

Impact of the sanctions and the economic crisis on the Russian military modernization

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Russian Federation in 2008-2009 began new stage of the military reform, during which some positive results in the increase of its military strength were achieved. Such achievements include: considerable growth of the new arms deliveries, serious improvement of the service conditions, serious increase of the training and exercise intensity, restructuration of the command chain etc. Most of these advancements would not be possible without huge increase of the defence spending. Russian official data shows, that defence budget increased from the 1,02 trillion roubles (33 billion USD) in 2008 to 2,48 trillion roubles (82,6 billion USD) in 2014¹.

By the currently operating State armament modernization program for 2011-2020 (SAP-2020), which was approved in 2010, Russia until 2020 is planning to spend 20,7 trillion roubles (around 414 billion USD²).

The sharp decrease of the oil prices (in much greater extent) and economic sanctions (in much lesser) in 2014-2015 has lead to the beginning of serious economic crisis in Russia. This paper analyses how the current and future of the economic crisis and sanctions on the Russian military transformation.

The structure of the paper:

1. Overview of the dynamics of the Russian military spending (both in general and fulfillment of the SAP-2020). Such aspects as share in the total government spending, comparison the dynamics of other spendings etc will be provided;
2. Overview of the Russian government logics behind the further increase of the defence spending (threat perception, interest groups, economic stimulation etc);
3. Negative economic and social factors, which could force Russia to partially abandon it's ambitious defence spending plans (possible future scenarios);
4. Impact of the Western economic sanctions on the Russian military transformation. How the sanctions affected already problematic Russian defence industry sector.

¹ <http://www.roskazna.ru>

² Everywhere in this proposal the calculations (if not stated otherwise) are based on the official RUR/USD exchange rate on 2015.05.24.

The decrease of the oil prices from the more than 110 USD per barrel of Brent oil in the middle of 2014 to the 65 USD in May, 2015 had very negative impact on the Russian economy. Despite official forecasts, which predict minimal growth in 2015, most analytics (including IMF, World Bank and other institutions) agree that Russian GDP in 2015 could shrink by 3 to 6 percent.

Russian Ministry of finance in the beginning of 2015 estimated, that because of the decline of the oil prices Federal budget will lose around 20 percent of its income (around 60 billion USD). It is predicted, that deficit of the Federal budget in 2015 will reach 3,4 percent of the GDP.

This also lead to another serious problem - sharp depreciation of the Russian national currency from 30 roubles for 1 USD in the beginning of 2014 to 50 roubles to 1 USD in May, 2015, which considerably diminished Russian nominal value in USD of the Russian GDP, Federal budget spending and incomes of the Russian citizens. Depreciation of the rouble seriously hit the purchasing power of the Russian defence spending. In 2013 size of the SAP-2020 in dollars was 690 billion, in May, 2015 - 414 billion.

At the same time in 2015, despite the economic crisis, the defence budget in roubles was increased by almost by one third to 3,12 trillion roubles (62,4 billion USD) or 4,2 percent of GDP. The main reasons for that are obvious:

Firstly, the current state of the Russian armed forces and its equipment despite some achievements is still far from perfect. This weakness in the eyes of the Russian ruling class is exacerbated by the increased tensions between the Russia and the West after the beginning of the Ukrainian crisis. Also the involvement of the Russian armed forces in the fightings in the Eastern Ukraine, demonstrated the weaknesses of the current Russian army. Beside confrontation with the West Russia faces the wide spectrum of the more realistic and dangerous national security threats including possible destabilization in the Central Asia, rising islamic radicalism in the Northern Caucasus, Chinese factor in the Far East etc.

Secondly, the acquisition of the new arms and direct support to the development of the defence industry is seen by the Kremlin (or at least by the part of the interest groups in the ruling elites) as very effective tool of the economic stimulation, which becomes even more vital in the situation of deepening economic crisis.

The research conducted by the Russian High school of economics in September, 2014 also support this argument - defence spending remained one of the most important stimulating factors for the Russian industrial sector, which without it would fall into depression already in 2013.

Thirdly, there is strong defence lobby, which is interested in the constant rise of the defence spending. Beside other tools it uses the arguments of the sustainability of the current Russian authorities. \ Employees of the defence industry plants could be seen as the part of the support base of the current political order. Stable and in at least part of the cases well paid jobs in the defence industrial complex become even more valuable amidst the rising unemployment.

On the other hand economic crisis has already began to negatively influence Russian military transformation.

If the oil prices will not considerably increase (at least to 90 USD per barrel of Brent) Russian government could face serious challenges in at least maintaining of the current high level of the defence spending.

Currently Moscow is filling the holes in the budget and keeping the stable exchange rate of the rouble with the funds from it's financial reserves, which are rapidly shrinking. For example, foreign reserves went from 472,3 billion USD in May, 2014 to 356,0 billion USD in May, 2015. Analysts disagree when the Reserve funds will be depleted. Forecasts vary from 2016 to 2018. A

After depletion of the financial reserves, Kremlin will be forced to seriously cut it's spending, because of the Western sanctions possibilities to borrow abroad are considerably limited (another possibility - to

borrow from China bears serious geopolitical risks). In May 2015 Ministry of finances already prepared the project of the serious sequestration of the Federal budget.

As the crisis get's deeper competition over the limited financial resources is also increasing. Defence spending increase means smaller funding for the social security, education, healthcare and subsidies to the regions.

At the moment of writing (May, 2015) there are no clear signs of the visible opposition in the Russian population against the increase of the defence spending. But if economic crisis will get deeper for the Russian government it could be difficult to explain why defence spending in 2015 increased by the 32 percent, when the average pensions will grow only by 9,8 percent (which does not compensate sharp decline of the rouble and high inflation).

It is very doubtful, that the goals of the current SAP-2020 will be fulfilled. Faster economic growth, expected in 2013, will definitely not come and there are no resources to increase the even further expand defence spending. Russian think tank CAST estimates, that total expenditures in the framework of SAP-2020 in 2011-2015 reached 6 trillion roubles (out of planned 20,7 trillion). In order to fully fulfill the spending plans Russia in 2016-2020 will need to spend 14,7 trillion roubles, which translates in 6 trillion roubles annual total defence spending (two times more, than it is planned in 2015 budget)³. The most probable scenario - transfer of the part of the planned acquisitions to the 2020-2025 and include them in the new SAP-2025. For example, most probable candidates for such transfer could be nuclear submarines "Borei"⁴.

Even with the lower than planned expenditures on arms acquisitions Russia managed to seriously increase it physical numbers of the arm purchases. For example, in 2014 defence industry companies successfully fulfilled 95 percent of the state contracts. The number of the delivered equipment compared to 2013 increased by the 30 percent. In 2014 armed forces received 100 new aircrafts.

At the same time Russian military modernization is slowed by the old structural problems of the defence industry, which will be partially worsened by the current economic crisis and sanctions:

Constant rise of costs. Inflation levels in the Russian defence industry are traditionally considerably higher than average inflation⁵. Beside objective factors - lack of the competition, corruption, inefficient management, outdated equipment. Extent of the corruption is difficult to estimate, because of the non transparent defence industry management system, but some scandals demonstrate that there are still huge problems in this field.

Economic crisis and sharp devaluation worsened the problem. Because of the sanctions and the devaluation of the rouble the cost of the raw materials and components (particularly, imported) sharply increased. Also it became much more difficult to receive the financing, because the interest rates on credits in Russia reached 18-40 percent and at the same time possibilities to borrow cheaper in the foreign financial markets were closed because of the sanctions.

At the same time state contracts are with the fixed prices and denominated in roubles, which creates additional pressure.

³ CAST, Государственные программы вооружения Российской Федерации: проблемы исполнения и потенциал оптимизации. 2015

⁴ <http://www.pircenter.org/media/content/files/12/13880454280.pdf>

⁵ <http://lenta.ru/news/2014/11/18/pricehigh/>

Reliance on the import of the equipment and components. Economic sanctions seriously hampered production of some Russian arms, because in many cases export of the components from the Western countries to Russia was stopped. It is doubtful, that Russia will manage to replace all the imports by itself, because it is, in many cases, extremely costly. So Russian producers are even more reorienting towards imports from China, Korea, Taiwan and other countries not participating in the sanctions regime.

But particularly painful was loss of the arms and their components from Ukraine, with which manufacturers Russian defence industry close cooperative relations from the Soviet period.

To sum it up, if Russia will not manage to solve its economic problems (which is highly unlikely if the oil prices will not rapidly rise as it was in 2010-2011) process of the military modernization could slow down, but it is unlikely that it will fully stop. Anyway Kremlin will soon need to find difficult balance between development of its military capabilities and living standards of the Russian population.