PUTIN’S THIRD TERM
Assessments amid Crisis

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In March 2012, Vladimir Putin was reelected for his third term as president of Russia. Despite several large-scale anti-government protests earlier that winter, the country remained on an upward trajectory with few serious challenges to the Putin regime. Three years later, the situation is quite different. The Maidan protests and the eventual overthrow of Ukrainian President Viktor Yanukovich in the fall of 2013 unleashed a spiral of escalation marked by the Russian annexation of Crimea and punitive sanctions by the West, followed soon after by a steep drop in oil prices and the subsequent fall of the ruble.

Today Russia faces widespread condemnation abroad and a protracted economic crisis at home. In its latest publication, the Center on Global Interests seeks to examine the state of the Russian Federation halfway through Putin’s third term, and evaluate the extent to which his policies have made the country – and his own regime – more or less able to weather the latest storm.

The report breaks down into three parts that individually examine Russia’s recent development in the spheres of politics, security, and the economy. The first section looks at the resiliency of the Putin system in the face of internal and external pressures, and concludes that while there are no ideological barriers to its rejuvenation, there is no certainty that it will be able to sustain the social contract that lies at the core of its stability.
The second section assesses the results of Russia’s much-vaulted program of military reform. While the author concludes that significant results have been achieved, as highlighted by the sophisticated operation in Crimea, they have come at the expense of heightened tension with NATO and the West that may result in a net security loss for Russia. In the end, it is unclear whether the country can continue its path of military modernization in the face of economic crisis and a state of “hot peace” with the West.

The final section places Russia’s latest economic downturn in the context of past economic crises in the country to predict the likely trajectory of the Kremlin’s counter-crisis approach. In conclusion, the author underscores the systemic nature of Russia’s economic problems and questions the feasibility of the import-substitution approach advocated by the Russian government in light of the country’s significant reliance on imports across all spheres of the economy.

The Center on Global Interests would like to thank Richard Sakwa of the University of Kent; Mark Galeotti of New York University; and Harley Balzer of Georgetown University for their outstanding work on this project. We hope this publication will shed light on the internal processes that have taken place in Russia during the last three years and provide a foundation for understanding where the country may be headed in the years to come.

Konstantin Avramov
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March 2015
In both domestic and foreign policy, the era associated with the name of Vladimir Putin has undergone a significant evolution. Yet at the same time, it is marked by considerable elements of continuity. The idea of Russia as a great power, which lies at the very root of Russian national self-identity, has come to trump all other considerations in the Putin era. The Putin regime responded to domestic and external challenges and adapted its policies, yet certain fundamental principles remained constant. Putin remains the dominant political figure in Russian politics, while the “regime” built on his ideas and preferences continues to rule. However, in his third term since May 2012, the system has encountered unprecedented challenges, and its adaptive and reactive potential has been tested to the limits.

Third-Term Putinism

The central idea of Putin’s rule is built on a narrative of the 1990s as a new “time of troubles” (smutnoe vremya), which Putin was destined to overcome to restore the country to its natural greatness. Although Putin came to power as the designated heir to Boris Yeltsin, he condemned the degradation of the state that occurred during his predecessor’s rule. The state, in his view, lost managerial capacity and was overwhelmed by the intrusion of societal interests (notably
in the form of oligarch and regional power) into the very heart of government. The legislature of that period was unmanageable and unruly, acting not in the alleged interests of the state but for its own short-term benefit. In the regions, governors were elected who were sometimes little more than criminals, and who adopted laws that ran counter to the stipulations of the federal constitution. Thus, recuperation from the 1990s meant insulating the governing regime from outside interests while at the same time taming the various elements that made up the polity.

This strategy was implemented through a systemic policy of power and asset accumulation: the regime assiduously gathered power, while the state accumulated resources. The recuperative project and its attendant accumulation strategies remain the foundation stone of the Putin system today. Although it delivered substantive public goods in the 2000s – including bringing the regions and the national legislature to heel, increasing public revenues and managing the party and electoral system – by the time of the transition in 2011-12, it was clear that the old model of Putin governance had reached its limits. Putin himself understood how long-term leaders can ultimately become the destroyers of their own legacy, and in 2008 he had engineered the transfer of power to his designated successor, Dmitry Medvedev. Putin himself thus avoided the stigma of joining the club of “presidents for life,” common in Central Asia and elsewhere.

**Medvedev’s Role in the Putin Project**

Of all the many potential successors, Medvedev was the most liberal and reformist, while at the same time the most pliant leader in Putin’s hands. During his presidency, Medvedev outlined a program of legal
reform and attempted to consolidate property rights while developing a more dynamic, diversified and innovative economy. In foreign policy, the “reset” with the United States resulted in the signing of the New START strategic arms treaty in 2010, and rendered Russia less of an obstacle to the strategic interests of the Atlantic community. This was to be accompanied by elements of domestic political reform that later came to be known “Perestroika 2” — a rather inauspicious model in hindsight, given that the first perestroika under Mikhail Gorbachev in the late 1980s had precipitated the dissolution of the Soviet system and the disintegration of the Soviet state.

Not much was achieved in delivering this ambitious program, yet it did establish a direction of travel. Putinism is a capacious and elastic political project. The essence of Putinism is to draw energy, ideas and political support from all classes in society and all the key factions that make up the ruling elite, while at the same time ensuring that none becomes so dominant as to restrict the president’s freedom to maneuver, let alone threaten his own power. In this regard, the Medvedev initiatives form part of the broader Putinite project. In addition, they suggest that Putinism has an evolutionary potential to transcend its own limitations and contradictions.

The key element is the distinction between the state and regime. As Francis Fukuyama recently reminded us, there are three main factors that shape political behavior: the state, the rule of law and democratic accountability. These three sub-systems can assume a wide variety of forms, but they are the bedrock of liberal democracies. In Russia the state came before the rule of law, resulting in immeasurable consequences that persist to this day. The Medvedev promise, or at least the promise of those in favor of his second term, was that at last the state could be brought within the ambit of the law, and that the democratic accountability of the regime to popular representative institutions would at last be achieved.

These hopes were brusquely terminated with the sudden announcement in September 2011 that Putin planned to return to the presidency.
Putin’s return had always been in the cards, yet Medvedev’s possible return for a second term had never been rejected a priori. In the end, the manner in which Putin’s return was orchestrated included the customary distortion of election results in the parliamentary elections of December 2011 and the presidential election of March 2012. This provoked the biggest political mobilization against Putin’s style of governance during his entire time in power. Everyone had been in a winner in the Putin era, but few were satisfied. Putin was unable to understand this paradox, which is a normal characteristic of a country that has had the same leader for too long and which perceives its gains to be precarious and susceptible to raids by more powerful elites. This outbreak of contentious politics left a mark on Putin’s third term and has shaped his decisions in both domestic and foreign policy.

**Domestic Challenges**

*The Beginning of Putin’s Third Term: An Imperfect Return*

Although Putin delivered unprecedented prosperity and opportunities to the citizenry during his first years in power, Russia was suffering from serious governance problems, including corruption, elite kleptocracy, weakly defended property rights and the lack of an independent judiciary. A symptom of this political crisis was the long-term erosion of the Putinite majority: well before the announcement of his return in September 2011, there had been signs of crumbling support. Russia is not immune to the laws of political gravity, and even Putin’s remarkably long period of sustained high public opinion ratings would one day have to come down to earth. Although the fall in Putin’s popular support is often exaggerated, there was a real decline from the heights enjoyed in his second term and during his time as prime minister. The “Putin majority” had dissolved, and Putin was forced back onto his core electorate, which tended to be more traditionalist and susceptible to anti-Western and conservative rhetoric.
The methods of rule that had worked so well for Putin in his first two terms as president between 2000 and 2008 were not as well-suited for his third term. There was less political capital to be made from condemning the smutnoe vremya of the 1990s, since Putin now had to take responsibility for the conditions in the country that he had largely created. The legitimacy derived from the recuperative agenda had to be supplemented by performance. A period of unprecedented economic growth and rising living standards had expanded and transformed what Russian commentators like to call the “middle class,” otherwise dubbed the “creative class.” A large group of urban, educated and professionally confident people now demanded their full citizenship rights, above all the right to free and fair elections. Moreover, the country now expected to see policy innovation and good governance, above all through lifting the burden of corruption, raiding and bureaucratic interference, and in general by imbuing the economy with a new dynamism and the country as a whole with a sense of renewal and positive purpose. Instead, Putin’s return became associated with a return to the past and to more politics as usual, which proved a dreary prospect for many of Russia’s best and brightest.

Abandoning the Modernization Agenda

In December 2011, as one of his last acts as president, Medvedev announced a range of political reforms in response to the recent protests. There were elements of a “regime reset” in the early period, masterminded by the new head of the domestic politics department of the presidential administration, Vyacheslav Volodin, who had replaced the former “grey cardinal” in this post, Vladislav Surkov, in December 2011. The new measures included a return to direct regional elections.
for the heads of Russian regions, the introduction of a simplified procedure for the registration of political parties, and a return to the split majoritarian and proportional system for the State Duma’s 450 deputies. In one way or another, these reforms were introduced in the early years of Putin’s third term. However, they were implemented within the framework of the remedial strategy and its accompanying strategies of accumulation, and thus were deprived of any substantive ability to have an autonomous dynamic of their own.

Even though there was a great spate of party formation, elections remained firmly under regime control, and even moderate signs of liberalization were accompanied by punitive measures against some of those who had taken part in the protest movement of 2011-12. In September 2013, the outspoken “national liberal,” Alexei Navalny, was encouraged to take part in the Moscow mayoral election, where he won an unprecedented 27 percent of the vote. The new Putin strategy appeared to be a gradual decompression of the system, beginning with lower-level elections. Meanwhile, the restored gubernatorial elections remained firmly controlled.

To balance the desire for change, the great bureaucratic and security class that had developed under Putin began to look for stability and continuity. As a result, Putin in his third term was unable to move beyond the remedial matrix towards a new developmental model. Recuperation did not give way to a more forward-looking model of modernization; by Putin’s third term, the mantra of the Medvedev era was abandoned. In the end, even the modest elements of innovation implemented within the framework of the regime reset were thrown off course by the crisis over Ukraine in spring 2014.

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**With modernization set aside, Eurasian integration became the centerpiece of Putin’s third term.**
Eurasian Integration and Beyond

With modernization set aside, Eurasian integration became the centerpiece of Putin’s third term. His keynote article published in October 2011, a few months before the presidential election of March 4, 2012, emphasized the success of the recently-formed Customs Union with Belarus and Kazakhstan and the creation of the Common Economic Space with the three countries, which introduced standardized legislation and the free movement of capital, services and labor among the member-states. Putin outlined plans for the enlargement of this project to encompass Kyrgyzstan, Tajikistan (and Armenia) and its evolution into a Eurasian Economic Union (EEU) and eventually a Eurasian Union (EaU). The planned EEU was intended to serve as a complement to the European Union rather than an alternative. The goal, according to Putin, was not to “fence ourselves off from anyone,” but rather to create a new economic region based on “universal integrative principles as an inalienable part of Greater Europe, united by mutual values of freedom, democracy and market rules.”

The EEU Treaty of May 29, 2014 effectively consolidated the existing legal-regulatory framework of the Common Economic Space (CES) and the Customs Union (CU), consisting of more than one hundred international treaties signed between 1995 and 2012, into one document. When the Treaty came into effect on January 1, 2015, the three founding states covered approximately three-quarters of the post-Soviet region and had a combined market of 173 million people (including Crimea), along with a total GDP of approximately $2.7 trillion. While this was a small amount compared to the EU’s GDP of $16.6 trillion, it marked an important step toward giving substance to aspirations for Eurasian integration. Armenia joined the Union on January 2, and Kyrgyzstan is due to become part of the bloc in later-2015.

Nevertheless, Eurasian integration remains a fundamentally contested project. Even Putin’s enthusiasm began to wane when confronted
by the reality of the loss of sovereignty, the difficulties of ensuring foreign-policy coordination with neighboring states, and the prospects of a long-term rift with the West, exacerbated since then by the Ukrainian crisis. Regional integration remains an important part of his policy agenda, but as is typical with Putin, he tries to keep his policy options open to the maximum extent.

This involves intensified efforts to turn the strategic partnership with China into something akin to an alliance, while strengthening macro-regional forms of alliance-building, notably within the format of the Shanghai Cooperation Organization (SCO) and the BRICS (Brazil, Russia, India, China and South Africa) association of states. Putin refused to accept that Russia would become an outcast from Europe. As a result he has sought to ensure that his turn to Asia and the world is accompanied by attempts to rebuild the relationship with the EU, if not with the Atlantic community as a whole.

A Black Swan from Ukraine

*Putin’s Foreign Policy: From New Realism to Neo-Revisionism*

When he came to power in 2000, Putin sought engagement and accommodation with the West, and was perhaps the most pro-European leader Russia had ever had. The new Russian president initially pursued a policy of *new realism*, based on classic realist notions of international politics in which states pursue their conception of the national interest without fear or favor. But this approach also sought to establish a genuinely equilateral dynamic of mutual advantage in Russia’s integration into European and global structures. The bottom line was that Russia sought to achieve autonomy in the management of its
foreign policy, but this would not be based on anything approaching neo-Soviet notions of Russia as the core of an alternative geopolitical or ideological bloc.

After 2007, Russian foreign policy entered a new phase of *neo-revisionism*. Russia’s behavior became more assertive, in part derived from its economic recovery bolstered by windfall energy rents, and political stabilization of the ruling regime. In addition, the Russian leadership experienced a growing sense of alienation abroad – not so much from the structures of hegemonic power, but from its practices. From a status-quo state, Russia became a distinctive type of neo-revisionist power, claiming to be a norm-enforcer rather than merely a norm-taker. Yet in practice, Russia did not put itself forward in any substantive sense as a norm-maker, since the essence of neo-revisionism is not the attempt to create new rules or dangle a vision of a new international order, but to ensure the universal application of existing norms in at-most a modified international system.

The enlargement of NATO to encompass 28 states, 40 percent of which were former Soviet bloc countries, accompanied by the continuing struggle against American plans to build elements of a missile defense system in Europe, represented the massive consolidation of the Atlantic alliance system from which Russia was excluded. Even the European Union was perceived to have part of this alliance. As far as Russia was concerned, the five-day Russo-Georgian War in 2008 demonstrated the systemic degradation of the post-Cold War order and the reassertion of geopolitical contestation. The struggle to extend the EU’s normative power to the East was one thing, but the attempt to institutionalize this process in the form of the Eastern Partnership appeared provocative and unnecessary to Moscow.

*The Ukrainian Crisis and Domestic Consolidation*

The growing tension with the West came to a head with the ouster of Ukrainian President Viktor Yanukovych in February 2014, accompanied by the rise of significantly nationalistic new forces in
Kiev. The Russian response was swift and punitive, seizing Crimea and restoring it to Russian sovereignty. Soon after, an insurgency began in the Donbass, prompted in part by the actions of alleged Russian volunteers and local pro-Russian activists, but initially reflecting a widespread dissatisfaction in Russophone areas with the consolidation of an intense form of Ukrainian nationalism in the Western part of the country. Russia was drawn into a conflict from which no end point is apparent. The imposition of four phases of U.S. and EU sanctions in 2014 was intended to force Putin to change his approach.

While some in the Russian opposition declared that a Russian Maidan (popular uprising) was inevitable, the Ukrainian events had, at least initially, the opposite effect. The elite consolidated around Putin, while the people rallied around the flag. Putin’s approval ratings soared back to the levels of 2007-2008, if not higher, at some points reaching 85 percent. If there was to be “regime change” in Russia, all the polls indicate that this would be followed by a more authoritarian consolidation.

Challenges from Left-Field

The third-term Putin government will almost certainly survive the sanctions regime. But when accompanied by a dramatic fall in the price of oil that threatens a decline in the Russian standard of living, the Putin regime is entering uncharted territory. While the initial logic of the sanctions was to target a small circle of Russian elites, the sanctions are now threatening to have a spillover effect on the broader Russian society. Amid depressed oil prices, the government has had to implement significant budget cuts, especially to public sector workers. Already, cuts in the number of health workers in Moscow in late 2014 provoked demonstrations. Incomes would be depressed for the first time in a decade. As a result, the sanctions – set against the backdrop of declining oil revenues and counter-measures by the Russian government – may become a form of collective punishment on the Russian people, threatening to reduce a significant proportion of the population to penury.
Putinite stability proved resilient for well over a decade, but symptoms of the system’s fragility were clear as he entered his third term. An underlying structural weakness was reliance on high energy prices to maintain budgetary stability, the lack of diversification of the economy, insecure property rights, and the lack of reform in the social sector. In 2011 the economy grew by 4.3 percent, slowing to 3.4 percent growth in 2012 – still better than the Western average in a time of recession but far short of the eight percent of Putin’s first decade in power. The further slowdown to 1.3 percent in 2013 and then 0.4 percent in 2014 came as a shock to the authorities. Under the impact of sanctions and the collapse in oil prices from summer 2014, the country entered a period of stagnation caused by high levels of social spending and structural problems. It was clear that the accustomed growth model was running out of steam.

The relentless collapse in the price of oil came as a major shock not only to the Russian economy but to its political system. As the price fell from its peak earlier in 2014 of $115 per barrel to below $50 in January 2015, the government faced some very harsh choices. Oil and gas comprise 18.7 percent of Russian GDP but provide 27.4 percent of tax revenues. The ruble lost half of its value in 2014, forcing a drastic rise in interest rates at the end of the year. The crisis deflated much of Russia’s self-confidence, and in the immediate term forced the adoption of some drastic economic measures. In the long term, it may set Russia onto a new political path altogether.

Further government actions halted the economic slide, notably pumping capital into the banking system and ruling out capital controls. This maintained confidence in the banks and prevented panic withdrawals.
by depositors. Yet if interest rates were kept high the economy would be ruined. Investment, already low, would fall further. The oligarch class is deeply opposed to the imposition of capital controls, but the government may well soon be running out of other options. Exchange controls greatly restrict the options of the business class, who until now have used Western banks and various offshore holdings to manage their Russian investments and to limit their exposure to political risks emanating from the Russian regime.

Capital controls would represent a fundamental game-changer for the Putin system. The so-called policy of “deoffshorization” and “nationalization” of the elites has been at the heart of Putin’s third-term presidency, and it is a policy that was accelerated by the sanctions and the economic crisis as a whole. The likelihood of a potential split between Putin and the economic elite is low, yet we know that when a run on the banks begins, it is almost impossible to stop. As is typical, Putin is using the actions of his adversaries to advance his own agenda by fostering elite consolidation at the top and amid the population more broadly.

As is typical, Putin is using the actions of his adversaries to advance his own agenda. Putin himself retained his characteristic nerve in the crisis. In his annual presidential address to the Federal Assembly on December 4, 2014, he outlined the key challenges facing Russia. In a rather surprising move, he indicated that rather than intensifying state controls, the crisis would force Russia to liberalize and to develop a more dynamic small and medium business sector by removing the deadweight of the bureaucracy. Above all, he suggested that Russia will not turn back to the past for models of its future, at a time when many in the West were expecting Putin to tighten the screws and isolate Russia further. Instead of turning to the mobilization strategy for development, which would mean greater state involvement over investment decisions and a more autarchic model of economic development – something
advocated by his nationalist and neo-Soviet critics – there was a shift towards supporting small and medium entrepreneurs. Already moves have been taken to reduce the regulatory and inspection burden, and to strengthen the rule of law in the sphere of property rights.

Conclusion

The current phase of the regime can be characterized as “developed Putinism,” analogous to the period of “developed socialism” proclaimed during the mature phase of the Leonid Brezhnev era in the 1970s. The emphasis remains on managing competing demands amid pressure for political participation and social welfare; reversing the fragmentation of post-Soviet Eurasia; and responding adequately to new security challenges. The administration is caught in a turbulent policy conflict over the most appropriate developmental model, the country’s place in Eurasia and in energy markets, and the general position that Russia should adopt in a world torn between rising powers and defenders of the apparently triumphant Western hegemonic system. As an aspirant power, Russia advances the concept of “multipolarity” and defends the institutions of international governance, notably the United Nations system, as part of its struggle for recognition.

The system is built to sustain inertia, and operates within the framework of balancing the various factions in Russian society. The crisis may precisely force a breakout from the economic dead end and political stalemate to achieve a meaningful rejuvenation of the polity and the economy. Putin is a master at the unexpected feint and demarche, and as a result of this crisis he may well surprise us yet. The Putin system has thrived by the pragmatic use of the various materials at hand, and although there is no question of Putin backing down under Western pressure, however dire the economy looks, he is intelligent enough to avoid the trap in which the Soviet system found itself by responding symmetrically to Western challenges. Delaying reforms too long and upping defense spending in response to the exaggerated Western threat drove the Soviet Union into oblivion.
Already the system is looking to the December 2016 parliamentary elections, and the March 2018 presidential elections. Once again, the fundamental question is whether the Putin system can shift from a recuperative to a developmental strategy. Today there are no ideological obstacles to reforms that would meet the expectations of what some have taken to calling the rising middle class. Such reforms would involve more competitive elections and a more vibrant and pluralist public sphere.

The recuperative strategy worked remarkably well in the beginning, but the accumulation of power and resources can only work as long as it is accompanied by a sense of purpose and achievement. Otherwise there has to be greater reliance on the other elements of Fukuyama’s triad, namely accountability and legality (or more broadly, defensible property and political rights). The turn towards a more conservative rhetoric to sustain the “Putin majority” did little to make up for the regime’s lack of a consistent ideology. Instead, like the late Soviet regime, the system is built on eudemonic principles: the proclaimed satisfaction of human needs and the delivery of public goods, including non-material ones. But the regime becomes vulnerable when it can no longer deliver. The political social contract will dissolve, and a new historical era will begin.

Notes

The sight of the so-called “little green men” swiftly seizing key locations in Crimea – purposeful, disciplined, and looking like the soldiers of any advanced nation – drove home the extent to which Russia’s security agencies have evolved from their Soviet past and the traumatic near-collapse of the 1990s. The government’s massive and sustained military spending, political priority and the opportunity to learn from operations ranging from the two Chechen wars to the Georgian intervention have together helped to significantly rebuild Russian military power.

On the surface, Russia may appear undoubtedly more secure than even in the first half of Vladimir Putin’s third term as president. However, these very capacities also seem to have encouraged Moscow to adopt an increasingly assertive policy in its neighborhood, as recently seen in Crimea, leading to a new era of confrontation with the West. The question must therefore be whether, in the bigger picture, the country’s greater military strength has not also led Russia into an unexpectedly risky situation.
Military Reform: A Tale of Two Armies

Although the Kremlin initially laughed off any notion that the “little green men” in Crimea were Russian troops, it later emerged that these were indeed elite Russian Spetsnaz and Naval Infantry marines, who would later be reinforced by paratroopers of the VDV Airborne Assault Forces and a range of other high-readiness units. While still not equipped to the level of the most modern Western armies – especially in regard to communications and night-vision technologies – the Russian forces nevertheless stood as a testament to the results of a long-term program of defense spending and a more recent reform and reorganization effort drawing on the lessons of the 2008 Russian-Georgian War.

The expert seizure of Crimea reflected the extent to which Russian security forces have evolved since the 1990s.

The restructuring of the Russian military began under former Defense Minister Anatoly Serdyukov, an outsider to the military world who was thus despised by his generals, but who was also free from old loyalties or service interests. Serdyukov’s program (or rather, that of his Chief of the General Staff, Nikolai Makarov) replaced Soviet-era divisions with smaller, more flexible brigades as the basic unit of the army, reduced the total size of the military to more manageable proportions – not least by pruning some of the top-heavy officer corps – and introduced basic and long-overdue managerial reforms.

However, the Russian military – which has continued to reform under Serdyukov’s successor, Sergei Shoigu – remains very much a work in progress. On the one hand, it has a core of modernized units with higher proportions of volunteers rather than conscripts, and possessing the latest equipment as well as the best officers. These include the elite units, the Naval Infantry, the paratroopers, and
some of the more specialized and prestigious of the regular units, such as the Moscow-based Taman and Kantemir divisions as well as the 205th Brigade in the North Caucasus.

But there also exists another army, where progress has been patchy and often deliberately concentrated on strengthening units with key roles and in especially significant locations. While some Spetsnaz brigades are all-professional, for example, the average proportion of professional troops across the entire armed forces is just under 35%. At most, half of the Ground Forces could be considered anything close to properly modernized, and indiscipline, hazing and simple unprofessionalism remain prevalent in many of these second-line units. For example, according to Shoigu, cases of the institutionalized seniority-based hazing known as dedovshchina fell by 30% in 2014. While this is a genuine achievement, it follows an uptick in hazing cases in 2009-10. Meanwhile, violence remains a serious problem more broadly, especially between conscripts from different ethnic groups.

There are also distinct differences in the readiness of each arm of the security service. Russia’s nuclear forces, for instance, are going through their own modernization cycle, which is still troubled by some technical challenges: for example, the new Bulava submarine-launched ballistic missile only entered service in October 2014, years behind schedule, because of successive test failures. However, Russia’s nuclear shield remains its fundamental and most reliable security guarantor.

By contrast, reform of the navy is still lagging, in part because of the sheer expense of re-equipping a fleet still dependent on ageing Soviet designs. Efforts to demonstrate that Russia has a “blue water” capacity to project its naval power globally have tended to be awkward and embarrassing gestures rather than credible displays of its might. Only around half of Russia’s 270 warships are truly operational,
while much-vaunted plans to build a fleet of full-deck aircraft carriers to match those of the U.S. Navy are essentially mere declaratory statements until the country manages to build facilities capable of building ships that size. In general, Russia’s shipyards do not have the capacity to build more than 50-70% of the vessels Moscow needs to meet its 2020 targets. There appears to have been a clear decision to prioritize those arms of service deemed genuinely vital to the defense of Russia and the projection of power in Eurasia – such as the ground, nuclear and perhaps air forces – while reform of the navy has been put on hold.

**Changing Kinds of War**

Russia’s neat seizure of Crimea, along with subsequent, rather messier operations in south-eastern Ukraine, created considerable Western alarm – sometimes verging on panic – about its ability to wage “hybrid,” “special” or “non-linear” warfare that seamlessly blended overt, covert, political, economic and intelligence operations and capacities. To an extent, all wars involve this full spectrum of forms of conflict. But Russia is refining these techniques to a significant degree. In part, ironically, this reflects its relative weakness in aggregate conventional forces compared with NATO and, increasingly, China. Unable to rely purely on massive battlefield preponderance, Russia must now consider how to play to its strengths and potential enemies’ weaknesses in an asymmetric way.

This approach was enshrined in the new military doctrine introduced hurriedly at the end of 2014. While in many ways a restatement of the preceding 2010 document, albeit written in rather more starkly combative language, this version differs from its predecessor in emphasizing the way that modern warfare is about “the comprehensive use of military force as well as political, economic, informational
and other non-military means, together with the extensive use of the population’s potential for protest and special operations forces.”

Beyond the expansion of the Spetsnaz – including the creation of a new Special Operations Command (KSO), which saw its first action in Crimea – this also involves addressing the way that it is now possible, in the words of the 2014 doctrine, to use “information and communication technologies… against the sovereignty, political independence and territorial integrity of states.” In addition to propaganda and intelligence-driven “active measures” (political operations), this means an emphasis on cyberwar, both in its offensive and defensive applications.

This is not new: Russia has long been exploring and developing cyberwar capacities. Rather, given the central role of the doctrine document to Russian military planning, it is a recognition of the growing importance of cyberwarfare capabilities to Russia’s military policy. It is still unclear what this will mean in practice. However, a key shift appears to be a decreased reliance on the initiative of freelance “patriotic hackers” (who, for example, launched attacks on Georgian government systems in 2008 during the brief Russo-Georgian war) and greater emphasis on directly-controlled state information warfare specialists. To that end, Shoigu announced in 2013 that $500 million would be spent over the next five years on a “cyber army” with both offensive and defensive capacities under the oversight deputy defense minister Colonel General Pavel Popov.

**Internal Security: Preparing for Diffuse Threats**

Russia faces a series of domestic threats, from the continuing insurgency in the North Caucasus and occasional terrorism elsewhere in the country, to serious organized crime and drug trafficking. There is also a potential future public order challenge to the Kremlin, especially if the economic downturn leads to a resurgence of the political protest movement, labor unrest, or inter-ethnic violence reminiscent of the 2013 riots in Moscow’s Biryulevo suburb.
At the same time, the country has a formidable security apparatus to respond to these threats. This includes the Ministry of Internal Affairs (MVD), which consists of not only the police but an additional 150,000 militarized Interior Troops; the Federal Security Service (FSB) with 70,000 staff and 170,000 Border Troops; and a range of other agencies, from the Federal Guard Service (FSO) with 30,000 officers to the Federal Anti-Drugs Service (FSKN) with over 30,000 personnel. Many have already gone through reform and modernization programs in recent years. Meanwhile, after the introduction of the 2011 Law on the Police, Russia’s law enforcement agencies have received not only additional funding to cover everything from salary raises to new uniforms, but also new training syllabi emphasizing the rights of citizens as well as procedures less heavily dominated by Soviet practices.

Yet problems, once again, remain. Corruption persists as a serious challenge within law enforcement, something Interior Minister Vladimir Kolokoltsev admitted even as he was still head of the Moscow police. More broadly, the relationship between the police and the policed is often tense and mistrustful. While the MVD claims that public approval of the police has increased, independent surveys indicate that at least half of Russians either mistrust the police or do not feel they do their job well. A 2014 survey by the opinion polling agency Levada, for example, found that traffic and regular police are still characterized as the two most corrupt institutions in the country. Similarly, the Interior Troops and FSB are (rightly) regarded first and foremost as instruments of the state rather than guardians of society. Independent human rights monitors continue to warn that
abuses remain widespread, especially in the North Caucasus, where the security agencies continue to combat a bubbling local jihadist and national insurgency.

This does not mean the security forces are inept at their jobs, however. Although the so-called “Caucasus Emirate” had threatened to launch terrorist attacks against the 2014 Sochi Winter Olympics, for example, they passed smoothly and without incident – much to the surprise of many foreign observers, who were expecting heavy-handed security procedures during the event. Likewise, the year 2014 saw a reduction in terrorist attacks by two-thirds since the previous year, according to the FSB. Although part of this decrease can be attributed to the outflow of radicals joining the Islamic State in Iraq and Syria, it is largely a result of improvements within the security forces.

Production and Imperfection

Overall, the majority of the real and imminent threats facing Russian security come from within. Crime and corruption have been identified by President Putin as national security concerns in their own right, but they also magnify and exacerbate other challenges, from facilitating terrorism to draining the state’s coffers of money that could otherwise be spent on procurement.

There is also the broader issue of the extent to which the architecture of power in modern Russia acts against the national interest. While every country’s defense industry lobbies for its own private advantage, Russia’s military-industrial complex (VPK) is especially powerful. As a result, many Russian military figures have expressed a concern that they often get the weapons the industrialists want to provide – and when they want to

Compared to other countries, Russia’s military-industrial complex is especially powerful.
provide them – rather than the ones they actually need. This most infamously came to a head in 2011, when Serdyukov backed his Chief of the General Staff, Nikolai Makarov, in his critique of the T-90 tank. At the time, Serdyukov wanted to halt the purchase of additional tanks, both because of questions about the T-90 and a sense that other priorities were more important. The manufacturer of the T-90s, Uralvagonzavod, lobbied hard against this decision – and despite Serdyukov’s five-year moratorium on the purchase of T-90s, the purchase went ahead while Serdyukov himself was soon dismissed.

Today, there is a sense that the new military hierarchy is much less willing to challenge the VPK. This is especially reflected in the vexed issue of buying military foreign equipment. Serdyukov championed the notion that this ought to be an option, both to ensure that Russia’s forces had the best and most appropriate kit, and also to bring pressure to bear on domestic producers to lower their prices and meet their deadlines. This provoked an angry response from an alliance of the VPK and nationalist politicians, including Deputy Prime Minister Dmitri Rogozin, who is also in charge of the VPK portfolio. As a result, the defense ministry has now essentially backed away from an idea which could have ensured greater competition for Russian state orders, as well as more bang for its ruble.

Russia’s last major foreign procurement project was the acquisition of two Mistral-class amphibious assault ships from France. Serdyukov’s then-General Chief of Staff Makarov explicitly said this move reflected the inability of domestic shipyards to build comparable designs for another decade. However, because of Russian policies in Ukraine, the French government decided to block the transfer of the first vessel, Vladivostok, in November 2014. As a result, the Mistral affair is likely to strengthen the hand of those who believe that Russia ought to depend only on domestic sources of materiel so as not to leave itself vulnerable to foreign pressure or impediment. In this way, political concerns are superseding military requirements.
Prospects: Hot Peace and Cold Comfort

Is Russia safer now that when Putin first came into office? Undoubtedly so: by the end of the 1990s, not only was the country widely regarded as irrelevant at best in world affairs, but there were serious questions about the very continued existence of the Russian Federation. The state and security of its nuclear arsenal was uncertain, organized crime was running amok, and the military had suffered a humiliating failure to bring rebellious Chechnya to heel.

Two years into Putin’s third term, Russia’s position is very different. While military reform is still a work in progress, the armed forces are vastly more competent than before. Its police have likewise gone through a reform process that has begun to address many of the problems undermining their ability to provide security to the nation’s streets, while the internal security apparatus as a whole has massive resources and powers. There is little doubt these forces are much more capable of securing the country from external threats than the ones that existed when Putin first came to power. They have also – as was evident in Crimea and in subsequent actions, from the deployment of forces into eastern Ukraine to the penetration of NATO airspace by long-range bomber sorties – provided the Kremlin with a much more powerful, extensive and varied range of military instruments in support of its geopolitical aims.

But to what extent do these improvements make Russia truly safer? For one, the reform of the security services has diverted funding from other critical areas. Moscow’s determination to rebuild its security structures is part of the reason for the neglect of state investment in crucial areas and heightened security tensions with the West.

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Russian military reform has come at the expense of under-investment in crucial areas and heightened security tensions with the West.
in infrastructure and economic diversification, both of which are becoming a serious economic security challenge now that oil prices have dropped. The empowered internal security forces have also fomented tension within society by often using heavy-handed tactics that create further problems for the future, whether by alienating local populations or sparking blood feuds. Furthermore, Moscow’s decision to annex Crimea sparked a dramatic decline in relations with the West, along with an increasingly stringent sanctions regime that exacerbates Russia’s economic problems and increases the country’s isolation. Arguably, had the Kremlin not had such professional intervention forces at its disposal, it may not have been tempted to take Crimea, however popular the move undoubtedly was at home.

The interplay of Russian and Western actions and counter-actions have lead not so much to a new Cold War but to a “hot peace” in which neither side seeks conflict or even direct confrontation, but in which both regard the other as a threat to its interests. The new Russian military doctrine introduced at the end of 2014, for example, noted that “despite a decreased likelihood of a large-scale war against Russia, some security threats continue to grow” and specifically identified NATO expansion and activities as one of the most serious risks it faced. Likewise, the declaration issued by NATO after its Wales Summit in 2014 asserted that Russia’s “aggressive actions” have “undermined peace, security, and stability across the region.” In this respect, perversely, the very improvement of Russian military capabilities could be argued to have jeopardized its economic security and geopolitical position.

Domestically, however, this appears to be a moot point. Although pressures on the state budget are likely to lead to some retrenchment, President Putin has made it clear that he has no intention of retreating in essence from his ambitious rearmament program. As of this writing, the plan of the Russian government is still to spend a record 3.3 trillion rubles on defense in 2015, which amounts to 4.2% of national GDP and a 33% increase from the 2014 defense budget. The aim is still that by 2020, fully 70% of Russia’s weapon systems will be of the...
most modern standards, compared with 10% in 2010.12 Meanwhile, the
government is making an effort to integrate systems and doctrines to
fight conflicts in the information and cyber realms alongside or instead
of more conventional kinetic means.

For the foreseeable future, Russia will continue to strengthen its
military capabilities so long as the resources hold out and it faces no
plausible direct threats from across its borders. However, this will be at
the cost of raising numerous, less visible risks, from the implications
of the “hot peace” with the West to the effects of under-investment
elsewhere.

Notes

1 This topic is best explored in Anton Lavrov, “Russian Again: The Military operation
   for Crimea,” in Colby Howard & Ruslan Pukhov (eds), Brothers Armed: Military Aspects
   of the Crisis in Ukraine (Minneapolis: East View Press, 2014) pp. 157-86.
2 “Sergei Shoigu obyavil o snizhenii chisla sluchaih dedovshchiny v armii” (Sergei
   Shoigu Announces Decline of Hazing Instances in the Army), Rossiiskaya gazeta,
   August 5, 2014.
3 Dmitry Gorenburg, “Russian Naval Capabilities and Procurement Plans,” Russian
   Military Reform, January 14, 2015, https://russiamil.wordpress.com/2015/01/14/
   russian-naval-capabilities-and-procurement-plans/.
4 These are the author’s own data, based on multiple open source reports and
   conversations with Russian officials.
6 “Korruptsiya v sisteme gosudarstvennoi vlasti” (Corruption in the State Government
   korruptsiya-v-sisteme-gosudarstvennoi-vlasti.
7 “FSB: Russian Terror Threat Reduced Threefold in 2014,” The Moscow Times,
   December 9, 2014.
8 The author explores this concept further in “Not a New Cold War: Great
   Detail/?lng=en&id=178660.
   media/events/files/41d527556bec8deb3530.pdf.
   natohq/official_texts_112964.htm.

“K 2010 godu sukhoputnie voiska RF ukomplektuyut novym vooruzheniem na 70%” (Land Troops to be Supplied with 70% New Weapons by 2020) Izvestiya, October 1, 2014.
As Vladimir Putin enters the second half of his third term as president, the downturn in the domestic economy presents itself as the most serious challenge of his long tenure as Russia’s leader. This is not the first time economic crisis has hit Russia, but the latest downturn stands apart from its predecessors in its severity and the long-term dilemmas it raises for Russia.

Is there any reason to believe the Russian economy will be more diversified and sustainable in 2016 or 2018 than it was in 2014? Will necessity, in this instance, become the mother of invention?

To answer this question, this paper notes Russia’s performance in three earlier crises (1989-1995, 1998, and 2008). Reform efforts in 1992-95 and 1999-2003 provide a sharp contrast to the absence of significant change in 2008-09. It then assesses the initial response of the Russian government to the 2014 crisis. The conclusion focuses on the bleak prospects for the Russian government to carry out import substitution, significant reform or a shift to a more diversified economy.
Three Crises in the Modern Russian Economy

1989 - 1995

The first economic crisis in modern-day Russia began with Mikhail Gorbachev’s flawed attempt at perestroika, bequeathing economic chaos to the 15 nations that emerged from the breakup of the USSR. The much-maligned shock therapy program that was launched in 1992 was a desperate attempt to deal with the consequences of Gorbachev’s failed reforms, exacerbated by the severing of Soviet economic ties and Russia’s domestic political conflicts. The economic team of then-Prime Minister Yegor Gaidar endeavored to implement reforms that, if not undermined by the Soviet-holdover Russian legislature, might have put Russia on a more sound economic footing. While the program of stabilization, liberalization and privatization worked reasonably well in nearby Poland, stabilization in Russia was undermined by subsidies, monetary policy and lack of control of the ruble zone, while liberalization was only partial due to “winners” seeking to preserve the economic opportunities provided by a semi-reformed system. In these conditions, politically motivated privatization did not achieve the anticipated positive results.

1998

The failure to quickly and fully implement reforms in 1992-95 set the stage for the second Russian economic crisis, which arrived in August 1998. While this downturn coincided with the Asian financial crisis of 1997-98, Russia’s problems were largely self-made. The combination of badly sequenced and incomplete reforms in the 1990s along with massive borrowing in the form of GKOs (state credit obligations) created an environment in which crisis was all but inevitable. The August 1998 collapse ushered in a new government, which finally achieved economic stabilization under Prime Minister Evgeny Primakov. This laid the basis for reformers like Alexei Kudrin and German Gref to push through significant reforms in the early years of Putin’s presidency. A number of important reforms were introduced in
1999–2003, including tax reforms for both businesses and individuals, policies to ease the creation of small and medium businesses, and first steps to allowing sale of agricultural land. These positive changes were curtailed in 2003, when the seizure of the Yukos oil company initiated policies of renationalization and greater emphasis on the role of the state in Russia’s economy.

2008–09

Russia managed the worst economic performance of any G-20 nation in the global financial crisis that began in 2008. With many observers having believed that Russia would be an “island of stability” even as other world regions experienced serious economic problems, the impact on Russia turned out to be unexpected. The government provided a stimulus program to aid businesses, but did not introduce major reforms. By 2008, the Putin-Medvedev tandem had the Duma fully under control, and could have implemented structural reforms. The necessity for this was alleviated as oil prices recovered in 2009. The opportunity to use the crisis for significant reform was wasted, laying the groundwork for a subsequent crisis.

2014–15: Dealing with the Current Crisis

The economic disaster facing Russia in 2015 cannot be blamed on a crisis in the world economy, though some Russian economists have sought to make this connection. Russia’s current crisis stems from multiple accumulating problems, including excessive and growing dependence on commodities exports, low productivity, corruption,
an atrociously poor environment for small and medium business, and government policy choices, including deferring reform.

Three major factors determined the timing of the present crisis:

1. The Russian economy was already experiencing serious structural problems, having exhausted the potential for recovery growth and hydrocarbon-based development;
2. The price of oil, the single most important factor in Russia’s economic health, began to plummet midway through 2014;
3. Russia’s invasion of Ukraine in 2014 resulted in targeted Western sanctions against individuals and major state corporations, making it nearly impossible for debt-laden Russian firms to refinance their obligations. This has led to a sharp rise in inflation and has accelerated the depreciation of the ruble.

Russia’s government responded slowly in the first weeks of the crisis. Its refusal to acknowledge the appearance of a serious threat resulted in intermittent intervention measures that stemmed the ruble’s slide for no more than a few days at a time. Since then, the policy of the Russian Central Bank has continued to fluctuate. As a result, the effects of the crisis are beginning to affect average Russian citizens. The government’s retaliatory ban on imports from Europe has caused the cost of food to rise for many Russians, particularly in European Russia, though the problems are also appearing in many other locations. Failure to develop a domestic pharmaceutical industry means that the cost of most medicines has increased rapidly, and Russians who depend on insulin and other life-sustaining drugs will likely face impossible choices. As public discontent continues to grow, the government will find it increasingly difficult to substitute reform with rhetoric.

Russian leaders have put up a brave front, noting that the government has significant foreign currency reserves. However, they tend to overstate the funds available to defend the ruble and aid troubled firms, which rather than being $370 billion in February 2015 may be closer to $170 billion due to previous spending and other obligations,
including pensions. The reserves are probably sufficient to meet short- to medium-term needs, but there is a broad consensus that this crisis will last longer than the one in 2008.

President Putin managed to put a positive spin on the decline in the ruble exchange rate, noting that the government would have little difficulty balancing its budget. Putin’s optimistic assessment ignores the damage stemming from currency depreciation; inflation, currently projected to be at least 15%; declining economic performance; loss of confidence; and failure to address critically needed reforms; not to mention the impact of Western sanctions.

The government’s anti-crisis program thus far appears far from comprehensive. Policies include defending the ruble; cutting the budget except for defense, agriculture and specific social programs; providing support for banks and major state corporations; blaming Western sanctions; and promoting import substitution.

The major spending elements in the anti-crisis plan involve support for potentially troubled banks and for major state corporations. Rosneft alone is asking for more than $40 billion to cover the cost of payments for its acquisition of BP’s share of the TNK-BP oil company. This compares to $35 billion allocated for the entire anti-crisis program. Russian financial analysts have noted that the support promised for industry is less than in the 2008-09 crisis, a situation they attribute to the government having less money available for a stimulus program.

According to Russian Finance Minister Anton Siluanov, to find the funds needed for the anti-crisis program, all construction projects other than in Crimea will be frozen in 2015. A program that cuts investment and infrastructure spending across Russia does not promise...
significant help for a struggling economy. Moreover, it directly
contradicts the much-heralded import substitution effort undertaken
by the government. The major factors in successful recovery after
1998 were import substitution facilitated by the ruble devaluation,
followed by economic reforms and the sustained rise in the price of
oil beginning in 1999. In 2014-15, any recovery in oil prices appears
months if not years away. In 1998, the government and many
economic policy-makers were replaced, making policy change possible.
In 2008, no significant changes in personnel took place. The same lack of
turnover characterizes personnel in 2015.

At a meeting with economists on February 13, 2015, President Putin
sounded like the late Soviet leaders who felt the necessity of economic
reform but were at a loss as to how to approach it.:

“All in all it is clear what we are talking about – we talk with you
about this constantly. It is diversification of the economy, creating
conditions for a definite growth tempo, creating a good business
climate, improving management at all levels of government, from
the highest to the municipal, stabilization in the currency sphere
and, it seems, maintaining order in macroeconomic indicators. All
this is understood, but what is not clear is what specifically must
be done at the current moment to order to realize all of this.”

Amid the present economic downturn, Putin is not well-served by
the departure or sidelining of reform-minded officials. Chief among
these is former Finance Minister Aleksei Kudrin, who resigned in
2011 to protest proposed increases in defense spending but reportedly
remains close to Putin. While people close to Kudrin, who attended
the February meeting, say that rumors of his having been offered
a high position are not true, members of the business community
continue to view him as the last hope for a more effective government
economic policy. Kudrin remains wary, not least because serious reform
would inevitably require changes in personnel, along with political
reforms that are not acceptable to many Putin insiders. Another
option currently under discussion is the possible return of German Gref to head an economic reform policy center, which might provide specific proposals without changing personnel.

Lessons Learned?

The crucial question in 2015 is whether Russia’s leaders will find a way to repeat the performance in 1992-95 and 1999-2003, using the crisis to undertake serious reforms, or whether they will behave as they did in 2009, eschewing reform and hoping for a return to higher oil prices. In 2008-09, Russia’s leaders ignored the most important lesson of 1998 and other economic downturns: never waste a good crisis. Unfortunately, the government’s limited response of modest budget cuts, guarantees of continued spending for defense and social programs, and lip service to structural reform in late 2014 and early 2015 suggest that a repeat of 2008 is the more likely trajectory. Given the changes in the Russian economy in the past decade, this could have profoundly negative results.

Russia’s GDP grew an average of 6.9% from 2000 to 2008, a period during which oil prices increased more than tenfold, and the regime reaped $900 billion in revenues. In the wake of the 2008 crisis, Russia’s GDP grew an average of 1% during 2009-2013, despite oil revenues of $1.2 trillion. Russia’s leaders have failed to utilize the hydrocarbon windfall of the past 15 years, with vast sums either squandered on massive state programs or stolen. Amid the latest crisis, the Russian government has announced a massive increase in defense spending even as most other sectors of government spending will be cut. The Soviet experience demonstrates that a combination of low hydrocarbon prices and increased defense spending can produce a catastrophe. Yet Russian leaders appear unfazed by the dangers.
Challenges to Diversification

The most positive comments from Russian leaders regarding the crisis have been promises to finally get serious about diversifying the economy. Despite a tenfold increase in oil prices between 2000 and 2008, Russia was more dependent on hydrocarbons at the end of the commodity boom than it was at the beginning. Oil revenue represented less than 10% of the Russian budget in 2000, but rose to more than 50% by 2008. Why was none of that windfall used to spur diversification?

Regime defenders might invoke an old proverb: “The peasant does not cross himself until he hears the thunder.” While long-term rational behavior might suggest that an era of high oil prices is precisely the time to diversify an economy, short-term calculations provide a disincentive to doing so. For example, developing a technology start-up firm generally involves several years of borrowing to stay afloat, and perhaps a few years of moderate profitability before the firm takes off and begins to see substantial returns. A few Russian firms such as Yandex have managed successful IPOs, but these are the exceptions to the norm. In a commodity boom where oil and gas return 50% per year, who would devote a decade to establishing an uncertain technology business?

The start-up option is even more precarious given that business services such as accounting, legal help, shipping, insurance, back office work, and security generally set prices based on what Gazprom and Rosneft can afford. The outlook is not improved by widespread predation on the part of government agents. The spin-off model is another way to generate new business, but few Russian industrial enterprises are developing new technology or products that could undergird business development. The trend in the past decade has been to increasingly consolidate enterprises into large state holding companies. This reduces both flexibility and transparency in their work.
Diversification and business development require investment, but the government’s program proposes stricter budget policies at the national and regional levels. Finding capital will be a challenge. Yet the need for investment is even more pronounced given changes in Russia’s relationship to the world economy since 1998. In the 1998 crisis, Russia was to a large extent insulated due to its thin integration with the global economy. In the 2000s, Russia became far more interconnected with the global economy. Many large Russian corporations have borrowed on foreign credit markets and face significant debt rescheduling difficulties as a result.

A chorus of economists overwhelmingly agree that Russia’s current economic difficulties are due to long-term structural problems. Both Prime Minister Dmitry Medvedev and President Putin have said the same thing. Yet the policies adopted thus far appear sadly inadequate relative to the causes of the problems, their magnitude, and their likely duration.

The Not-So-Magic Bullet of Import Substitution

If oil price recovery and major reform are unlikely, that leaves import substitution as the remaining means of dealing with the crisis. Unfortunately, this approach is not a plausible remedy in the current conditions. Compared to 1998, when the ruble was devalued by more than four times, the decline in the ruble by early 2015 was about 50%. While this does provide some space for domestic producers, it is nothing like the opportunities that existed in 1998, when it was possible to raise prices to improve production while still undercutting foreign competitors.
Nevertheless, the idea that Russian producers can replace many imports with Russian equivalents remains at the center of the Russian leadership’s approach to the crisis. Prime Minister Medvedev asked his team to develop an anti-crisis program based on import substitution by April 1, 2015, making the following comments:9

“First we need to maintain macroeconomic and social stability, create conditions for industrial and agricultural development, [and] proceed with innovations.”

“Ultimately, it is necessary to create conditions for sustainable economic growth, although under the present conditions, it is a very difficult task.”

Medvedev also stated that strategic companies would begin to receive government support within two weeks. He promised that funding for import substitution would total $300 million in 2015. This is far less than the $20 billion allocated for the “real sector” in 2009. Meanwhile, regions were instructed to reduce taxes at the same time that control over their use of budget funds would be tightened.10

Not only is less funding available, but import substitution will be far more difficult in 2015 due to the changed character of Russia’s import dependency since the mid-2000s, and especially since the 2008 crisis. While in the first seven years after 1998 Russia imported primarily consumer goods, since 2006 the share of intermediate goods used by Russian industry to produce final products has increased significantly.11 If Russia’s thin integration with global industrial and financial activity proved beneficial in 1998, today the country is more integrated, and therefore far more dependent on the global economy.

In 2006, Russian industry depended on imports for 8.5% of its production inputs. By 2013, this proportion had increased to 14.7%. The overall number, however, conceals the full impact of Russia’s foreign dependency in key sectors. In machine building, the crucial element in industrial renewal, the dependence on imports rose from
13.4% in 2006 to 36.5% in 2013. In communications equipment during this period the increase was from 7% to 22.3%. The only category in which dependence on imported producer goods did not increase was in consumer goods. This suggests that efforts at import substitution will require major investment, yet the anti-crisis plan publicly announced in early 2015 did not include substantial funds for this purpose. Indeed, aside from defense, agriculture and social programs, government expenditures are to be reduced by 10% across the board. At one former priority project, Skolkovo, purchases of foreign scientific equipment have been reduced by half.

The most rapid growth in dependence on imported producer goods occurred in 2006-7 and 2010-11, when the ruble strengthened. The increase in dependence slowed, but was not reduced, when the ruble weakened in 2013. In 2014-15 import substitution was nil despite slowing economic growth and the weaker ruble. Thus, the Russian economy’s dependence on imported production goods when the ruble weakens can become a major limit on economic growth.

Russian enterprises have sought to compensate for technological backwardness by purchasing higher-quality imported inputs. This growing dependence stems from producers not carrying out technological modernization, mainly due to lack of interest or insufficient funds. In some areas of machine building where Russia is less dependent on imported producer goods, like metal-cutting machinery, the explanation is that higher-quality foreign imports of final products have captured the Russian market. A weaker ruble will not help these sectors.
In the raw materials sector, dependence on imports is less pronounced, but remains high in areas that require advanced technology, such as chemicals and rubber/plastics. While the chemical industry overall appears relatively self-sufficient, with imports accounting for just 17.3% of inputs, in more advanced technologies dependence remains quite high. For pesticides and other agricultural chemical products imports constitute 74%; in pharmaceutical products imports account for 48.4%.\textsuperscript{15}

For many products, substitution carries the threat of either higher prices or lower quality. Russia’s place in the international division of labor remains problematic. Technological backwardness represents a serious drawback. Russia desperately needs modernization, which requires activating investment and entrepreneurship. During his presidency, Dmitry Medvedev spoke of this constantly, but nothing significant was accomplished. Rather, the shift from buying finished goods to purchasing components for production has caused dependence on imports to increase.

To successfully carry out import substitution, Russia needs quickly to achieve a series of difficult and expensive reforms. These include:\textsuperscript{16}

- modernizing production
- increasing the share of value-added production generated in Russia
- reducing the impact of currency value on enterprise financial-industrial indicators
- closing the gap between lagging high-technology industrial production and Russian raw material producers using modern technology
- creating the basis for non-raw-materials production
- shifting from raw material production to providing financial and technological support to other economic sectors.
Import Dependence and Sanctions: Implications for Russian Energy and Defense

The Russian energy sector is particularly exposed to dependence on imports: Russian companies import 56% of the equipment used for horizontal drilling and 93% of equipment used for hydraulic fracturing. An equally large reliance on western technology characterizes drilling in the Arctic region. A large-scale joint project between Rosneft and ExxonMobil in the Karsk Sea was suspended amid the Ukrainian crisis, and development of Arctic resources has been delayed indefinitely. While the sanctions harm everyone, the decline in oil prices has made the impact quite uneven. Lukoil’s Leonid Fedun predicted that sanctions would mean a decline of 7% per year in production at Russia’s number two oil producer over the next 4-5 years. This may have been a cry for help, given that Lukoil profits were down 50% in the 3rd quarter of 2014.

The problems in the energy sector predate the sanctions, and if the sanctions regime ended tomorrow it would not significantly improve the situation. The fundamental difficulties are inefficiency and the quality of state management:

As is frequently the case in Russia, the fundamental problem is seen as external, although the main source of problems is internal. Low efficiency is the key risk for the fuel-energy sector. Low efficiency is due to various causes: excessive state control, corruption, an ineffective tax system, lack of small and medium innovative firms in prospecting, non-transparent licensing, and a shortage of qualified staff.

Additional detail about the effects of the sanctions comes from thorough studies by Russian economist Vladimir Faltsman. In his account of the defense and fuel-energy sectors, Faltsman reinforces the descriptions of growing dependence on imported components for crucial Russian production. He notes that much of Russia’s innovation capacity is located in the defense industrial sector, while the entire
economy relies on the energy sector for financial well-being. The sanctions affect 68% of the imports used in the oil and gas sector. Russia depends on South Korea for 90% of drilling platforms.  

The situation in the defense sector is more varied, but in the crucial area of electronics, a persistent Russian bottleneck, it is fraught. Some 65-79% of the electronics used in Russian missiles and space rockets are imported. Russia produces no drones, and all of the piston motors used in these aircraft must be imported.

Even without American and European sanctions, the conflict with Ukraine was creating serious problems for the Russian defense sector. The list of components produced in Ukraine includes motors for civilian and military helicopters, as well as several types of warships. While some and perhaps many of these components could be produced in Russia, it will require time and money to replace the imports. Faltsman estimates that replacing the Ukrainian contribution alone will require a minimum four years and $20 billion in state expenditures. Other Russian experts, speaking off the record, suggest that the situation will be even more difficult, with enterprises like Yuzmash no longer able to fill Russian orders.

**Conclusion: A Bleak Prognosis for Reform**

Most observers believe that any help for business provided by the Russian government will go to large state corporations and favored insiders. While paying some lip service to developing small and medium-sized business, the Kremlin has done nothing to ameliorate widespread predatory behavior. The result has been a significant increase in “non-creative destruction.” Russian entrepreneurs are putting their businesses up for sale at unprecedented rates, with advertisements for sales in 2014 increasing 14 times compared to the same number in 2013. A growing number of Russians are relocating their families abroad and moving their business activity out of Russia, with London being a favored destination. In 2010, 33,578 people left Russia. In all of 2013 the number was 186,382. In the first nine
months of 2014 this rose to 203,000.\textsuperscript{24} The government’s program to counter offshoring of Russian business has exacerbated the situation. Recent studies document how the Russian labor market fails to create turnover that might provide labor for new businesses. Workers receive up to half their remuneration in the form of bonuses, which may be withheld when the economy (or the firm) experiences difficulties. Unlike the widespread practice in the United States of making workers redundant, Russian firms keep them employed but reduce their hours or wages. This permits workers to avoid unemployment, but also prevents optimizing placement and skill acquisition for the labor force. The workers remain at enterprises that do not grow, but also do not die. Productivity does not rise in this environment.\textsuperscript{25}

The alternative to raising productivity at existing enterprises is to move workers to more productive sites or add workers to the labor force. However, the priority of avoiding unemployment means that few workers become redundant. They acquire no new skills through retraining programs. Russia’s demographic situation means the country will experience an unprecedented decline in the working-age share of the population over the next two decades. Labor shortages and skill shortages are already causing problems.

Labor practices are leading to a devaluation of human capital, as labor in the Russian economy becomes more primitive with the expansion of the less productive informal sector. Both business and the state share responsibility for this development. Businesses failed to invest in modernization or new businesses formation in the 2000s, preferring to invest in the stock of existing companies, including foreign investments. The government, while trumpeting a program to create 25 million high technology jobs, spent its windfall income on foreign securities.\textsuperscript{26}

The crisis is also creating massive problems in sectors crucial to Russia’s future development, particularly science and education. Internationalizing research and development (R&D) and education
has become a significantly more expensive task. Education itself is undergoing massive price inflation for officially listed services. While it is too early to have much data on the side payments for admission and successful progress, the chairman of the Duma Committee on Education Vladimir Burmatov noted increases of 30-35% in the prices charged at higher education institutions, with some illegally demanding that students pay in a hard currency rather than rubles.27

In sum, Russia’s economic problems are long-term and structural. These problems cannot be solved by printing money or waiting for higher oil prices. Serious reform may be impossible without replacing key people responsible for economic policy, but long-term Putin associates – such as Gazprom CEO Alexei Miller and head of Rosneft Igor Sechin – appear immune to turnover. The circle with access to President Putin has narrowed, while economists proposing needed policies have minimal influence on Russian policy-making. While the war in Ukraine by itself is not a major financial burden on the government, the impact of sanctions combined with an outmoded growth model, low oil prices and pervasive corruption suggest that Russia faces a long and deep economic crisis.
Notes

1 The currency depreciation does cut two ways. Putin is correct that Russia’s foreign currency exports will represent more rubles, making it easier to balance the budget. But the positive ramifications are likely to be more than offset by higher prices for more imports, including food and critical components of a range of industrial products.


7 In one illustrative example, the journalist and author Peter Pomerantsev recounts the story of a woman entrepreneur, Yana Nikolaevna, who fell victim to an attempt by then-head of the state’s narcotic control Viktor Cherkessov to corner the chemical and pharmaceutical industries in Russia in Nothing is True and Everything is Possible: The Surreal Heart of the New Russia (New York: Public Affairs, 2014), pp. 79-104.


10 Ibid.

11 Olga Berezinskaia and Aleksey Vedev, “Proizvodstvennaia zavisimost rossiiskoi promyshlennosti ot importa i mekhanizm strategicheskogo importozameshcheniia” (The Russian Industry’s Import Dependence and the Mechanism of Strategic Import Substitution), Voprosy ekonomiki, No. 1: January 2015, pp. 103-115.

12 Ibid, pg. 104.

13 Ibid.


16 Ibid. This article has been cited extensively due to the influence both authors have
on Russian economic policy. Bereziskaia is at the Russian Presidential Academy of National Economy and Public Administration while Vedev is Deputy Minister of Economic Development.

17 Petr Kazantsev, “Sanctions are Slowly Working, or Russia in the Oil Trap,” Slon.ru, December 12, 2014.

18 Ibid.

19 Ibid.


21 Ibid, pg. 119.

22 Ibid, pg. 188.


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