](#) on 2014 figures). Nonetheless, none of the representatives of the Russian forestry sector openly objected to Patrushev's proposal; Minister of Economic Development Alexey Ulyukaev only vaguely responded that the issue is a "subject for discussions." This proposal and the muted reaction from the forestry industry both reflect the fact that in present-day Russia geopolitical rhetoric and posturing increasingly dominate economic considerations. More broadly, in an atmosphere of widespread public [discrediting of Russian liberals](#) for pro-Western orientations, any defense of free trade or complaints of the sector's losses are summarily dismissed.

This small episode illustrates the changing environment of economic decisionmaking in Russia. The top priorities of economic growth and development, which were promoted

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vigorously during President Vladimir Putin's first two terms, have been supplanted by ambitious geopolitical goals and smaller foreign policy slights. Granted, allocating economic resources for geopolitical aims is hardly new or unique. But the dominance of a foreign policy agenda over economic considerations has recently taken on new, sometimes major and sometimes petty, self-defeating forms in Russia.

The early signs of the geopolitical turn in Russia's economic policymaking first became apparent in September 2011, with the forced resignation of Alexei Kudrin. After eleven successful years as Russia's minister of finance, Kudrin was fired from his post following his opposition to large increases in military expenditures. While some economically liberal decisionmakers have kept their jobs in Putin's third term, Russia has also seen the rise of radical interventionists and statist, like the presidential advisor for Eurasian integration affairs, Sergey Glazyev.

Since the annexation of Crimea and ensuing conflict with the West over Ukraine, the downgrading of economic priorities vis-à-vis foreign policy considerations has become increasingly apparent. In the years and months leading up to the crisis, Russia's politicized use of energy exports (including ceasing gas delivery to key markets via Ukraine) already risked serious economic repercussions as it encouraged European customers to diversify energy sources. But more examples of geopolitically motivated economic policymaking arose at the time of the crisis, including the long-term subsidized gas contracts offered to Ukraine in December 2013, along with a \$15 billion loan package and an additional \$15 billion investment in Ukrainian securities. Hoping to stave off a free trade agreement between Ukraine and the EU, the Russian government employed its energy and financial resources to achieve foreign policy ends, namely preventing the reorientation of Ukraine toward the West.

When Western countries imposed targeted sanctions on Russia, restricting travel and access to capital by political and economic elites and top Russian enterprises, the Kremlin responded with additional self-imposed countersanctions. These included an import ban on many foreign food products, which caused a steep rise of consumer prices and [poor quality food substitutes](#) at home. Other protectionist countermeasures included a new law on the preferential use of Russian software for state orders and in state-owned companies (adopted in 2015) and proposals to ban a range of medical equipment and contraceptives for state procurement. Attracting widespread media attention, the Russian government made a dramatic public spectacle of destroying banned food imports, even setting alight Dutch flower imports following a draft UN resolution put forth by the Netherlands and four other states to prosecute the parties responsible for shooting down flight MH17 over the Donbas in July 2014.

Russia engaged in similar politically motivated bans occasionally in the past, like the 2006 ban of wine imports from Moldova and Georgia, as well as temporary bans of meat from Poland and canned fish from Latvia. The current set of bans is not simply a

continuity of past behavior, however. These previous trade conflicts were occasional, issue-specific, and had a minor impact on Russia. The current actions, by contrast, are frequent, general, and have become mainstream policy.

Some proposals are grand and unrealistic, such as Minister of Agriculture Alexander Tkachev's [announcement](#) that Russia will seek to achieve 100% substitution of food imports by 2025 and increase funding for Russian agricultural producers during the next five years to \$35 billion (2 trillion rubles). A major shift in budgetary allocations from social spending to the military (discussed below) is another large example. On a smaller scale, foreign cinema became a target of this new tit-for-tat mentality, when Minister of Culture Vladimir Medinskii [insisted](#) on the introduction of special taxes on foreign films shown in Russian movie theaters in order to promote domestic, patriotic films. Medinskii [explained](#) that the introduction of a VAT on foreign movies would harm Hollywood. In essence, such proposals allowed a small group of actors to enjoy concentrated symbolic and material benefits at the expense of many industrial sectors and the society at large.

Putting geopolitics increasingly before economics has imposed concentrated costs on certain sectors, inconvenienced and depleted the purchasing power of a wide swath of Russian consumers, and put a substantial burden on the Russian economy. Against the background of a decline in global oil prices and economic contraction, this new approach to policymaking has contributed to great economic instability, eviscerated investor confidence, and generated \$151 billion in [capital flight](#) in 2014 (two-and-a-half times the previous year's figure).

### **Ideas and Interests in a Geopolitical Policy Turn**

Why has geopolitics increasingly prevailed over economic considerations in Russian policymaking? In the spirit of neo-Kremlinology, one might argue that the geopolitical turn demonstrates the decisive victory of *siloviki* over their rivals, namely economic liberals, in the battle for Putin's heart and mind. The roots of this victory, however, are not limited to Kremlin intrigues. They also stem from a new mindset and worldview. More specifically, they are based upon a conceptualization of global politics and economics as a zero-sum game, so that any gain for one side implies a loss for the other side. In a recent interview, Russia's Federal Security Council Secretary, Nikolai Patrushev, [claimed](#) that the ultimate goal of U.S. economic policy is to take Europe and the Asia-Pacific region under American control, with "special attention devoted to undermining of the Russian economy and, especially, the financial system." In effect, the world is divided into friends and enemies, and maximizing the losses of one's enemies yields gains for oneself.

The problem is that the international economy and global business operate in a more complex fashion and cannot be reduced to a zero-sum game. Economic policymaking is

complicated and requires serious policy expertise. The temptation to resort to this rather simplistic approach to economic policymaking exists elsewhere certainly, but the current attractiveness of this approach in Russia has grown substantially. In the Russian case, perceptions of an existential threat to the country and its rulers, as well as a desire for revenge for post-Cold War foreign policy losses, fuel these temptations. In the same interview, Patrushev asserted conspiratorially that the United States aimed at a takeover of Russian natural resources and that international sanctions were designed to encourage the overthrow of Russia's political regime via a color revolution. He argued that a decline in Russians' quality of life resulting from the sanctions would lead to mass protests and political upheaval. Thus, Russia must respond by all possible means.

Given this zero-sum mentality, Russian authorities propose tit-for-tat responses to all real or imagined challenges from the West. It is not clear whether Russian leaders sincerely think food counter-sanctions or a ban on wood exports to Finland cause serious damage to European economies. However, the lack of resistance or protest from domestic losers (such as public sector workers or consumers) serves to legitimize this approach to economic decision-making. Given popular and industrial acquiescence, decision-makers are free to ignore the negative consequences of trade barriers, or the fact that the initiators of trade barriers may lose more than their counterparts. Counter-sanctions and trade barriers instead have increasingly become an *idee fixe* in Russian politics, affecting many sectors.

There are not only losers but also influential winners of this geopolitical turn in Russian economic foreign policy. Indeed the new Russian economic model is driven not only by foreign policy aims but also encouraged independently by a newly emerging coalition of special interest groups. First and foremost, the Russian military and defense industry have greatly benefited from a dramatic increase in funding. Despite Kudrin's protests, military spending rose to 4.5 percent of Russian GDP from 2011 to 2014, markedly more than in the United States, China, and most European states.<sup>3</sup> This rise, as predicted by Kudrin, has imposed a heavy burden on the Russian economy and the federal budget. Given the expected [decline](#) of budgetary revenues by \$44 billion in 2015 alone, this emphasis has forced cuts in social and infrastructure spending. For 2016, the government announced the cutting of major public expenditures (excluding defense) by at least 10 percent.

This new model portends significant fiscal stress. In the wake of forthcoming parliamentary elections (rescheduled for September 2016, three months earlier than initially planned) and the 2018 presidential election, Russia's rulers may perceive an acute, time-sensitive need to buy the loyalty of their fellow citizens, while Russia's Reserve Fund may be [substantially drained](#) by then. Hence, cutting social expenditures

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<sup>3</sup> World Bank Indicators, 2015. For earlier discussion, see Brian Taylor, "[Kudrin's Complaint: Does Russia Face a Guns vs. Butter Dilemma?](#)," PONARS Policy Memo No. 254, June 2013.

is a risky game for the Kremlin despite a lack of visible social unrest. The extent to which the Kremlin will adhere to its [current priorities](#) remains unclear, and the tensions between conflicting goals in Russian economic policy may increase.

### **The Politics of Subordinated Economic Policy**

In sum, economic development during Putin’s third presidential term appears more a means than an end in and of itself. This contrasts with Russia’s approach in the early 2000s, not to mention with other countries that prioritize economic growth, like China and other BRIC countries. At present, the president’s reliance on economic experts is declining, and as a result the sometimes severe economic implications of government policies are not always appropriately gauged or prioritized. The episode of “Black Tuesday” of December 16, 2014, is one stark example, when the value of the Russian currency plummeted and the stock markets dramatically fell by about one quarter over several hours.

Despite the subordinated status of economic policymaking in Russia, at least one policy area remains of primary importance—namely, the accumulation of hard currency reserves. But the privileging of foreign exchange accumulation also has a geopolitical edge. According to a recent Bloomberg [report](#), the only economic matter that Putin discussed with his economic experts before the decision on Crimea was the amount of currency reserves in Russian state coffers. The president allegedly wanted reassurance that Russia could withstand the ensuing costs, including possible international sanctions. In February 2014, the total amount of international reserves—at \$499 billion—was evidently perceived as sufficient, greenlighting the Kremlin’s foreign policy agenda. By November 1, 2015, Russia had [lost](#) 25 percent of its international reserves, with only \$375 billion remaining. Replenishing these reserves requires a commitment at the highest levels. During the second quarter of 2015, as global oil prices and Russia’s currency held steady, the Russian Central Bank announced plans to [restore](#) international reserves to the pre-Crimean level of \$500 billion over the next five years.

Given the expectations of future risks for the Russian economy and further foreign policy-driven economic costs, it is understandable that the Russian leadership wants to restore a monetary cushion (or springboard). As of yet, these foreign policy expenses have been affordable to a certain degree, but the current willingness to absorb the economic costs of growing foreign policy ambitions make the future of Russia’s economy highly uncertain.