

COUNCIL *on*  
FOREIGN  
RELATIONS

*Maurice R. Greenberg*  
*Center for Geoeconomic Studies*

*DISCUSSION PAPER*

# Economic Constraints on Russian Foreign Policy

And What They Mean for the United States

Christopher Smart  
November 2017

*This discussion paper was made possible by a grant from the Carnegie Corporation of New York. The statements made and views expressed are solely the responsibility of the author.*

The Council on Foreign Relations (CFR) is an independent, nonpartisan membership organization, think tank, and publisher dedicated to being a resource for its members, government officials, business executives, journalists, educators and students, civic and religious leaders, and other interested citizens in order to help them better understand the world and the foreign policy choices facing the United States and other countries. Founded in 1921, CFR carries out its mission by maintaining a diverse membership, with special programs to promote interest and develop expertise in the next generation of foreign policy leaders; convening meetings at its headquarters in New York and in Washington, DC, and other cities where senior government officials, members of Congress, global leaders, and prominent thinkers come together with CFR members to discuss and debate major international issues; supporting a Studies Program that fosters independent research, enabling CFR scholars to produce articles, reports, and books and hold roundtables that analyze foreign policy issues and make concrete policy recommendations; publishing *Foreign Affairs*, the preeminent journal on international affairs and U.S. foreign policy; sponsoring Independent Task Forces that produce reports with both findings and policy prescriptions on the most important foreign policy topics; and providing up-to-date information and analysis about world events and American foreign policy on its website, CFR.org.

**The Council on Foreign Relations takes no institutional positions on policy issues and has no affiliation with the U.S. government. All views expressed in its publications and on its website are the sole responsibility of the author or authors.**

For further information about CFR or this paper, please write to the Council on Foreign Relations, 58 East 68th Street, New York, NY 10065, or call Communications at 212.434.9888. Visit CFR's website, [www.cfr.org](http://www.cfr.org).

Copyright © 2017 by the Council on Foreign Relations® Inc.  
All rights reserved.

This paper may not be reproduced in whole or in part, in any form beyond the reproduction permitted by Sections 107 and 108 of the U.S. Copyright Law Act (17 U.S.C. Sections 107 and 108) and excerpts by reviewers for the public press, without express written permission from the Council on Foreign Relations.

## Managing U.S.-Russia Relations

The recent collapse in the U.S.-Russia relationship has roots that stretch back to fundamental misunderstandings at the end of the Cold War. Western democracies have watched with dismay as tightening political controls in Russia have throttled domestic pluralism, while Moscow's roughshod foreign policy and military tactics have driven its neighbors into submission or open hostility. Russia has bemoaned what it sees as Western arrogance and a stubborn refusal to recognize its security concerns and great-power status. Today, Russia's annexation of Crimea, support of Syrian repression, and, above all, meddling in the U.S. presidential election have shattered any desire in Washington—at least outside the Oval Office—to search for common ground. Indeed, amid congressional logjams on nearly every issue, overwhelming bipartisan majorities passed a stiffer sanctions regime. The narrative in Moscow, meanwhile, paints a consistent picture of Washington actively rallying Europeans to expand footholds around Russia's borders with an ultimate goal of regime change in the Kremlin itself. In spite of President Donald J. Trump's apparent eagerness to improve relations, deepening resistance across the political spectrum makes any progress fanciful at this stage. Whether either side understands how to get relations back on track remains uncertain. What is clear is that neither side currently wants to. Deep-seated U.S. mistrust and an unyielding Russian government seem likely to confine the bilateral relationship to a series of sour exchanges and blustery confrontations for now.

Yet one persistent weakness will ultimately limit Russia's foreign agenda: an economy that is likely to fall increasingly behind those of its major neighbors and partners. For now, Russia has largely learned to tolerate Western economic sanctions, and its companies have found ways to live with restricted access to finance. Without reform and economic integration with the West, however, Russian influence will drift toward the margins of global diplomacy. Russia's economy will atrophy from a combination of hyperconcentrated decision-making, continuing dependence on hydrocarbons, and persistent financial isolation. Core goals of Russia's foreign policy will steadily recede from view, including important elements of the economic agenda with its immediate neighbors, the European Union and China. Though a snapback of oil prices would undoubtedly delay any day of reckoning, even large new inflows of petro-profits will not fundamentally close the widening gap with major partners.

For policymakers in the United States, the quandary is how to resist Russia's obstreperous behavior abroad while remaining alert to the potential for change. Mounting economic challenges to Russia's foreign policy goals will likely not force a new course anytime soon. Russians have an impressive historical record of withstanding extended economic hardship far worse than what they face today. Even more challenging is that Russian President Vladimir Putin has proved adept at foreign policy on the cheap, through a mix of tactics he has deployed in spite of a shrinking budget. These include sophisticated public diplomacy, including cyber interference in elections; targeted financial support to troublesome regimes; and carefully limited military interventions. These specific involvements range from Ukraine to Syria to Venezuela, but the broader theme has been to rally global resistance to the U.S.-led liberal international order. For the foreseeable future, this leaves the United States to respond with vigorous diplomatic resistance, extended economic sanctions, and fresh displays of military readiness. Over the next decade, however, as Russia's economic lag widens and core foreign policy goals fade further from view, a potential future generation of Russia's leaders could begin to realize that their

focus on what they term economic sovereignty is self-defeating. Such a change is hardly inevitable, but if anything is likely to alter the current calculus in Moscow, it is the realization that any prospect of a global role for Russia is slipping away. The challenge for Washington will be to watch for signs that Moscow is ready to make changes and judge whether those changes could warrant relaxing sanctions, or even introducing incentives. History suggests that the two worldviews may never fully reconcile and that some rivalry is inevitable. Still, the United States should prepare for the possibility that economic constraints could trigger meaningful changes in Russia that could then lead to limited cooperation on major U.S. priorities—whether in Eastern Europe or the Middle East, cyberspace or outer space.

## Long Odds for Russia's Economy

The Russian economy has weakened substantially over the last five years, due to continued dysfunction in its investment climate and the twin shocks of falling oil prices and Western sanctions. Though the economy hardly seems headed for crisis, its most likely trajectory is a far cry from the ambitious targets Putin himself set in 2007 to make Russia one of the world's top five economies as well as a leader in technological innovation and a global financial center.<sup>1</sup> Even with a recovery of oil and gas revenues, the country's increasingly centralized and corrupt business climate and relative isolation from the most dynamic forces of the global economy have substantially reduced its growth potential.

### *STRUCTURAL CONSTRAINTS*

From the Soviet Union's collapse to the annexation of Crimea, a central pillar of Western involvement with Russia was trade and investment promotion. The logic was that the more Russia was given a stake in its relationships with Europe and the United States, the more cooperative its government would be on other issues. From 1995 to 2013, net foreign direct investment in Russia grew from \$2.1 billion to \$69.2 billion.<sup>2</sup> Whether increased investment had a significant effect on Russia's foreign policy behavior during those years will long be debated, but it certainly coincided with a period of intermittent cooperation on military, diplomatic, and commercial issues. There was Russian aggression in Moldova and Georgia, but there were also cooperative achievements, including the significant New Strategic Arms Reduction Treaty, Russia's World Trade Organization (WTO) accession, and expanded cooperation in space.

Russia's economic growth model, however, was deeply problematic. The lurching post-Soviet efforts to build a growing market economy were interrupted by Russia's 1998 default and devaluation amid plummeting oil prices and high international borrowing rates. The subsequent collapse in the exchange rate and industrial capacity utilization set the stage for recovery on the back of rising oil prices and a massive consumer boom that only ended with the much larger global financial crisis in 2008. Amid these macro booms and busts, Russia's investment climate, which was never terribly attractive, deteriorated as political and economic power was centralized in the hands of a favored few. There were many laws and regulations to be observed, but they were enforced unpredictably. Important economic decisions were under the purview of a narrowing circle of officials, and investors reported rampant corruption. Following the privatization of the Soviet industrial base in the 1990s, the share of the Russian economy controlled by the government had dipped below Italy's, but under Putin the government has clawed back significant control.<sup>3</sup> By 2013, well before the most recent oil price slide and the annexation of Crimea, annualized growth had slowed to 1.3 percent, the lowest rate since the 2008 economic crisis. The rate for the prior full year was 3.5 percent, which was less than half the rate of the decade prior to 2009.<sup>4</sup> Gross domestic product (GDP) per capita, in terms of purchasing power parity, has been essentially stagnant since 2011.<sup>5</sup>

*FALLING REVENUES AND TIGHTENING FINANCES*

The most recent blow was delivered by the falling price of hydrocarbons. Natural resources represent about 10 percent of Russia's economy, but oil and gas have historically accounted for roughly half of federal budget revenues.<sup>6</sup> Budget deficits were contained in 2016 because of the government's decision to allow the ruble to float, supporting fiscal revenues in local currency terms, but the budget also made large draws on its reserve fund and limited the indexation of wages and pensions.<sup>7</sup> High interest rates helped avert full-scale flight from ruble assets and protected the reserves of the Central Bank of the Russian Federation, but they also throttled investment and household consumption.<sup>8</sup>

While the oil price hit fiscal accounts and domestic demand, the sanctions that were implemented beginning in 2014 were aimed at restricting foreign financing and investment. The measures that the United States and European Union deployed fell into three categories: blocking the financial transactions of individuals close to Putin; restricting new financing and investment to certain large state-owned banks and firms; and stopping sales of advanced oil and gas technology that would have helped Russia exploit its Arctic, shale, and deep-water reserves. The restrictions were intended to target mainly firms and figures close to power without undermining the European—or even the Russian—economies. They were magnified by the threat of even more expansive measures, which forced Russian banks and firms into a scramble to repay their debts.<sup>9</sup> Firms tapped markets in sixty separate Eurobond deals in 2012, but only a handful by 2015.<sup>10</sup> In 2016, the Russian government made its first attempt to access markets since sanctions were imposed, but struggled to find Western banks willing to help raise even \$3 billion.<sup>11</sup> Not only were new lines of credit cut off, but the debt burdens themselves grew as the exchange rate halved.<sup>12</sup> The government scrambled to inject money into struggling firms, including a massive \$49 billion for oil giant Rosneft.<sup>13</sup>

It remains too soon to judge the precise impact of Western sanctions. Critics of the sanctions found different things to dislike. Some viewed sanctions as not broad or painful enough to yield results.<sup>14</sup> Some have worried that the measures simply reinforced popular support for the government, which blames the country's current economic woes on the West.<sup>15</sup> And some argued that sanctions undercut the West's primary aim of integrating Russia into the global community, and that Russia's military aggression toward Ukraine would be better answered with military assistance to Ukraine.<sup>16</sup> Yet the sanctions did demonstrate unity among the United States, Europe, and allies in Asia in opposing Russia's actions in Ukraine. Though the sanctions did not in themselves further erode domestic support for the Putin government, it is not clear that they contributed to further rallying domestic support.<sup>17</sup> Finally, though they did not drive Russia to retreat, they could have influenced Moscow's decision to hold back from more aggressive actions in Ukraine.<sup>18</sup> A U.S. State Department analysis argued persuasively that the sanctions' economic effect was essentially as intended: significant damage to sanctioned firms deemed close to government decision-makers, limited direct consequences to Russian households, and only mild spillovers to the European economy and global financial markets.<sup>19</sup> Though Russia's current oil and gas revenues were not damaged, the restrictions on access to exploration technology will have greater bite over time as the oil price recovers and Arctic projects become economically viable but technically out of reach.

*A CURE WORSE THAN THE DISEASE*

The combined impact of sanctions and lower oil prices accelerated the Kremlin's calls to reinforce Russia's economic sovereignty. The central lesson Russian leaders took from the global financial crisis and current sanctions is that any steps toward integration with the West leads to dependence on the West, which ultimately creates a security liability. Pivoting dramatically from their post-Soviet strategy of economic integration, they began concentrating on measures to reinforce self-sufficiency. "We were naive to think that international economic rules would not be eroded by politics," Putin told members of his government in January 2015. "This must encourage us to increase our sovereignty in the economic sphere while remaining, of course, a natural, organic part of the world economy."<sup>20</sup> A government study showed that dependence on imports nearly doubled between 2006 and 2013; the government responded in 2015 by providing nineteen priority sectors with tax benefits and preferred access to state contracts to boost their self-reliance.<sup>21</sup> The slide in the exchange rate reinforced the trend toward import substitution, as did a retaliatory ban on some Western food imports. When sanctioned Russian banks found that they could not process Visa or MasterCard transactions, Russian officials launched a brand-new homegrown payments card, although it was not clear just how widely accepted it would be.<sup>22</sup>

To replace lost Western financing, the government and the largest firms sought out new sources in Asia and the Middle East. Most prominently, they courted Chinese investment, loans, and contracts for significant oil and gas projects, including the vast Yamal LNG project in the Arctic.<sup>23</sup> Gazprom Neft began accepting renminbi for the oil it sold through the Eastern Siberia-Pacific Ocean pipeline to China, and Putin has encouraged the practice across the oil and gas sector.<sup>24</sup> Russian firms have also tried tapping into Middle Eastern capital: attempts have included a 2016 memorandum of understanding between sanctioned Vnesheconombank and the Islamic Development Bank, and a murky injection of money from the Qatar Investment Authority into beleaguered Rosneft.<sup>25</sup>

Yet the current path seems likely to lock in feeble growth, not reverse it. To be sure, Russia is hardly in crisis, given its current account surplus, low government debt, and ample Central Bank reserves. The long-term trends, however, suggest that a strong and durable recovery will be difficult. Without major new investment and technology, significantly expanding oil production will present challenges. Even a recovery in oil prices and corresponding boost in current revenues will not trigger rapid new investment flows into such an unpredictable and difficult operating environment. Beyond these immediate pressures, current demographic patterns, including low birth rates, will shrink the workforce by as much as 8 percent over the next fifteen years.<sup>26</sup> The International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) both predict that Russian economic growth will lag behind the world average for at least the next five years, further diminishing the country's economic weight.<sup>27</sup>

## Three Major Russian Goals Receding From View

The widening gap between Russia's development and that of its neighbors and partners will frustrate agendas crucial to Russia that depend on sustained economic strength. Economic constraints have posed few limitations so far on Moscow's tactics to frustrate U.S. interests, but persistent weakness ultimately undermines other major Russian goals. For example, poor growth will further undermine Putin's prized goal of building up the Eurasian Economic Union (EEU), which will remain a drain on resources rather than a viable post-Soviet commercial space. With efforts frozen to integrate with European economies, Russian growth prospects will face further headwinds, and these economic relationships seem unlikely to expand much beyond the traditional flows of oil and gas. Finally, Russia's lagging economic and technological progress relative to China's will consign it to junior-partner status in the world's fastest-growing region.

### *THE BURDEN OF THE "NEAR ABROAD"*

One of Putin's central foreign policy aims is to bolster Russia's weight in a world that seems to be evolving toward regional economic blocs. The EEU was meant to build on the post-Soviet customs union and the Eurasian Economic Community to serve as a counterweight to the European Union, giving Russia greater heft in its dealings with Brussels. At the same time, the EEU was also meant to help resist commercial encroachment from China and Europe into the markets of Russia's immediate neighbors. At an early summit in 2011, Putin described the effort as "restoring natural economic and trade ties in the post-Soviet space."<sup>28</sup>

The vision was greeted skeptically by Russia's neighbors and largely ignored by Europe and the United States. Moreover, its terms were one-sided from the start, as Moscow insisted on a customs union that aligned all members with Russian tariffs. Kazakhstan, for example, was required to increase some tariff lines—albeit after a transitional period and with compensation—complicating its accession to the WTO. The offer never seemed especially tempting to Ukraine, whose decision to opt for a trade agreement with the European Union accelerated the deterioration in relations with Russia even before Viktor Yanukovich's government fell.<sup>29</sup> Armenia, Belarus, and Kyrgyzstan were early members, but they hardly add much to the bloc's economic weight. Meanwhile, Azerbaijan, Tajikistan, and Uzbekistan seem to be dragging their feet about joining. Operationally, decisions in the EEU require a two-thirds vote, but members effectively abdicate their trade policy to Russia, which accounts for four-fifths of the area's GDP, population, and landmass.

Though there has been progress on integration, the EEU remains largely a collection of bilateral, and often subsidized, trading relationships rather than an integrated economic space. Indeed, rather than helping bolster Russia's own economic weakness, it drains Moscow's limited resources, and Russia's recession and Western sanctions further cloud its prospects. Moscow's ability to provide soft loans to its neighbors has been constricted by its own loss of access to Western finance, as well as by the recent economic downturn. The sharp depreciation of the ruble during the Ukraine crisis forced Kazakhstan to devalue the tenge, which imposed significant losses on its firms and citizens. Finally, Russia's weak growth prospects have aggravated its deteriorating relationship with Belarus.<sup>30</sup> Though

ostensibly still an economic priority, trade with EEU partners remains minimal compared to Russia's trade with the European Union.<sup>31</sup>

### *EUROPE AND THE LIMITS OF INTERDEPENDENCE*

Russia's crucial economic relationship with Europe faces daunting new challenges as well, which will restrict Russian efforts to grow beyond its traditional role as Europe's principal supplier of oil and gas. Since the fall of the Berlin Wall, the case for European investment in Russia has rested on its low-cost production base and vast untapped consumer market. These are now far less compelling amid rising domestic costs and the unpredictability of the sanctions regimes. Russia also remains a difficult place to conduct business. The European Union continues to be Russia's largest trading partner, but the flows have declined sharply amid sanctions and recession.<sup>32</sup>

More damaging to Russia than the loss of investment and trade, however, is its relative and growing isolation from competitive pressures. Economic sovereignty has been sold at home as a means to protect Russian industry and agriculture in an increasingly hostile world. Limited and temporary protection can help when a targeted industry needs to boost productivity, but contemporary Russia faces much greater challenges. Russian productivity lags significantly behind its competitors in Europe and Asia. Imports of Western technology and know-how could spur catch-up, but continuing sanctions will make this more difficult.<sup>33</sup> Moreover, Russia remains a relatively small economy, which makes the climb to the regional or international scale even steeper for most Russian firms.<sup>34</sup>

Even the oil and gas trade faces pressures. In the next few years, production from Russia's low-cost oil fields will not grow. The bulk of its untapped reserves would not be profitable to exploit at current prices, and development still depends on sanctioned Western technology. An end to sanctions and a spike in oil prices could reinvigorate trade with Europe, but the centralization of economic decision-making and the opacity of business conditions will always limit the scope of the relationship. If Russian leaders have concluded they cannot depend on the West, the unavoidable lesson in Western corporate boardrooms is that long-term investment strategies cannot depend on improving relations with Russia.

### *LAGGING IN THE WORLD'S FASTEST-GROWING REGION*

If Russian influence over European events is diminished, its ability to shape developments in Asia—where three-quarters of its own territory lies—is rapidly receding from view. China is not only larger economically, more diverse, and faster growing, but it has also developed a robust web of trading and investment relationships across Asia. China's Belt and Road Initiative to export excess industrial capacity and finance infrastructure through the China Development Bank and the Asian Infrastructure Investment Bank represents a coherent and well-resourced strategy to deepen relationships across Asia, the Middle East, and North Africa. Even an open, growing, and integrated Russia would have a difficult time keeping up with the scale and scope of China's efforts, and the current trajectory of Russia's economy makes for an ever-widening gap. Russia participated in the New Development Bank, but it has been slow to launch and remains dominated by China and India.

With access to Western finance restricted by sanctions, Russia has actively courted Chinese sources, but the reception there has been limited and careful. Chinese government officials and business executives have preferred to take advantage of Russia's current predicament and weaker bargaining power as they negotiate a strategic economic relationship. During Putin's 2014 trip to Shanghai at the height

of the Ukraine crisis, Russia and China committed to settling more bilateral trade in their own currencies rather than in dollars. At the same time, however, Gazprom accepted lopsided terms on a thirty-year gas contract with China National Petroleum Corporation.<sup>35</sup>

Chinese investors, like everyone else, have found Russia's business environment difficult, and China's banks have been careful not to let any ties to sanctioned Russian entities muddle their relationships with U.S. and European officials, where much larger markets could be put at risk. While the Russia-China trading relationship had reached nearly \$100 billion in 2014, it had fallen almost a third by 2016 on low commodity prices.<sup>36</sup>

## The Limited Implications for U.S.-Russia Relations

As economic constraints steadily erode elements of Russia's agenda with its most important neighbors and partners, they have had little effect on issues that matter to the United States. Soviet officials had a long tradition of conducting an active foreign policy in spite of the limitations of their sclerotic economy. In recent years, facing similar challenges, the Russian government has deployed carefully timed diplomatic initiatives, targeted soft loans, and public diplomacy to frustrate perceived overreach by the United States. Moscow's most notable recent initiatives are the cyberattacks that aimed to influence the outcomes of elections in the United States and Europe. For now, U.S. policymakers have few choices beyond countering obstreperous Russian behavior with straight talk, continued sanctions, and military readiness. Yet the United States should also be prepared to act if economic pressures begin to trigger even some reordering of Russian priorities. These will not be easy to identify, but they could represent the best path to a more stable bilateral relationship. If fundamentally different worldviews make it impossible for Washington and Moscow to be allied or even aligned, then the best that can be expected is for the United States to encourage cooperation that advances U.S. interests while resisting behavior that does not.

### *AN UNEXPECTEDLY STRONG HAND*

Though U.S. policy has traditionally aimed to build a cooperative international order based on liberal and democratic principles, Russia continues to view the world through spheres of influence and zero-sum games that are meant to thwart what it sees as misguided U.S. overreach.<sup>37</sup> As the Cold War ended, there were areas of significant cooperation, but tensions mounted rapidly due to the two countries' fundamentally different interpretations of events in the Balkans, the Middle East, and North Africa. Those tensions also helped to consolidate Russia's domestic power structures, including by serving as a helpful excuse for the crackdown on political opposition. By the time of the Ukraine crisis, it was not difficult for Russian leaders to paint a picture of a hostile world seeking to block Russia's resurgence.<sup>38</sup> Putin's most colorful metaphor for the relationship portrayed Russia as a harmless bear and Western countries as eager to "put him on a chain, and as soon as they succeed in doing so, . . . tear out his fangs and his claws."<sup>39</sup>

So far, Russia's economic woes have not substantially undermined its military strength, even if there have been signs of belt-tightening. The government proposed cuts to its defense budget in October 2016, but overall military spending remains substantial, at 4.7 percent of GDP.<sup>40</sup> Though Putin has confirmed further cuts for next year, he has also promised that they will not affect current plans to modernize.<sup>41</sup> Protecting elite troops from budget cuts would certainly help ensure that Russia's immediate neighbors pay attention. Its nuclear arsenal is also in line for an upgrade, amid a rapidly fraying consensus on arms control.<sup>42</sup> Interventions in Syria and eastern Ukraine have hardly been limited by budgetary concerns, and diplomatic efforts to frustrate U.S. agendas in the Balkans, North Africa, and even Central America carry few direct financial costs.<sup>43</sup> Russia's challenge to the United States also benefits from increasingly assertive Chinese naval activities in the Pacific, which come at no direct cost to Moscow. These efforts can be amplified through Russian public diplomacy and active measures,

which are both effective and cheap. Most often, the reasonable response from the United States to such forays is vigorous diplomatic resistance backed, where appropriate, by additional financial sanctions. New sanctions should be weighed against their potential to further encourage financial mechanisms that bypass the dollar, such as driving more oil trade into renminbi. Still, sanctions do inflict a direct cost, and expanded measures could make that cost rise.

### *IMAGINING RUSSIAN CHANGE AND A U.S. RESPONSE*

Russians' stamina in the face of economic hardship is legendary, but on this economic trajectory their sense that their country is falling further behind their neighbors and rivals will grow.<sup>44</sup> Russia's leaders will long be haunted by the historical lesson that Mikhail Gorbachev's reforms improved the economy—and also triggered the country's collapse. At some point, however, lagging standards of living at home and declining economic weight abroad could lead them to accept these risks. There could be fresh incentives for Russia to reinvigorate its economy, and its foreign policy aspirations, with foreign investment and technology. While his influence remains limited, even Prime Minister Dmitry Medvedev acknowledged in a 2015 article that “[i]t is hard to name countries that have made continuing, steady progress by prolonged self-limitation in trade.”<sup>45</sup> As Russia's relative economic influence begins to wane among its immediate neighbors in Europe and Asia, its leaders could become willing to reconsider self-defeating policies, including in areas that matter to the United States, whether in Ukraine, the Middle East, or cyberspace. If cooperation in these areas seems fantastic today, it could be easier to envision conversations on shared concerns such as nuclear nonproliferation or Islamist extremism. Such an evolution is hardly inevitable, but it behooves U.S. policymakers to prepare. Some would prefer to maintain the pressure until the Russian economy collapses, in the hope that pro-Western democrats emerge from the debris, but this is fanciful thinking. Cooperation with Russia is not an end in itself, but Washington should stand ready to encourage positive movement that advances U.S. interests.

If signs of real change do appear, they will likely be tentative and limited, and they will only be credible if they demonstrate Russia's willingness to make concessions to resolve current sources of tension. The precise shape of what will count as progress is difficult to predict. In Ukraine, for example, concessions would probably involve, at the very least, abandoning efforts to weaken the country. In Syria, any settlement will likely need to include Russia's acceptance of a new regime. Given how difficult it will be to dismantle U.S. sanctions that are now enshrined in law, policymakers in Washington would need to consider some targeted incentives to respond to a new Russian policy direction while sanctions are still in place. U.S. policymakers will need to think creatively, for example, if there is ever real progress on a Ukrainian settlement that balances territorial sovereignty with the rights of ethnic Russians. Though Russian leaders will likely withhold their final concessions until all economic sanctions are lifted, the United States and Europe might, for example, develop a roadmap for a closer relationship with the Eurasian Economic Union. This could start with informal consultations on commercial standards and regulatory alignment, but ultimately lead to a plan to negotiate investment and trade agreements. Formal deals will take many years to design, let alone ratify, and will not be possible without significant reforms within the EEU, but the prospect of better economic opportunities for Russia's immediate neighbors could prove attractive. Other organizations, such as Asia-Pacific Economic Cooperation and the WTO, could help the EEU with reforms to improve the investment climate and facilitate greater trade flows. The European Bank for Reconstruction and Development and the World

Bank, which have limited their loans to Russia since the Ukraine crisis began, could resume some lending. Restrictions on trade and financing could also be relaxed within the limits of current legislation in response to progress on a settlement around Syria. In time, a more muscular Chinese foreign policy in Asia could create the basis for limited coordination. Conceivably, cooperative development projects in South Asia, for example, could provide a counterweight to Beijing's efforts there. New trade and investment talks will not advance far without real domestic economic reform, and that will inevitably be a tortuous and uncertain process. Yet any path toward a better relationship will be fitful—as it was with the Soviet Union, and is today with China.

## Conclusion

As Russia continues an indefinite period of economic underperformance, its leaders will endure disappointing results for a long time. Meanwhile, they will continue to draw on a range of relatively inexpensive measures to frustrate U.S. foreign policy. If anything can trigger a change in Russian behavior, however, it might well be the realization that its dwindling economic weight is undermining its foreign policy goals. In the next few years, friction will likely require the United States to consider more economic sanctions in the absence of other measures that avoid military escalation. Over time, however, Russia's leaders may realize that their economy cannot catch up and that without a fresh approach, a global role will remain beyond reach. They could be ready to seek limited accommodation in Ukraine or Syria, for example, if that cooperation helps alter their country's current economic trajectory. For U.S. policymakers, identifying real signs of change in the current climate could be just as difficult as deciding how to respond. Russia's transformation into a less confrontational power is difficult to imagine even in a post-Putin era, but even limited cooperation could help reduce tensions, manage potential crises, and advance U.S. interests.

## About the Author

An investor, scholar, and journalist, **Christopher Smart** is a senior fellow at the Carnegie Endowment for International Peace. He spent six years in the Barack Obama administration as a senior policy-maker for international economic affairs. As special assistant to the president at the National Economic Council and the National Security Council, he was the principal advisor on trade, investment, and a wide range of global economic issues. From 2009 to 2013, he was a deputy assistant secretary at the Department of the Treasury, where he led the response to the European financial crisis and designed U.S. financial policy toward Europe, Russia, and Central Asia.

Before entering government, Smart was director of international investments at Pioneer Investments, where he managed top-performing emerging markets and international portfolios. Following the collapse of the Soviet Union, he worked in Moscow, advising Russian government agencies on economic policy and financial market reform. Smart is the author of *The Imagery of Soviet Foreign Policy and the Collapse of the Russian Empire* and numerous analytical and opinion articles. He earned a BA in history from Yale University and a PhD in international relations from Columbia University.

## Acknowledgments

I am grateful to Denis Fedin for his invaluable research assistance throughout this project. I would also like to thank Timothy Frye, Robert Legvold, Rory MacFarquhar, Chris Osborne, Alexandra Vacroux, and several anonymous reviewers for their helpful suggestions, as well as participants in a seminar at the Council on Foreign Relations on these issues. Finally, many thanks to Jennifer M. Harris and Brad W. Setser for their generous invitation to write this paper and their help in framing it.

## Endnotes

- 
1. Andrew C. Kuchins, Amy Beavin, and Anna Bryndza, "Russia's 2020 Strategic Economic Goals and the Role of International Integration," Center for Strategic and International Studies and Institute Français des Relations Internationales, July 2008.
  2. "Foreign Direct Investment: Investments in Russia," Factosphere: Project Russia, September 27, 2017, <http://www.factosphere.com/macro/investments/fdi>.
  3. Various estimates set government control at anywhere from 50 to 70 percent of Russia's GDP. See Alexander Abramov, Alexander Radygin, and Maria Chernova, "State-Owned Enterprises in the Russian Market: Ownership Structure and Their Role in the Economy," *Russian Journal of Economics* 3 (2017): 1–23.
  4. "GDP Growth (Annual %)," World Bank Open Data, <http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=2015&locations=RU&start=1990&view=chart>, <http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=2008&locations=RU&start=1999&view=chart>.
  5. "GDP Per Capita, PPP (Current International \$)," World Bank Open Data, <http://data.worldbank.org/indicator/NY.GDP.PCAP.PP.CD?locations=RU>.
  6. "Total Natural Resources Rents (% of GDP)," World Bank Open Data, <https://data.worldbank.org/indicator/NY.GDP.TOTL.RT.ZS?locations=RU>.
  7. The Reserve Fund, which peaked at \$142.6 billion in 2008, may be depleted in 2017. Officials have conceded that they may need to draw from the National Wealth Fund, which was originally created to cover long-term social spending needs. Vladimir Kuznetsov, "Russian Wealth Fund Has This Year's Biggest Drop as Buffers Wilt," *Bloomberg Markets*, September 6, 2016, <https://www.bloomberg.com/news/articles/2016-09-06/russian-wealth-fund-has-this-year-s-biggest-drop-as-buffers-wilt>. See also Olga Tanas and Anna Adrianova, "Russia Offers Pensioners One-Time Payment Instead of Adjustment," *Bloomberg Markets*, August 23, 2016, <https://www.bloomberg.com/news/articles/2016-08-23/russia-offers-pensioners-one-time-payment-instead-of-adjustment>.
  8. By December 2016, retail sales had fallen 15 percent from the previous year, while capital investment had fallen 8.7 percent. Alex Luhn, "Russia's GDP Falls 3.7% as Sanctions and Low Oil Prices Take Effect," *Guardian*, January 25, 2016, <https://www.theguardian.com/world/2016/jan/25/russias-gdp-falls-37-as-sanctions-and-low-oil-price-take-effect>.
  9. Foreign loan repayments in late 2014 and early 2015 reached 10 percent of GDP. Sergei Aleksashenko, *Evaluating Western Sanctions on Russia* (Washington, DC: Atlantic Council, 2016): 9–10, <http://www.atlanticcouncil.org/publications/reports/evaluating-western-sanctions-on-russia>.
  10. Gareth Gore and Michael Turner, "Sanctions Fail to Stem Access to Finance for Russian Corporates," Reuters, November 20, 2015, <http://www.reuters.com/article/russia-sanctions-banks-idUSL8N13F1FC20151120>.
  11. Technically, lending to the government itself remained outside the scope of sanctions. Christopher Whittall and Andrey Ostroukh, "More Banks Steer Clear of Russia's Bond Sale; European Banks Join U.S. Peers in Shunning Potential \$3 Billion Deal," *Wall Street Journal*, March 23, 2016, <https://www.wsj.com/articles/russia-struggles-to-find-global-banks-to-handle-bond-deal-1458750539>.
  12. Global Credit Research, "Most Russian Companies Have Sufficient Liquidity to Repay Debt Through End 2016," Moody's, October 15, 2015.
  13. Oil giant Rosneft sought a whopping 2 trillion rubles. Alexander Kolyandr, "Rosneft Seeks More Aid from Russian Government," *Wall Street Journal*, October 22, 2014, <https://www.wsj.com/articles/rosneft-seeks-more-aid-from-russian-government-1414002757>.
  14. Both Republicans and Democrats in the U.S. Congress pressed for tougher measures, which ultimately led to the overwhelming support to legislate sanctions in 2017.
  15. Andrey Movchan, "How the Sanctions Are Helping Putin," *Politico*, March 28, 2017, <http://www.politico.com/magazine/story/2017/03/how-the-sanctions-are-helping-putin-214963>. For a more nuanced and empirical view, see Timothy Frye, "Economic Sanctions and the Rally Round the Flag Effect in Russia" (unpublished paper).
  16. Robert Legvold, *Return to Cold War* (Cambridge, UK, and Malden, MA: Polity Books, 2016): 157–158.
  17. The logic was to limit the collateral impact of punishments that were intended for major decision-makers, although opinion surveys suggest that the sanctions themselves have had little direct impact on existing support for the Russian government. See Timothy Frye, "Economic Sanctions and Public Opinion: Survey Experiments from Russia" (unpublished paper, April 28, 2017).
  18. Andrew S. Weiss and Richard Nephew, "The Role of Sanctions in U.S.-Russian Relations," Carnegie Endowment for International Peace and Chicago Council on Global Affairs, June 29, 2016, [http://carnegieendowment.org/files/6-29-16\\_Weiss\\_and\\_Nephew\\_Sanctions\\_clean.pdf](http://carnegieendowment.org/files/6-29-16_Weiss_and_Nephew_Sanctions_clean.pdf).
  19. Daniel P. Ahn and Rodney Ludema, "Measuring Smartness: Understanding the Economic Impact of Targeted Sanctions," Working Paper 2017-01, U.S. Department of State Office of the Chief Economist, <https://www.state.gov/documents/organization/267590.pdf>.

For a Russian perspective, see Evsey Gurvich and Ilya Prilepskiy, “The Impact of Financial Sanctions on the Russian Economy,” *Russian Journal of Economics* 1 (2015): 359–385.

20. “Soveshchanie s Chlenami Pravitel’sstva” [Meeting with members of the government], Kremlin.ru, January 21, 2015, <http://kremlin.ru/events/president/news/47497>. Cited in Richard Connolly and Philip Hanson, *Import Substitution and Economic Sovereignty in Russia* (London: Chatham House, the Royal Institute of International Affairs, 2016): 3, <https://www.chathamhouse.org/publication/import-substitution-and-economic-sovereignty-russia>.

21. Overall, imports as a share of producers’ total costs rose from 8.5 percent to 14.7 percent. In machine-building alone, import dependence rose from 13.4 percent to 36.5 percent. See Connolly and Hanson, “Import Substitution and Economic Sovereignty,” 5.

22. The official website of the Russian National Payment Cards System boasts: “Unlike international payment systems’ card transactions, Russian Mir card transactions cannot be suspended and no external economic and political factors can influence their processing.” “Mir’ Payment System,” National Payment Cards System, <http://www.nspk.ru/en/cards-mir/>.

23. Maria Domanska and Szymon Kardas, “The Consequences of the Western Financial Sanctions on the Russian Economy,” *OSW Commentary*, Osrodek Studiów Wschodnich [Center for Eastern Studies] no. 203 (March 23, 2016): 6, [https://www.osw.waw.pl/sites/default/files/commentary\\_203.pdf](https://www.osw.waw.pl/sites/default/files/commentary_203.pdf).

24. Jack Farchy, “Gazprom Neft Sells Oil to China in Renminbi Rather Than Dollars,” *Financial Times*, June 1, 2015, <https://www.ft.com/content/8e88d464-0870-11e5-85de-00144feabdc0>.

25. Alexander Winning and Bernardo Vizcaino, “Russian Bank Trio to Roll Out Islamic Finance Products,” Reuters, June 20, 2016; Sara MacFarlane and Summer Said, “Russia’s Rosneft Stake Sale Came With a Twist: Moscow Always Wanted It Back,” *Wall Street Journal*, June 7, 2017, <https://www.wsj.com/articles/russiatobuybackstakeitsoldinrosneft1496827804>.

26. Alexey Kudrin and Evsey Gurvich, “A New Growth Model for the Russian Economy,” *Russian Journal of Economics* 1 (2015): 41.

27. For comparative long-term forecasts, see “Russia GDP Growth Forecast 2015–2020 and Up to 2060, Data and Charts,” Knoema, May 10, 2017, <https://knoema.com/mgarnze/russia-gdp-growth-forecast-2015-2020-and-up-to-2060-data-and-charts>. For IMF forecasts, see the World Economic Outlook Database, International Monetary Fund, October 2017, <http://www.imf.org/external/pubs/ft/weo/2017/01/weodata/index.aspx>.

28. Neil Buckley, “Putin Sets Sights on Eurasian Economic Union,” *Financial Times*, August 16, 2011, <https://www.ft.com/content/a7db2310-b769-11e0-b95d-00144feabdc0>.

29. Gonzalo Pozo-Martin, “Eurasian Economic Union: Ambitions—Analysis,” Elcano Royal Institute, *Eurasia Review*, October 13, 2015.

30. Russian officials have reckoned that energy subsidies alone exceeded \$22 billion between 2011 and 2015. Yuras Karmanau and Vladimir Isanchenkov, “Russia-Belarus Rift Grows as Putin Loses Patience,” Associated Press, February 18, 2017, <http://bigstory.ap.org/article/04fc05845d3b449aa202c7a01ceccfb/russia-belarus-rift-grows-putin-loses-patience>.

31. EEU trade amounts to 6.6 percent of Russia’s international trade, compared to 49.5 percent with the European Union. See Jan Strzlecki, “The Eurasian Economic Union: A Time of Crisis,” *OSW Commentary*, Osrodek Studiów Wschodnich [Center for Eastern Studies], no. 195 (January 27, 2016): 5, [https://www.osw.waw.pl/sites/default/files/commentary\\_195.pdf](https://www.osw.waw.pl/sites/default/files/commentary_195.pdf).

32. From 2012 to 2016, overall EU imports from Russia declined at an annual rate of 13.8 percent, while energy imports alone fell 15.9 percent annually. “European Union: Trade with Russia,” European Commission, Directorate-General for Trade, February 17, 2017. See also the excellent economics discussion in Eugene Rumer, Richard Sokolsky, Paul Stronski, and Andrew S. Weiss, “Illusions vs. Reality: Twenty-Five Years of U.S. Policy Toward Russia, Ukraine, and Eurasia,” *Carnegie Endowment for International Peace* (February 2017): 16–19.

33. The OECD calculates Russia’s labor productivity at 37 percent that of the United States. See “Labor Productivity Levels in the Total Economy,” OECD.Stat, Organization for Economic Cooperation and Development, <http://stats.oecd.org/Index.aspx?DatasetCode=LEVEL>.

34. Sergei Guriev, “Deglobalizing Russia,” *Carnegie Moscow Center*, December 16, 2015, <http://carnegie.ru/2015/12/16/deglobalizing-russia-pub-62294>.

35. In particular, the terms gave Gazprom little protection against falling gas price volatility. Jack Farchy, “Gazprom’s China Contract Offers No Protection Against Low Prices,” *Financial Times*, August 10, 2015, <https://www.ft.com/content/4ac1cdd6-3f79-11e5-9abe-5b335da3a90e>.

36. Alexander Gabuev, “Did Western Sanctions Affect Sino-Russian Economic Ties,” *Carnegie Moscow Center*, April 26, 2016, <http://carnegie.ru/2016/04/26/did-western-sanctions-affect-sino-russian-economic-ties-pub-63461>.

37. For a particularly good summary of the two views, see Kadri Liik, “What Does Russia Want?,” *Commentary*, European Council on Foreign Relations, May 26, 2017, [http://www.ecfr.eu/article/commentary\\_what\\_does\\_russia\\_want\\_7297](http://www.ecfr.eu/article/commentary_what_does_russia_want_7297).

38. There were, of course, plenty of misunderstandings on both sides. Robert Legvold offers a typically thoughtful account of the recent “descent” of the U.S.-Russian relationship in *Return to Cold War*.

39. Heather Saul, “Putin Speech: President Claims West Wants to ‘Chain the Bear’ as He Warns Economic Recovery Could Take Two Years,” *Independent*, December 18, 2014, <http://www.independent.co.uk/news/world/europe/putin-speech-president-to-finally-face-his-public-in-anticipated-address-amid-economic-crisis-9932371.html>.

40. Paul Sonne, “Low Oil Prices Force Defense Cuts, Top Military Business Boss Says,” *Wall Street Journal*, March 10, 2016, <https://www.wsj.com/articles/low-oil-prices-force-russian-defense-cuts-top-military-business-boss-says-1457656937>. See also Kath-

---

rin Hille, "Russia Prepares for Deep Budget Cuts That May Even Hit Defense," *Financial Times*, October 30, 2016, <https://www.ft.com/content/806400be-9e94-11e6-891e-abe238dee8e2>. For a more nuanced analysis of the numbers, see Mark Galeotti, "The Truth About Russia's Defense Budget," Commentary, European Council on Foreign Relations, March 24, 2017, [http://www.ecfr.eu/article/commentary\\_the\\_truth\\_about\\_russias\\_defence\\_budget\\_7255](http://www.ecfr.eu/article/commentary_the_truth_about_russias_defence_budget_7255).

41. "Putin poobeshchal sokratit' voennye raskhody bez usherba dlya perevooruzheniya" [Putin promised to decrease military spending without harming rearmament], Lenta.ru, August 15, 2017, <https://lenta.ru/news/2017/08/15/budget/>.

42. Hans M. Kristensen and Robert S. Norris, "Russian Nuclear Forces, 2017," *Bulletin of Atomic Scientists*, March 4, 2017, <http://thebulletin.org/2017/march/russian-nuclear-forces-201710568>.

43. Eugene Rumer and Andrew S. Weiss, "Vladimir Putin's Russia Goes Global," *Wall Street Journal*, August 4, 2017, <https://www.wsj.com/articles/vladimir-putins-russia-goes-global-1501877673?mg=prod/accounts-wsj>.

44. Anders Aslund, "How Russia Stays Afloat," Project Syndicate, November 28, 2016, <https://www.project-syndicate.org/commentary/putin-russian-sanctions-economy-by-anders-aslund-2016-11>.

45. Dmitri Medvedev, "Novaya real'nost': Rossiya i global'nye vyzovy" [The new reality: Russia and global challenges], *Voprosy Ekonomiki* [Economic questions] no. 10 (2015): 5–29, <http://www.vopreco.ru/rus/redaction.files/10-15.pdf>. Quoted in Connolly and Hanson, "Import Substitution and Economic Sovereignty in Russia," 12.