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Can Russia live up to its geopolitical ambitions?

Russia's geopolitical influence is at its highest level since the end of the cold war and fall of the Soviet Union nearly thirty years ago. Russia has partitioned Georgia (2008), annexed Crimea (2014), stopped Ukraine from joining the European Union and NATO, and kept the Assad regime in power in Syria. Russia has also been accused of meddling in the 2016 U.S. presidential election by bombarding websites with fake news.

Though Russian President Vladimir Putin has proved a very shrewd geopolitical tactician, he faces many challenges. For one thing, Russia's long-term structural economic weaknesses are at odds with its geopolitical ambitions. There is also the risk that the cost of these geopolitical successes may ultimately outweigh their benefits.

Will Russia's geopolitical victories turn into losses in the long run?

Ukraine: Russia's geopolitical redline

After the fall of the Berlin Wall in 1989, Russia's sphere of influence shrank drastically as former satellite states and Soviet Republics joined NATO and the EU. In an attempt to stop it from shrinking further, Russia took a firm stand against Ukraine also joining NATO and/or the EU. Some analysts have pointed out that Russia's concern would be similar to America's if Canada ever decided to join the alliance of a powerful geopolitical competitor.

Despite having annexed Crimea and ignited a rebellion in much of eastern Ukraine, Russia has not succeeded in bringing Ukraine back under its thumb. In fact, some analysts have argued that Crimea's annexation has freed Ukraine of its most pro-Moscow region and, in turn, has made it much easier for anti-Russian forces to consolidate control of the rest of the country.

Syrian mission creep

While Russia has managed to keep Assad in power in Syria, this victory could become increasingly costly for two major reasons. First, there is the question of when and how to pull out. Indeed, it is difficult to imagine a Russian exit from Syria that does not leave Assad vulnerable. Second, supporting the Assad regime is growing ever more costly. Russian efforts to get Western countries to help finance reconstruction will continue to fail as long as Assad remains in power. The United Nations estimate reconstruction costs to be at least \$250 billion.

Meddling in U.S. elections

In hindsight, Putin's decision to meddle in the U.S. elections will be seen as unwise because it had the effect of refocusing the attention of U.S. intelligence services and of both Democrats and Republicans on Russia.

The U.S. response to Russian actions

While many western countries have imposed sanctions on Russia, the U.S. response has been particularly harsh. Indeed, despite Trump's conciliatory rhetoric, his administration has been much tougher on Russia than any other in the post-Cold War era.

Almost 700 Russian nationals and companies have been subjected to U.S. sanctions. Travel restrictions have been imposed on individuals and their assets held abroad have been frozen, while certain Russian banks and energy companies are for all intents and purposes barred from obtaining financing through the U.S. financial markets. What's more, congressional approval is required to undo many of these sanctions.

The most recent U.S. sanctions have been imposed in response to the alleged chemical attack by Russia (which it denies) against a former agent in the UK. Effective August 22, restrictions will apply to U.S. exports of certain technological and industrial goods. Unless Russia agrees within 90 days to stop all use of chemical weapons and to permit inspections to confirm their elimination, the law will require the United States to choose from a range of additional measures, including the suspension of Aeroflot flights to the United States and further restrictions on financing from U.S. banks.

Other moves indicative of a much harder line against Russia include increasing U.S. defence spending, stationing U.S. troops in NATO countries close to the Russian border, delivering U.S. anti-tank weapons to Ukraine (something Obama refused to do), and killing hundreds of Russian mercenaries during clashes with a pro-Assad militia last February.

The weaponization of the U.S.-dominated financial system

Since taking office last year, U.S. President Donald Trump has intensified the use of draconian economic sanctions to target geopolitical adversaries. Though the strategy has proved highly effective, the more the United States employs these measures, the more likely it is that countries will intensify their efforts to reduce their reliance on the U.S. financial system.

Russia's relatively small economy at odds with geopolitical ambitions

Despite being endowed with natural resources, a large landmass and a well-educated population, Russia has a surprisingly small GDP. For example, on a purchasing power parity basis, its economy is only about 20% the size of America's despite having a population that is 44% as large.

Russia spends the equivalent of over 5% of its GDP on defence, compared with just over 3% for the United States. However, Russia's much smaller economy means its military budget comes in at about \$70 billion, versus \$700 billion for the United States.

Thanks to the implementation of certain reforms and, more importantly, to high energy prices beginning in the early 2000s, Russia was able to bring its economy back from the abyss. However, since 2008 the economy has struggled to grow. Russia's GDP expanded 1.5% in 2017 and is projected to grow only 1.7% this year. If oil prices fall again, growth will be even weaker.



Source: "Business behind bars: the judicial threat to Russian growth," Financial Times, August 9, 2018

Oil and gas generate 30% of the country's GDP and 50% of budget revenues.¹ The breakeven price of oil for the Russian federal budget is about \$60 per barrel.²

¹ "Russia's economy: Still dependent on oil," Euractiv, March 22, 2018

² "Sanctions-Proofing Russia Helps Keep Economy Chugging Along," Bloomberg, August 9, 2018

Despite the rise in crude oil prices, the ruble has fallen over 14% this year against the USD. This is due to the impact of U.S. sanctions and to fears that Turkey's currency woes could spread to Russia.

The Russian ruble's deepening slump

Russia rubles per USD



In an attempt to counteract the impact of sanctions and to prevent the ruble from declining further, the government is considering raising its benchmark interest rate of 7.25%. While this high rate has helped inflation stay in the low single digits, it has also prevented the economy from growing more strongly.

Another factor weighing on economic growth is the fact that state ownership of the economy has gone from about 35% in 2000 to between 50% and 70% today.³ Such a level of state ownership in a country struggling with corruption means many business decisions are being made for political rather than business reasons.

Russia's finances in relatively good shape

Debt is one area where Russia appears to be on more solid footing. Its ratio of public debt to GDP is only 13%, which is much lower than any of its European counterparts. Its ratio of external debt to GDP is 33.9%, which is also fairly low compared with the ratios of emerging-market economies such as Turkey, Argentina, and South Africa.

Russia's central bank is also slowly rebuilding its foreign reserves after almost \$150 billion were spent in 2014 and 2015 propping up the ruble after oil prices collapsed and the first wave of international sanctions took effect following the annexation of Crimea. Its total reserves are now worth \$458 billion, compared to \$513 billion in July 2013.⁴

Russia's banking sector, however, constitutes a potential risk. In 2017, the central bank took control of three large private banks burdened with bad debt at a cost of \$44 billion and counting.⁵

Rapidly aging population another risk

After hovering around 144 million for a decade, Russia's population is once again shrinking. Without a sharp increase in the birthrate or immigration, its population will drop to as low as 119 million by 2050, according to a United Nations estimate.⁶

In addition, Russia is also dealing with a persistent brain drain. About 350,000 (mostly highly educated) Russians emigrated from their home country in 2015, a tenfold increase from 2010.⁷

³ "Putin, or the World? Sanctions May Force Oligarchs to Choose," *New York Times*, April 11, 2018

⁴ "Russia keeps getting hit with sanctions. Do they make a difference?," *Washington Post*, August 22, 2018

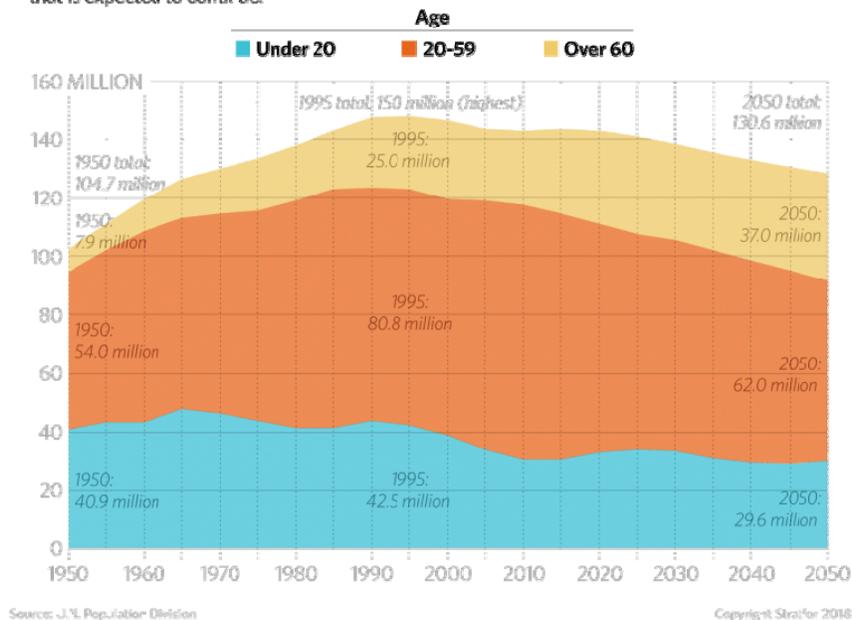
⁵ "Russia: Political news overshadows economic performance," *Deloitte Insights*, April 8, 2018

⁶ "World War Still Haunts Putin as Population Decline Taxes Economy," *Bloomberg*, April 4, 2018

⁷ "Vladimir Putin Is About to Win a Fourth Term," *Time Magazine*, March 16, 2018

Russia's Population Distribution

As the number of working-age Russian has shrunk, its elderly population has increased, a trend that is expected to continue.



Source: "In Russia, a Dilemma for the Ages," Stratfor, July 12, 2018

Russia pushed into the arms of China

Surging tensions between the United States and Russia have had the unintended effect of pushing Russia into a closer alliance with China. This partnership has been strengthened by their shared opposition to the U.S.-dominated global order and by the fact that they have both been hit by U.S. tariffs and/or sanctions.

Their interests do diverge on key matters, however. Most significantly, Russia is an oil-exporting country and favours high oil prices whereas China is a major oil importer best served by the lowest possible prices.

This divergence in interests is highlighted by the fact that China took advantage of Russia's strained relations with the West and its urgent need to build up its energy exports in areas beyond Europe to do two things: 1) negotiate a significant price discount for natural gas; and 2) successfully demand that the recently built gas pipeline from Siberia runs through eastern China, thus ensuring that it would not be profitable for Gazprom to use the pipeline to deliver gas to other countries.⁸

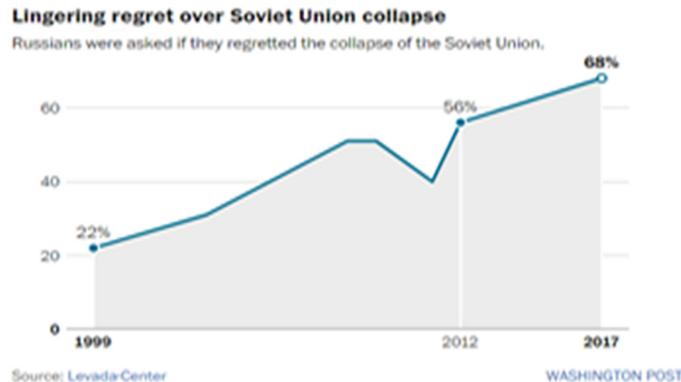


Source: "Russia's \$55bn pipeline gamble on China's demand for gas," Financial Times, April 3, 2018

⁸ "Russia's \$55bn pipeline gamble on China's demand for gas," Financial Times, April 3, 2018

Why is Putin so popular?

The vast majority of Russians remain grateful to Putin for having brought stability and some measure of economic prosperity after the massive economic hardship and political chaos that followed the collapse of the Soviet Union in 1991. Also, after seeing their borders shrink to where they were in the early 18th century, they view the annexation of Crimea as both the correction of an historical injustice and a restoration of some measure of national pride. Furthermore, many Russians—no doubt influenced by government-controlled media—blame the West for Russia’s political and economic difficulties.



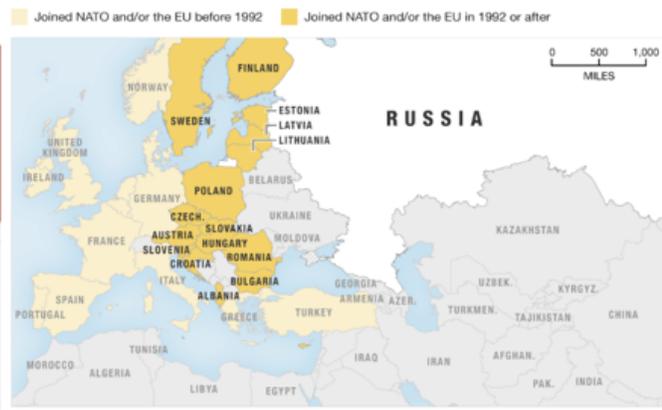
“9 charts that lay out Russia’s uncertain future – with or without Putin,” Washington Post, March 16, 2018

How would any country react to losing so much territory?

The Soviet Union In Its Prime



The EU And NATO Move East



Source: “Latvia’s Ex-President: ‘We Have to Worry’ About Russia,” NPR, April 2014

However, Putin’s popularity has recently taken a hit. The Levada Center, a Russian polling organization, found that only 67% of Russians approved of Putin in July 2018, down from 82% in April. One of the potential factors behind this drop is the government’s proposal to increase the retirement age from 60 to 65 for men by 2028 and from 55 to 63 for women by 2034. This new retirement age would be only one year lower than the current average life expectancy of 66 years for men in Russia, which is 15 years shorter than the average life expectancy for men in Germany and Italy.

Conclusion

Russia's recent string of geopolitical victories comes nowhere near to making up for its relatively small economy. Indeed, thanks to a lack of economic reforms, an over-reliance on fossil fuels, excessive state intervention, an aging population, and corruption, Russia faces decades of slow growth. Successive waves of sanctions only add to the headwinds already facing Russia. Russia's central-bank chief, Elvira Nabiullina, stated as much recently: "Even if the price of oil rose to \$100, from around \$65 today, it's very unlikely that our economy can grow above 1.5% to 2% a year."⁹

Given Russia's large landmass, strategic location and massive nuclear arsenal, the challenge for the West, and in particular the United States, is to find a way to balance the need to restrain Russia without squeezing it so hard as to cause its economy to tank and regional tensions to even further worsen.

Another major risk is that China and Russia overcome their historical suspicion of one another to form a durable alliance able to challenge the United States and the West on several fronts, including greater efforts to shun the dollar in their trade relationship.

Angelo Katsoras

⁹ "Putin's Unlikely Ally in His Standoff With the West: His Central Banker," Wall Street Journal, August 20, 2018

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