



# NDC Research Report

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## WHAT MID-TERM FUTURE FOR PUTIN'S RUSSIA?

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### I. Point of Departure

For 16 years – more than the equivalent of three American presidential terms – Russian President Vladimir Putin has been presiding over the largest nation on the globe, one in possession of the world's most powerful nuclear arsenal and massive natural resources. Yet there is still debate about who he really is, what his intentions are, how long his rule could possibly last and whether Putinism will outlive his departure. Russia's growing assertiveness vis-à-vis its neighbours and former partners in the West has, thus far, culminated in its annexation of Crimea as well as in a stand-off over Ukraine. This, together with the Kremlin's military muscle-flexing and anti-Western rhetoric, has reinforced the widespread perception that Putin has increasingly become unpredictable, aggressive and thus dangerous for the West. For these reasons, the question of Russia's mid-term future has become ever more pressing.

More broadly, this assessment is focused on two sets of questions:

First: Following Moscow's annexation of Crimea and destabilizing actions in Ukraine, how stable is the current Russian political regime? What are the main drivers of President Putin's future course of action and what type of challenges will he have to face at home in the next 12-18 months? Are there serious challengers to his rule and if so, how strong are their ambitions to create the political grounds for a post-Putin order in Russia?

Second: In light of Western economic sanctions against Russia, which are the most important challenges that the Muscovite leadership has to cope with in the socio-economic domain? Are any of those challenges prone to become game changers, encompassing the potential to trigger disruptive change(s) in Russia in the mid-term future? And how do these challenges affect Putin's ability to remain in power?

Overall, this analysis is geared to help create a plausible scenario for Russia's mid-term future, which should be useful for political decision-makers who are contemplating how to frame the West's future engagement with Russia.

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## II. Putin's Russia Today—and Tomorrow

Russia in 2015 is not a united, forward-looking country but a nation full of contradictions. Under Putin's rule, Russia has grown wealthier but has become more fragmented and feudal. It has Europe's largest online presence and one of the world's biggest social media markets, but its society and political opposition suffers from one of the most rigid and repressive regimes. Russia's real income increased by 140% in the last decade, but it ranks 160<sup>th</sup> out of 175 countries in the International Monetary Fund (IMF) corruption index. While elements of the old Russian and Soviet political cultures still prevail and influence state-society relations, as well as the defence and economic spheres, there are nevertheless small pockets of change, in particular among the young, urban middle class and political activists in the regions.

In late 2011 and early 2012, those pockets almost caused the tectonic plates underlying the Russian political order to shift. An emerging urban middle class that had grown confident and increasingly politically sophisticated was demanding change. The elite was divided between technocrats advocating political reform and economic modernization and hard-liners seeking to maintain the status quo, and Putin himself seemed to be losing his aura of invincibility. His vital role as "The Decider" – a trusted broker among elite factions – appeared to be in jeopardy. There was even talk of a battle of succession emerging among his most trusted lieutenants. And Russia's economy, heavily dependent on energy exports, appeared headed for a deep recession. Taken as a whole, it looked like a perfect storm, creating hope that Putinism could, at some point in the future, exhaust itself.

Putin rightly sensed that the situation had become dangerously shaky, and decided to strengthen his position by achieving some "successes" abroad, by "bringing Crimea home to Russia" and fostering the narrative of "Russia's patriotic awakening." Now, with nationalist fervour unleashed by the annexation of Crimea and the Ukraine crisis, he has re-emerged as Russia's ever stronger leader.

### *Authoritarianism and Inner Circles*

Over the past 16 years, Putin has been able to remain in power mainly because he successfully managed to strike a balance between the various competing interest groups that jointly control the country's main strategic assets. This "give-and-take" system allowed Putin to accomplish two core objectives: first, to have a free hand in consolidating the country, primarily strengthening Russia's defence, bolstering government revenues, stabilizing the economic system and suppressing dissent, whether from the political opposition or from militants in the Muslim Caucasus, and second in transferring the country's economic, financial and energy assets to a small group of people that is neither accountable to the government and/or the parliament nor enjoys any form of democratic legitimacy. Preserving and strengthening the political system that he has created was, is and will be the top priority for Putin.

Under Putin's current presidency, Russia has now almost fully turned into an authoritarian state, making the modernization efforts of former President Dmitry Medvedev a thing of the past. In today's Russia, there are no checks and balances that could effectively limit presidential power. The Kremlin has direct control over the executive, legislative and judicial bodies. Similar to the Politburo in the former Soviet Union, the Presidential administration prepares and takes all important policy decisions, reducing the role of the Prime Minister and his cabinet to recipients of the President's instructions. Whereas Putin stages his public appearances with imperial pomp, underscoring that he is the ultimate holder of Russia's "vlast" (the source and owner of state power), Prime Minister Dmitry Medvedev has to take the blame for the government's poor performance.

Putin's inner circle is composed of a number of top oligarchs, best friends, senior officials and directors of state corporations. Many of them have personal ties to Putin dating back to the years they spent together in St. Petersburg; others have only been selected by Putin for tactical, short-term purposes, and others simply belong to the various groups because of their immense personal wealth. Overall, the members of Putin's

power structure lack any firm ideological belief. Their principal objective is to ensure continued access to the country's economic-financial resources and political power, allowing them to enhance their personal wealth and position as well as those of their supporting networks. In this sense, the Kremlin's current power structure can best be visualized in a spider diagram with Putin as the key manager and ultimate decision-maker. The key advantage of this inner-circle system for him is that none of its members have a realistic chance to challenge his rule: they all owe their power, positions and personal wealth to him.<sup>2</sup>

Since early 2014, not everyone seems to be happy with the president's current course of action. Due to the current sanctions regime, some of Russia's oligarchs have suffered substantial financial losses owing to the decrease in value of their shareholdings in various Russian companies and banks. Alischer Usmanov, Vladimir Lisin, Mikhail Prokhorov, Mikhail Fridman and many other top business people are said to be among them. Understandably, they not only fear the impact of more Western sanctions on their companies but are also concerned that Putin could soon decide to halt their attempts to secure their money outside Russia. Other members of Putin's inner circle appear to be worried about remaining "on a boat that could eventually sink": ex-Finance Minister Alexei Kudrin openly distanced himself from "the current anti-Western rhetoric", arguing that Russia's growing international isolation would "seriously damage Russia's business interests."

At the end of 2014, Putin gave a compelling example of how he seeks to handle "unpatriotic" business leaders. The Kremlin placed Vladimir Yevtushenkov, chairman of the Sistema conglomerate, under house arrest on charges of money laundering in connection with Sistema's acquisition of the Bashneft oil company. Only Rosneft CEO and close Putin ally Igor Sechin stands behind these accusations. Sechin had approached Sistema about the possible sale of the Bashneft oil company. Reportedly, Yevtushenkov declined Rosneft's offer to buy Bashneft because he considered the initial offer too low. The case against Yevtushenkov is indicative, because he did not challenge Putin's regime but was part of the system. He was a politically loyal businessman who played by the rules, but the attack against him was provoked by his unwillingness to make sacrifices "for the good of the Motherland" – an alarming signal for the Russian business community as well as for foreign investors. His arrest demonstrates that the economy is entering a "state of siege" in which all relations are governed in the interests of the "key players" whose survival guarantees the stability of the regime.

### ***Vertical Power***

While Russia, according to its constitution, is a federal state, the Kremlin has turned the so-called "vertical power" structures into an effective instrument to control and direct the country's 85 regions, which are all dependent on Moscow's financial subsidies. Per his own presidential decree from 2000, Putin can appoint his personal envoys to the now eight federal districts. The regime has few problems in ensuring that the posts of 85 governors and other key posts in the regions are filled with obedient Kremlin cronies. A recent example thereof is the regional elections held in Russia in September 2014, which resulted in victory for the United Russia party. In the race for governors' seats, the ruling party candidates scored an average of 77.2%, a record number since the return of direct elections. But the picture of United Russia's triumph was marred by a low turnout in many regions. In central Russia, only 25–30% of voters went to the polls, about as many as in the Far East. The capital experienced a record-low turnout: only 21% of Muscovites turned out to elect the Moscow City Duma deputies. During the voting, party observers noted more than 1,500 violations: in St. Petersburg, for example, the two United Russia candidates miraculously received 103% and 117% of the vote.

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<sup>2</sup> At present, Putin's most influential associates include top Presidential administration officials Sergey Ivanov, Vyacheslav Volodin and Yevgeny Shkolov; Deputy Prime Minister Dmitry Rogozin; Rosneft chief Igor Sechin; the head of the Investigative Committee Aleksandr Bastrykin; heads of state corporations and companies like Vladimir Yakunin (Russian railways) and Sergey Chemezov (Rostekh), as well as private businessmen who accumulated fortunes thanks to Putin's backing, such as Yuri Kavalshuk, Gennady Timchenko, and Arkady Rotenberg.

## ***Russia's Patriotic Surge***

The “2014 - Year of Russian Culture” campaign was one of the latest Kremlin-sponsored efforts, aimed at strengthening a broader surge of Russian patriotism and nationalism that is geared toward mobilizing Russian society and inspiring future generations. The glorification of the country's tsarist and Soviet history has become a key priority for the Kremlin, supported by patriotic organizations that have mushroomed across the country. One of the main bodies responsible for steering and promoting Russia's patriotic pivot is the “Directorate for Social Projects.” Created in 2012 as part of the Presidential Administration, it is tasked to “strengthen the spiritual and moral foundations of Russian society” and to improve “government policies in the field of patriotic upbringing.”

Putin first sketched out the contours of his patriotic project at his state-of-the-nation address in December 2012, leaving little doubt that he sought to make Russian patriotism the ideological cornerstone of his future policies. “Russian society today is experiencing an obvious deficit of spiritual bonds,” he said during the address, adding that his fellow countrymen should draw “inner strength” from their 1,000-year history. “We must not only develop confidently, but also preserve our national and spiritual identity, not lose ourselves as a nation. To be and to remain Russian,” he said, quoting former Soviet dissident Alexander Solzhenitsyn, is a “natural, organic feeling.”

Since his speech in late 2012, Putin has restlessly stoked patriotic sentiments throughout the country: by attending military anniversaries, renewing calls for the Russian Orthodox Church to “anchor the moral framework of public life and national statehood,” praising the creation of a new patriotic core group (Siet – network) within the pro-Kremlin youth movement “Nashi”, and sanctioning patrols by brigades of Cossacks to help “maintain law and order.” He even shared some of his personal favourite early 20th century philosophers – Nikolai Berdyaev, Vladimir Solovyev and Ivan Ilyin – with his countrymen, advising Russia's regional governors and United Russia leaders to read these authors during the 2014 winter holiday. The main message of these authors is Russia's messianic role in world history, the preservation and restoration of Russia's historical borders, and the unique role of the Russian Orthodox Church.

Putin's vision of Russian patriotism is clearly framed by anti-Western and anti-liberal ideas, against which the “Russian civilization” must guard, be it through enhanced “patriotic education” or the banning of foreign languages from Russian schools. One of the latest draft laws that his Minister of Culture, Vladimir Medinsky, has put to the State Duma aims at “the protection of Russian children against unpatriotic (i.e. Western-liberal) information”. In the absence of any other compelling vision for the country's future, the Kremlin's nation-wide patriotic surge is likely to last.

## ***Russia's Political Parties***

Putin's ability to maintain the political status quo is also due to Russia's weak and anachronistic party system which, with the slight exception of the Communist Party, does not offer any convincing alternative vision for the country's future. In the past, the lack of any strong political competitive force helped Putin to create party-like organizations like United Russia in order to mobilize Russian voters and ensure a comfortable majority in the State Duma. The United Russia faction holds 237 of the 499 seats in the Russian parliament, allowing Putin to receive legislative support for whatever he wants.<sup>3</sup>

Clearly the Kremlin has its own, very special view of what should constitute political pluralism in Russia. Since it was forced to introduce some liberal revisions of the electoral laws in 2012 (following the series of public protests), the overall number of parties has reached 77. However, there has been no increase in competition among parties. In order to prevent such competition from developing, the Kremlin has gone to great lengths. It has successfully created or facilitated the creation of both right-wing and left-wing “patriotic” parties (for example, the Right Cause Party and the Patriots of Russia Party) and has forced

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3 The Russian Communist Party holds 92 seats, the Just Russia party 64 seats and the LDPR 56 seats.

the opposition to compete with spoilers and multiple mini-parties, the names of which confuse voters. The government can meet with the leaders of these parties in the Kremlin, listen to their proposals, and invite them to State Duma meetings without worrying about them causing any trouble. In most cases, these parties are built around a “nobody”, surrounded by a couple of his or her political consultants.

With this practice, the Kremlin is evidently trying to secure itself against a new setback in United Russia’s poll standings by encouraging the appearance of a large number of political parties, of which only a few will stand a chance of gaining a seat in parliament. In the 2016 parliamentary elections, the regime will rely on candidates from single-member districts, who, in order to avoid the “crooks and thieves” label, will participate in elections as independent candidates. Real opposition parties and their candidates, on the other hand, will find it very difficult to obtain the right to take part in the elections.

Overall, the prospects for Russia’s small liberal opposition remain grim. First of all, the Kremlin will likely continue to suppress any form of political opposition. But even more, there is no leading figure that could mobilize Russia’s middle class, which is still small in size and not politically well-organized. Moreover, 35-40% of Russians who could be attributed to the middle class are state employees – the vast majority of them would not dare to fundamentally challenge the current political system.

### ***Repressive Legislation***

Since his return to the presidency in 2012, Putin has made intensive use of Russian legislation to restrict and, where possible, eliminate political opposition and dissent through enforcing a series of harsh laws. These laws increased the control of the internet, dramatically hiked fines for participating in unsanctioned street protests, expanded the definition of treason, and branded nongovernmental organizations (NGOs) that accepted foreign grants and engaged in vaguely defined “political activities” as “foreign agents.”

In June 2013, Putin signed a law introducing several legislative amendments directed at toughening Russia’s laws on fighting extremism. These include imprisonment for funding extremist activities and calling for extremism via the Internet. “Extremism” is a nebulous term, since in today’s Russia, any displeasure with the authorities is equated to extremism – especially if it is publicly expressed. For example, Grani.ru has been declared an extremist website. There were no court proceedings – officials from Roskomnadzor (the Federal Supervision Agency for Information Technologies and Communications) simply decided that the website was an extremist one, and ordered Russian Internet providers to block access to the online publication.

Russian citizens can now be sentenced to up to five years of imprisonment for inciting extremist activity through the Internet. More recently, on 26 September, the State Duma passed a draft law limiting foreign ownership of the country’s media to 20%. The text now has to be passed by the upper house, the Federation Council, and be ratified by President Vladimir Putin before it becomes law. If implemented, the law will require owners of media companies with foreign-owned stakes of more than 20% to lower these stakes by February 2017.

With the cooperation of the Russian Orthodox Church, the Kremlin has also sought to bolster its popular support by scapegoating immigrants and minorities in Russian society. In June and July last year, Putin signed laws that effectively outlawed lesbian, gay, bisexual, and transgender activism and expression, and banned gay couples in foreign countries from adopting Russian children. The government’s hostile stance has spurred a spate of homophobic attacks across the country, to which the state authorities largely reacted with indifference.

With the experience of the Ukrainian protests and other so-called “colour revolutions” in mind, the Kremlin is prone to add more restrictions and pressure on Russian opposition groups in the future. But it must not fear the emergence of a “Russian Maidan movement.” Thanks to the constant flow of state propaganda, most Russians think that their country is an island of stability and peace in comparison to neighbouring Ukraine, which they believe has sunk into chaos and anarchy.



## ***State Propaganda***

Over the last years, Russia has crafted a state media force which routinely circulates misinformation at home and abroad. To this end, Putin has restructured and invigorated the country's domestic and international media, investing over US \$1.6 billion annually. In March 2014, he declared that the newly created state media agency "Rossiya Sevodnya" bears "strategic importance for the country's security and defence." The results of the regime's investment to boost state propaganda are profound. Today's Russian media has reached levels of centralization and homogeneity which have not been seen since the days of the Soviet Union.

Domestically, Russian state media appears to be having the most tangible effects. Deprived of comparable alternatives, 70% of the Russian population turns to state-run television for news. Without competing narratives to contrast against the state's media, it becomes almost impossible for Russian viewers to decipher what is truth from what is speculation or fabrication. According to a 2013 Levada survey, almost two-thirds of the Russian population believes that Russian television provides an objective source of news. State-run channels such as the all-news Rossiya24 are complemented by NTV television, owned by Gazprom Media. Ren-TV and Channel 5 are owned by billionaire Yury Kovalchuk, a close adviser to Putin (and among the officials targeted by US sanctions). With this in mind, Putin can use state media to rally popular support for his political agenda – a technique which has been exemplified by the conflict in Ukraine.

Within this multifaceted approach, the Russian government has recently been investing heavily in an international television network RT, formerly known as Russia Today. Inspired by the state-controlled media of the Soviet regime, Putin's order aims at "making a concerted effort to break the monopoly of the Anglo-Saxon mass media" and to "illuminate abroad the state policies" of the Kremlin. The country now invests around US \$136 million each year just to influence public opinion abroad.

## ***Putin's Popularity***

Undoubtedly, Putin's "coup de Crimée" and the constant flow of patriotic state propaganda have enormously helped to bolster his popularity at home. In July 2014, a staggering 83% of Russians approved Putin's performance as President (his ratings already increased from 64% in December 2013 to 80% in March 2014). This is an 18% hike since the beginning of the year and just short of his 88% record, reached in September 2008, the month after Russia's war with Georgia over the pro-Moscow breakaway regions of South Ossetia and Abkhazia. In mid-September 2014, a poll by the Public Opinion Foundation found that Putin is seen as "Russia's highest moral authority." One third said no. Of the two-thirds of respondents who said yes, 36% see Putin as a shining beacon of morality.<sup>4</sup> Early in 2015, Putin's public support rate had not changed much and was still above 82%.

That Putin has always been especially popular when his country was locked in a military confrontation is no coincidence. During each of the three conflicts waged under his leadership – in Chechnya, Georgia, and now in Ukraine – Putin has tapped into Russian national pride and a deep-seated feeling that Russians are misunderstood and mistreated by the West. Before the crisis erupted in Kyiv last fall, his ratings had been at an all-time low. In September 2013, Putin's approval rates were at 61%. Even the Olympic Games held in February in Sochi, Putin's pet project, failed to boost his ratings by more than 3-4%. Interestingly, Moscow's assertiveness against Ukraine also boosted the approval ratings of Prime Minister Dmitry Medvedev (from 49% in September 2013 to 65% in May 2014) and the government (from 41% in September 2013 to 60% in May 2014).

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<sup>4</sup> Foreign Minister Sergey Lavrov and Defence Minister Sergey Shoigu lagged far behind, being considered moral authorities by 6% and 5% respectively. LDPR leader Vladimir Zhirinovskiy received 4%.

## ***Political Apathy***

It is seemingly one of the contradictions of modern Russia that, while public support for Putin is extraordinarily high, the majority of Russians are nevertheless politically indifferent. According to a sociological survey conducted by the Public Opinion Foundation in September 2014, the level of Russian civic engagement has dropped to nearly *zero*--a record low. Over the last two years, more than 90% of respondents could not express their civic or political position; 95% were not affiliated to any political party and did not support a particular politician by collecting signatures; 91% did not act as observers at elections; and 94% did not engage in campaigning against any legislative initiative. In other words, neither the notorious Dima Yakovlev Law that imposed a ban on Americans adopting children from Russia, nor the proposal to punish Internet users for using indecent language on the web, have stirred much discontent among ordinary Russians.

## **III. Maintaining Russia's Economic Growth**

Despite the successful consolidation of his power at home, Putin still faces a range of problems, most of which fall into the socio-economic domain. To avoid falling behind the economic development of other emerging powers, Russia would have to embark on a comprehensive reform programme, including institutional, regulatory, fiscal, labour market, financial sector, judicial, and many other reforms. Before the 2014 February events, there was already little political appetite among the Russian leadership to initiate far-reaching reform, chiefly because it would require taking on the vested interests of some key power factions and individuals close to the president. Now, with growing political and economic pressure from the West, Putin and the conservative-statist political forces close to him will feel even less inclined to initiate far-reaching socio-economic reforms.

But the Moscow leadership will have to find some answers to Russia's pressing economic problems if it wants to sustain at least a small degree of economic growth. The economy already started to slow down in 2012, growing by just 1.3% (instead of the 3.5% forecast). In June 2014, the Russian government announced that it would raise its annual growth forecast from 0.5% to around 1%, but in July 2014 the International Monetary Fund (IMF) downsized its estimate by 1.1 points to just 0.2% growth.

Russia's economy is heavily dependent on exports of crude oil, natural gas and petroleum products, which, in 2013, represented 68% of all Russian exports. Without the revenues from oil and gas exports as well as the related taxes and tariffs, Russia's state budget would suffer a deficit of 10.2% of GDP. The flip side to Russia's dominance of the energy sector is not only the vulnerability of global oil and, to a lesser extent, gas prices; it has also weighed on the development of those sectors where productivity growth tends to be fast, notably manufacturing. The huge earnings from oil and gas exports have led to a sharp increase in Russia's real exchange rate over the past decade, which, in turn, has made it harder for manufacturing companies in other economic sectors to compete internationally. Subsequently, Russia's manufacturing sector has declined steadily in recent years. Moreover, Russia's large dependency on oil and gas has undermined long-term sustainability of the country's public finances. The non-oil budget deficit has now widened to 10% of GDP, from just 4% a decade ago.

The fall in oil prices over the past year poses another headwind for Russia's struggling economy. The price of Urals crude, which is Russia's main export blend, fell from US \$114 per barrel in June 2014 to below US \$50 a barrel for the first time since May 2009. A major concern for Russia would be for oil prices to fall further and then stay low for a prolonged period. This is a realistic possibility and is a key reason to expect Russia's growth to remain extremely weak over the coming years. Russia loses about US \$2 billion in revenues for every dollar fall in the oil price, and the World Bank has warned that Russia's economy will shrink by at least 0.7% in 2015 if oil prices do not recover.

Russia's infrastructure is largely outdated and requires thorough modernization. Due to the lack of

adequate transportation means and capacities (airports, ports, electricity, highways, trains) Moscow's state budget loses 7 to 9% every year. Up to 2030, the government will seek to invest US \$125 billion in large infrastructure projects, but it is doubtful that Russia will be able to improve the precarious situation in the mid-term future.

While consumption rates remained rather high between 2011 and 2013, the country's industrial production rates continue to be low (in comparison to Brazil, South Korea, China or other emerging economies). As an example: Russia imports 100% of all mobile phones, 95% of all computers, 85% of all aircraft and 70% of all medical products. A main factor that constrains productivity growth is Russia's large number of inefficient companies. Much of Russia's industrial capacity was built during Soviet times and is now outdated. One example of this is Russia's "mono-towns" – towns employed by one factory that is often loss-making and propped up by government subsidies.<sup>5</sup>

Since 2007, the Russian economy has suffered from a shrinking labour force. Admittedly, the decline in the working age population has been mitigated by increased immigration into Russia. According to official Russian statistics, net migration has accelerated over the past five years and since 2007 has totalled 1.5 million (with 1.8 million migrants arriving in Russia). But this only partly offsets the 3 million decrease in the domestic working age population over the same period. What is more, immigration has been largely limited to lower-skilled jobs, while emigration is likely to have been from the highly-skilled segment. As a result, Russia is starting to experience shortages of highly-skilled professionals. According to the HR firm Antal Russia, nearly 90% of companies surveyed in 2012 had difficulty hiring highly-skilled workers.

For some time Russia has been suffering from declining investment rates. Investment as a share of GDP is currently around 21% – well below the nearly 30% average of other emerging economies. Public investment is especially low. In other emerging economies, a low investment rate is the consequence of a low domestic savings rate. But in the case of Russia, weak property rights and high levels of corruption are two key factors deterring interested investors from doing business.

The share of the public sector in Russia's economy is high; according to the European Bank for Research and Development it accounted for 35% of GDP in 2010, the highest share in the region. The government's participation in the economy appears to have increased even further in recent years. Some estimates suggest the public sector now accounts for as much as half of overall GDP. Of course, a large public sector is not in itself necessarily a bad thing. But in Russia's case, public companies are notoriously inefficient. What is more, in many sectors, over-mighty public companies prevent the emergence of more efficient private competitors. This problem is made worse by excessive state regulation. The combination of a dominant public sector and of a high cost of doing business has led to a sharp drop in the creation of new businesses. As a result, Russia suffers from some of the least competitive markets in the world.

Corruption in the government and business world is pervasive, and a growing lack of accountability enables bureaucrats to act with impunity. Russia's huge state bureaucracy employs 1.84 million officials, who not only put a heavy burden on the federal budget but also make Russia's administration slow at every level. According to Russian sources, corrupt state employees allegedly steal around €220 billion every year from the federal budget. The regime frequently announces anticorruption campaigns, but their main purpose is to ensure elite loyalty and prevent the issue from mobilizing the opposition. In April 2013, Putin signed a decree forcing state officials to give up any assets they hold abroad, leaving them more vulnerable to disfavour from the Kremlin and less exposed to international human rights sanctions. In December, Putin

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<sup>5</sup> The official definition of a "mono-town" is a settlement where either at least 25% of the population works at a single factory (or a group of closely related factories) or where at least 50% of all production is manufactured by such a factory. Currently, the government estimates that there are a total of 342 mono-towns in Russia. Mono-towns account for around 1/4 of the country's GDP and 1/4 of its population. In most cases the dominant enterprise of a mono-town is inefficient and loss-making. The 2008/09 crisis revealed the fragile nature of mono-towns, with many factories going bankrupt. However, fearing an eruption of public unrest, the government provided over US \$2 billion in subsidies to help keep the factories open and prevent mass lay-offs. This prevented a spike in unemployment in 2008/09 but reinforced the fundamental problems of inefficient mono-towns, which remain an issue today. A reform program is currently under discussion, with proposed measures including financial assistance for laid-off workers to reeducate or to move to another city.



set up a new department in the Presidential administration to fight corruption, but few observers expected it to produce real results. According to Transparency International, only 5% of the population thinks that the government's anticorruption efforts are effective.

### ***Mitigating the Impact of Western Sanctions***

The "Level 3 sanctions" that the EU and the US imposed on Russia at the end of July and further reinforced on 12 September 2014 come together in three parts. The first consists of financial sanctions on state-owned banks, which dominate Russia's banking system, as well as a number of major state-owned non-financial companies. The measures prevent these companies from raising long-term finance in European and US financial markets. The second part is an arms embargo, and the third a ban on exports of oil-related technologies and dual-use items to Russia. Of these, the arms embargo will probably have the smallest impact on Russia's economy. Arms exports only account for around 3% of Russia's total exports, and only a fifth of that goes to Europe. The other two elements of the sanctions package could have a more significant impact on the economy. In addition, dozens of senior Russian officials and separatist leaders are now subject to Western asset freezes and travel bans. Still, the gas industry, space technology and nuclear energy are excluded from the sanctions.

The financial sanctions have already shown damaging effects on the economy, as Russia's major state-owned banks and a number of large companies can no longer raise funds in Europe and the United States. Subsequently, most of them are struggling to roll over maturing external debts. Russian non-financial companies and banks had to repay over US \$80 billion in external debt by the end of 2014, forcing the Central Bank of Russia (CBR) to provide financial help to any companies that ran into trouble.

Indeed, the CBR has already pledged to support the sanctioned banks in the past months. But while this means that a wave of defaults (and thus widespread disruption to financial markets) should be averted, it does not mean that the sanctions will have yielded no impact. After all, 20-30% of the banking system is now locked out of Western capital markets.

At present, around a third of bank loans in Russia are financed by borrowing on the wholesale market. Admittedly, only a small part – roughly a third – of this comes from overseas. But with the CBR having to raise interest rates to stem capital outflows, domestic financing conditions are tightening at a time when access to external finance is also being restricted. The net result is that credit conditions have become much tighter for Russian companies – and all of this will weigh on an economy that is already on the edge of recession. The Russian government is said to have reserve funds of US \$170 billion in place, but much of these funds will soon be used to stabilize the ruble, grant credits to Russian firms and bail out state banks and companies. Moreover, if hydrocarbon revenues shrink in the future, Russia's federal reserves will come under additional pressure to do "damage control" and investment at the same time.

Looking beyond the next year, the ban on the export of technologies – particularly in the energy sector (the three major Russian state oil firms targeted are Rosneft, Transneft and Gazprom Neft, the oil unit of gas giant Gazprom) – could pose a serious threat to the economy over the medium term. Of course, this will depend to a large extent on how long the sanctions remain in place. But with most of Russia's oil production currently coming from Western Siberian fields that rely on outdated infrastructure, new investment and technology are needed in order to explore production in new fields, modernize production techniques and raise productivity. Without this, growth in Russia's key energy sector is likely to be sluggish, hitting overall economic growth and, in time, exports and government revenues.

Interestingly but unsurprisingly, Chinese banks and companies have upgraded their efforts in the past months to fill the various gaps on the Russian market by offering fresh money, purchasing state bonds, or creating joint ventures with local firms. This trend is likely to become more prominent in the future.

### *The Kremlin's Likely Course of Action*

Now that the economic crisis has reached a threatening dimension for Russia, the Kremlin will find it increasingly hard to compensate for the combined impact of economic sanctions, decreased oil prices, and delayed macro-economic reforms. For 2015, the World Bank expects the economy to contract by 2.9% – an outlook that could become even worse if oil were to average US \$50 a barrel this year. In such a scenario, Russia's federal budget would face a shortfall of US \$46 billion and an inflation rate of 15-17%. Thus far, the Kremlin has primarily used the national reserve and welfare funds to stabilize the economy but this is clearly not a long-term solution. The two funds could run out much faster than the Kremlin anticipates, in particular if oil prices do not rebound. When discussing the future of the sanction regime, the European Union (EU), for its part, would need to seriously consider a scenario of a Russian economic collapse in the medium future because it is evident that Moscow does not have an efficient recipe to mitigate the effects of this "perfect storm."

Putin's approach to solving both the country's short-term and endemic economic problems appears to be based on the concept of state-driven economic modernization in preference to trust in the market. Already over the past few years, he started to strengthen state control over the energy industry and committed enormous sums to increasing defence spending, large infrastructure projects, and a revival of plans to develop Russia's Far East. This will come at the expense of health and education spending. One must assume that the Russian leadership will reinforce its efforts to promote economic self-reliance, i.e. to move away from importing goods and to foster domestic production and managed (joint venture) relations with global companies.

The political consequence of this is that the liberal policy elite – hitherto well entrenched in Russia's key economic policy positions in the Ministry of Finance and the Ministry of Economic Development, as well as the Central Bank of Russia--will likely become marginalized, as economic policies that are consistent with a more statist and xenophobic government take hold. Factions in favour of even greater military spending will become emboldened and the prospects for future liberal economic reform will be considerably diminished.

Influential figures, such as Sergei Glazyev (Putin's economic adviser) and Dmitry Rogozin (Deputy Prime Minister overseeing the defence industry), have already called for increased state investment to boost domestic production in strategic industries, the imposition of greater control over the financial system, and a general shift away from two decades of integration with the largely Western-led global economic system. In the same vein, Putin has now urged the Defence Ministry to redouble its efforts to wean the defence sector off foreign suppliers. Russian firms currently make their own versions of just 58 of the 206 types of defence products that the country imports, but state development programmes should add another 40 to their repertoire by 2020.

Overall, the longer Russia feels isolated from the global economy and the longer sanctions persist, the more likely these conservative forces will come to dominate economic policy-making in Russia. From a political perspective, US and European economic sanctions have helped Putin and will continue to do so in the near future. Indeed, Russia looked to be heading towards recession before the Ukraine crisis began. But Putin can now shift the blame for any economic downturn onto external forces. While well-informed academics and policy-makers might think otherwise, current surveys demonstrate that a vast majority of Russian voters agree with the President.

#### **IV. Outlook – Can there be a Future NATO-Russian Relationship?**

With a view to the mid-term future, there are no reasons to believe that Putin will not remain in power for many years to come and preserve the current political system. There is neither a serious political challenger on the horizon nor mass resistance to the Kremlin's repressive, authoritarian rule. To this end,

any hopes for a gradual liberalization of the country are unfounded. The next political test for Putin will be the parliamentary elections at the end of 2016. If he succeeds in maintaining the current degree of public national euphoria and in mitigating the negative effects of Western sanctions on the economy, there is very little to prevent him from passing this test successfully. A victory in the 2016 elections would considerably help consolidate Putin's power base; he would, in all likelihood, then decide to run for a second presidential term in 2018, which would enable him to remain Russian president until 2024.

With Russia's economic growth likely to decline further in the mid-term, there may well be some sporadic public protests in Moscow and St. Petersburg, but these should not pose a fundamental challenge to the Kremlin. In order to demonstrate leadership and address some points on which public concern has been raised, Putin could well decide to reshuffle the government to some extent and replace a few individuals from his inner circle with other loyal supporters.

In 2015, the stand-off between Russia and the West over Moscow's illegal annexation of Crimea and its destabilizing actions in eastern Ukraine will most likely endure. President Putin seems to be unwilling to compromise on his strategic goals over cooperation with the West. He will neither give back Crimea to Ukraine nor drop his support for the separatists in Luhansk and Donetsk. Russia's ongoing actions in eastern Ukraine and its continuous resistance to accept Georgia's and Moldova's Euro-Atlantic aspirations provide sufficient reasons to believe that the West will have to face a protracted stalemate with the Kremlin over Europe's eastern neighbourhood.

That said, Russia's harsh economic realities may inspire Moscow to look for a gradual, de-escalatory and face-saving approach on Ukraine in order to mend fences with the EU and ease the burden of economic sanctions. In relations with the Alliance, Moscow will likely be less inclined to soften its political rhetoric and military actions along NATO's eastern flank, while, in turn, NATO cannot go back to the political status quo ante. Providing credible defence and deterrence for its member countries will be NATO's greatest challenge in 2015.

Against this background, NATO will have to start thinking about how it seeks to engage with Russia in the future. A related central question is how NATO could help its partners in Eastern and Northern Europe become more resilient against Russia's assertiveness. The most difficult political challenge for NATO, however, will be to imagine a policy towards Moscow that aims not at turning Russia into a country the Alliance would like to see, but at enabling the two to coexist. If the Kremlin perceives the Alliance as a strategic competitor or even threat, NATO needs to build its future strategy towards Russia so as to reflect its strategic advantages and weaknesses vis-à-vis Russia. There may be some useful lessons for NATO to learn from how the United States manages its relationship with China through a combination of deterrence, engagement, and balance. Russia, like China, is far too interwoven into the global system to be "contained" or "isolated"; but, before NATO prepares to re-engage Russia, it needs to be clear on what terms and in relation to what issues (for example, jihadist terrorism, Syria, Iraq and Afghanistan). The notion of "coexistence" may be a useful starting point to re-think the future of a complex NATO-Russia relationship. Coexistence would mean recognizing that NATO and Russia are both interdependent and in competition with each other. It would start from the presumption that both sides can accept differences between them, but also lay down red lines for behaviour according to what could be perceived as an existential threat by one side or the other.

In reality, accepting diverging views will be the most difficult thing. Russia, for example, will not likely change its opposition to NATO's Open Door policy, while the Alliance, in turn, will not be prepared to give up one of its founding principles. But can NATO find a way to manage these diverging views without the relationship becoming adversarial? Will the two sides be able to live with those disagreements, and at the same time collaborate on issues of mutual interest? Is there any viable alternative?

A coexistence approach would entail at least three different dimensions : first, a credible and strong defence and deterrence posture in support of NATO member countries (for which the NATO Summit in Wales has already laid the groundwork); second, a flexible dialogue and engagement dimension; and third, a dedicated effort to strengthen the Allies' and partner's resilience against Russian efforts to exert influence on them

(for example, through energy diversification, and in the fields of technology export and defence capacity building). To help conceptualize a coexistence approach with Russia, the Allies may wish to consider mandating a team of experts from Allied countries to informally reflect on some of the key principles.

To be clear, the process of re-engaging Russia can only be gradual and selective, taking into account the degree to which Moscow responds positively, first and foremost to the full implementation of the Minsk Agreement. It would also need to be pursued in close cooperation with other international organizations, chiefly the EU and the Organization for Security and Cooperation in Europe. The latter could also be a good venue for the Alliance to re-engage with Russia directly. Flexible formats dictated by substance of discussion might be the best way forward, with a view to re-establishing a dialogue with Russia on selected issues of common concern between the Alliance, its partners, and Russia.