Trade Profile: Russia Guards Against Its Vulnerabilities

Assessments

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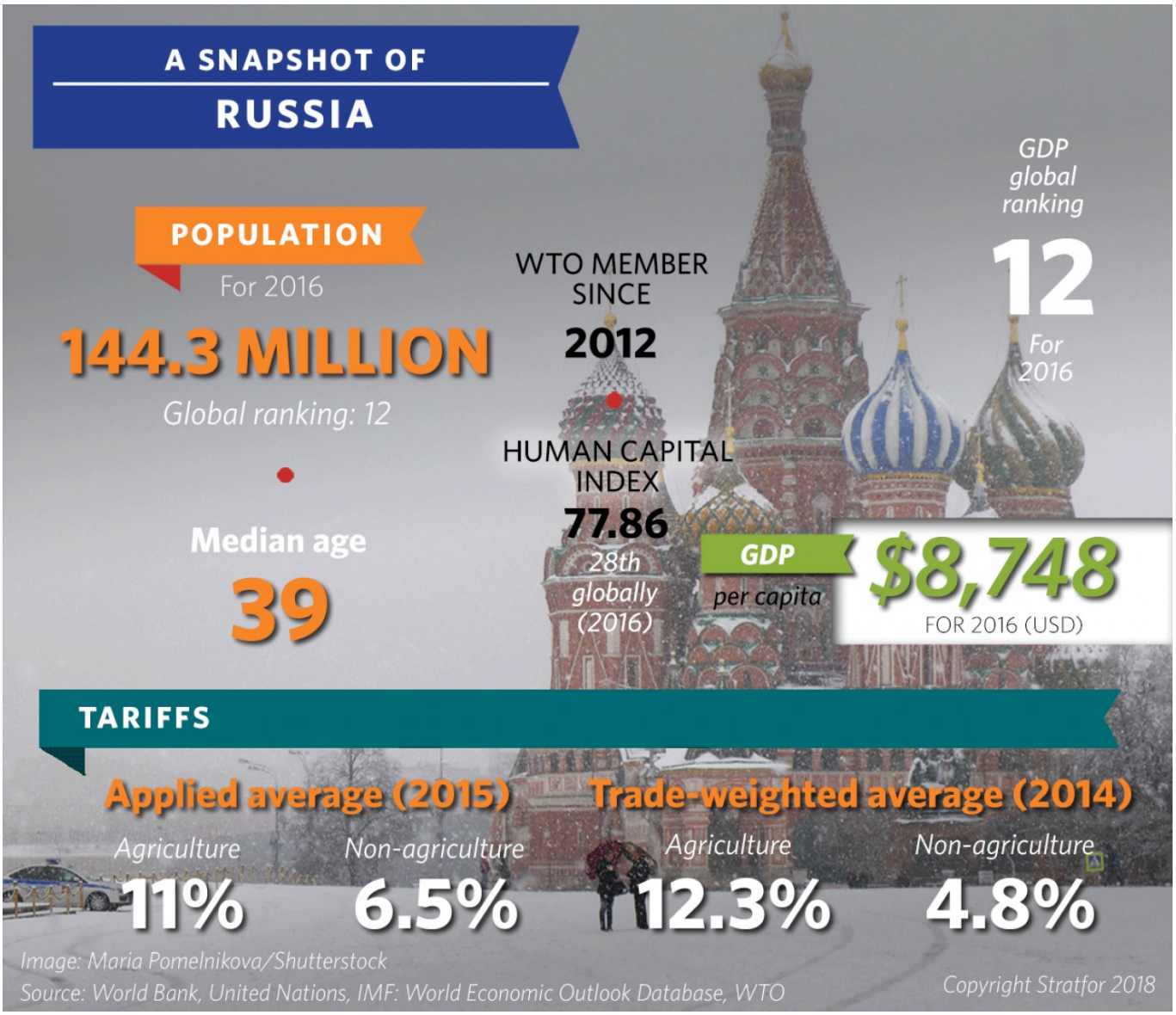
Editor's Note

Global trade is changing. The kinds of multilateral agreements that characterized the postwar years have stalled over the past two decades, prompting countries and economic blocs to try to negotiate smaller deals with fewer partners. Nations and blocs have more leeway under this new model to negotiate the trade agreements that best suit their interests and to avoid those that don't. Now, more than ever, the future of international trade depends on a country or bloc's defensive interests, offensive interests and underlying factors of production. Our fortnightly Trade Profiles aim to break down these factors to facilitate an understanding of where global trade stands today and where it's headed.

In the 16th installment, we focus on Russia.



STRATEGIC INTERESTS

■ Protect national sovereignty with insulated domestic economy; forge alliances to create a buffer region along borderlands; balance growing powers in the borderlands

DEFENSIVE INTERESTS

■ **Key interests**

Domestic production capacity; foreign investment; labor population

OFFENSIVE INTERESTS

■ **Key interests**

Energy sector; agriculture sector

FACTORS OF PRODUCTION

Land: ***Abundant*** but poorly connected

Labor: ***Scarce:*** 8.2 people per square kilometer (27 people per square milometer in Western Russia)

Capital: ***Scarce:*** Interest rate 7.3%

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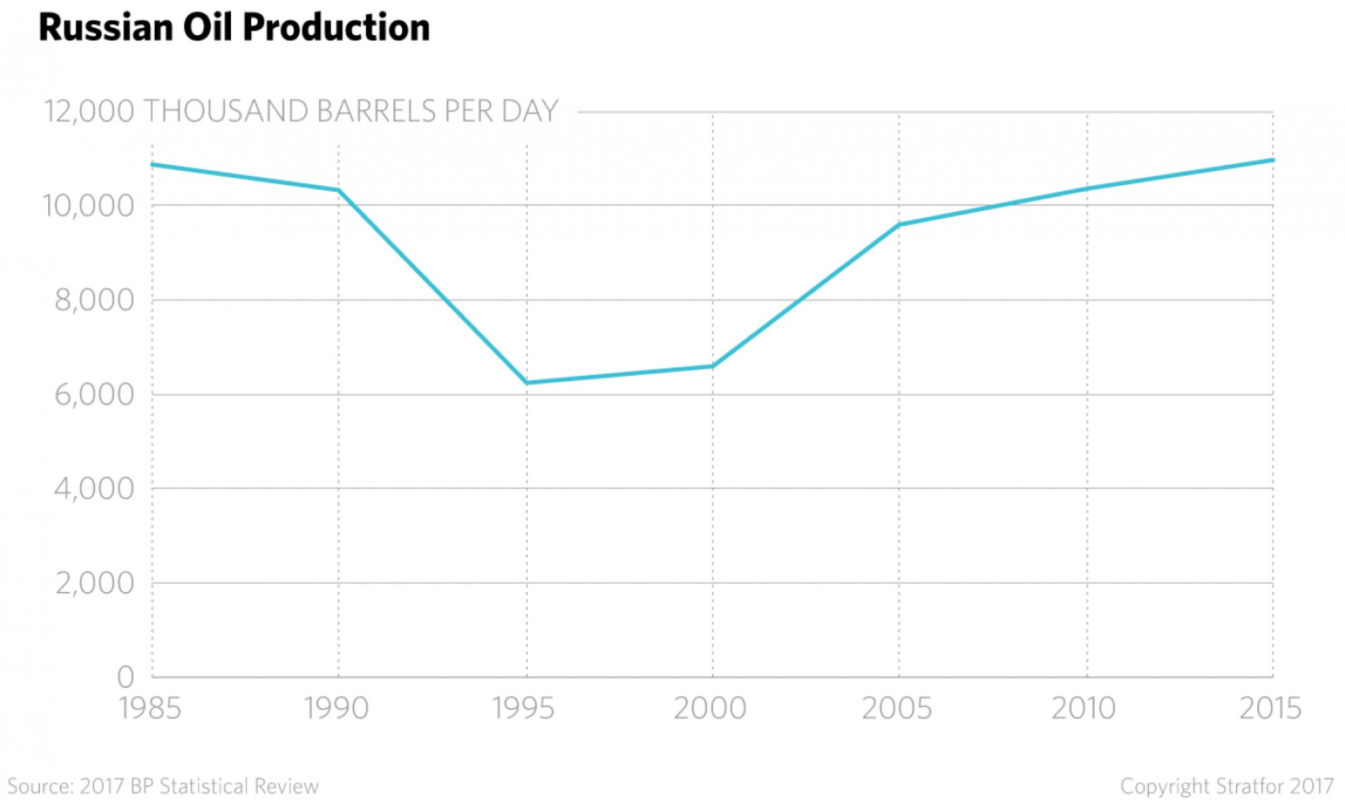
Russia's most abundant resource, land, has proved more a bane than a boon throughout history. Though Russia is the world's largest country by area, 75 percent of its territory is frozen most of the year, and marshlands make up most of the remainder. Some 160 ethnic groups populate its vast terrain, adding to the various regional affiliations that Moscow has to balance to govern the country. Furthermore, stretching from Europe to the Pacific, with borderlands abutting the Middle East and South Asia, Russia is surrounded by rival powers. The country's sheer size and complexity mean that its governing system historically has been highly centralized or else susceptible to geographic and weather barriers, competition and ethnic divisions. And because Russia's economy is not very competitive and depends on commodity exports, the hypercentralized government has taken a highly protectionist stance toward trade over the centuries.

Commodities are the backbone of Russian trade. For the bulk of Russia's imp[illegible] period, territory under the empire's control served as Europe's breadbasket. Th[illegible]

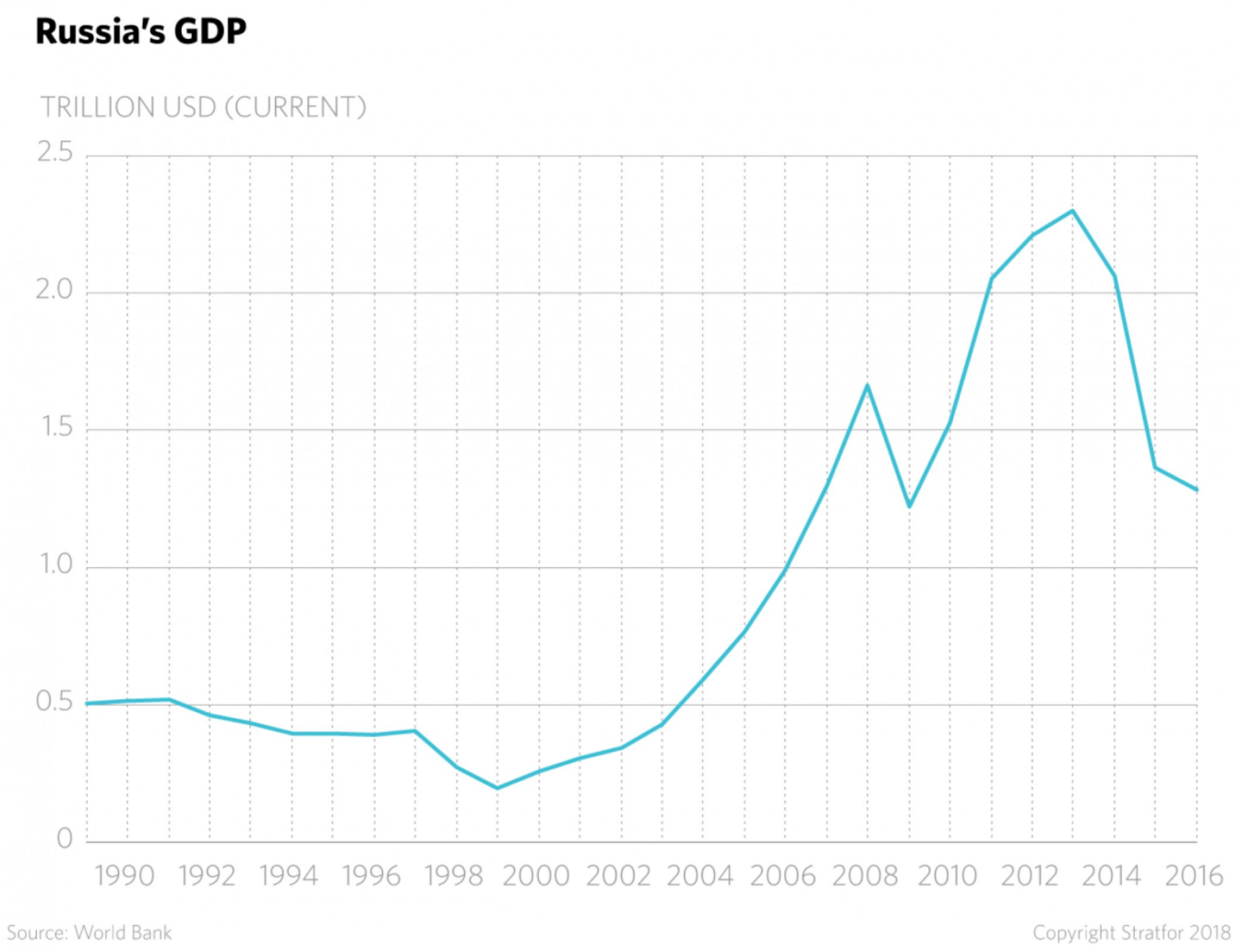
Russian Empire had become the world's largest agricultural exporter by the end of the 18th century, supplying one-third of Europe's wheat and half its other grains. Agriculture provided the livelihood of 80 percent of the empire's population, though the sector was inefficient compared with that of Western Europe. Two issues restrained Russia's agricultural power: the elite's fear of the massive peasant class and the logistical challenges entailed in transporting products abroad. To keep the peasants under control, Russia maintained a feudal system well into the 19th century, then divvied up land haphazardly among the former serfs after their emancipation in 1861 to prevent them from amassing wealth or power. The government constantly revised its land regulations in the empire's final decades, disrupting the agricultural industry in the process. And even after Russia completed the Trans-Siberian railway in 1916, the formidable task of moving grain to consumers in Europe hindered exports.

In light of this limitation, the Russian Empire considered opening up some sectors, particularly the massive oil, mining and metallurgy industries, to foreign investment to diversify its economy. The government began to see the benefit in decreasing its economic reliance on agriculture but needed foreign capital and technology to do so. At the same time, however, Russia's leaders feared – as they do still today – that investment would buy foreign powers influence in the country and that importing goods would be a liability for the Russian economy. Consequently, the Russian Empire maintained its protectionist stance on trade, relying on agricultural exports and levying massive tariffs on imports. (The 38 percent tariff the government imposed on imports in the early 1900s, for example, was six times higher than equivalent tariffs in Western Europe.) These kinds of protections caused massive shortages and a weak economy that eventually prompted the czar's overthrow in the Russian Revolution of 1917.

Once in power, the Soviets transformed Russia into an industrial juggernaut and revamped the agricultural sector through collectivization. Both endeavors benefited from Russia's large population and the centralized power structure that enabled Moscow to push people into the workforce. (Mismanagement, poor productivity, harsh working conditions and lingering logistical problems, however, cost the newly industrialized agricultural sector.) The Soviet government, meanwhile, developed Russia's energy sector and increased exports of oil and natural gas, which by 1950 accounted for more than half of the Soviet Union's annual income. Energy revenue was instrumental in building the large Soviet military and industrial bases and in propelling the Soviet empire to global prominence. But it also established the dependency on oil and natural gas production – and the vulnerability to global energy prices – that Russia suffers to this day.



Like the Russian Empire before it, the Soviet Union was mostly self-sufficient and cloistered from global trade beyond its main three exports: energy, arms and grain. Its economy, the world's second-largest throughout the Cold War, trailed well behind that of the United States. By 1989, for example, the Soviet Union's gross domestic product came to an estimated $2.6 trillion, fully $3 trillion less than the U.S. GDP. The United States and its allies built various economic and trade organizations during the Cold War, such as the General Agreement on Tariffs and Trade (predecessor to the World Trade Organization) and the Organization for Economic Cooperation and Development (OECD), to contain Soviet influence. Russia, in turn, formed the Council for Mutual Economic Assistance, known by the acronym Comecon, along with a handful of other communist countries, such as the Eastern Bloc states, Cuba, Mongolia and Vietnam. The organization helped Russia create a supply chain to turn its raw goods into finished goods in Eastern Europe, but otherwise, Comecon proved to be more of a political asset than an economic one.



The Soviet Union's collapse in 1991 was at once a blessing and a curse for Russia. On the one hand, the demise of its empire freed Moscow, which lost 23 percent of the territory and a little more than half the population under its control, from the travails of governing such vast lands and varied peoples. On the other, the post-Soviet era set off a struggle among the world's powers for sway over the former Soviet republics. The fall of its long-standing system of government and economics, moreover, plunged Russia into chaos.

After nearly a decade of turmoil in Russia, Vladimir Putin took over as president and began putting the country back together. Putin reconsolidated power over the country's political, economic, social and security institutions starting in the early 2000s. High energy prices gave the Russian government the money it needed to rebuild its security services, military and economy and to buy political influen The state resumed control over Russia's strategic industries and pushed out those

investors in and outside the country whose views clashed with those of the Kremlin. And when recession hit in 2009 and again in 2014, Moscow tightened its grip on Russia's assets.

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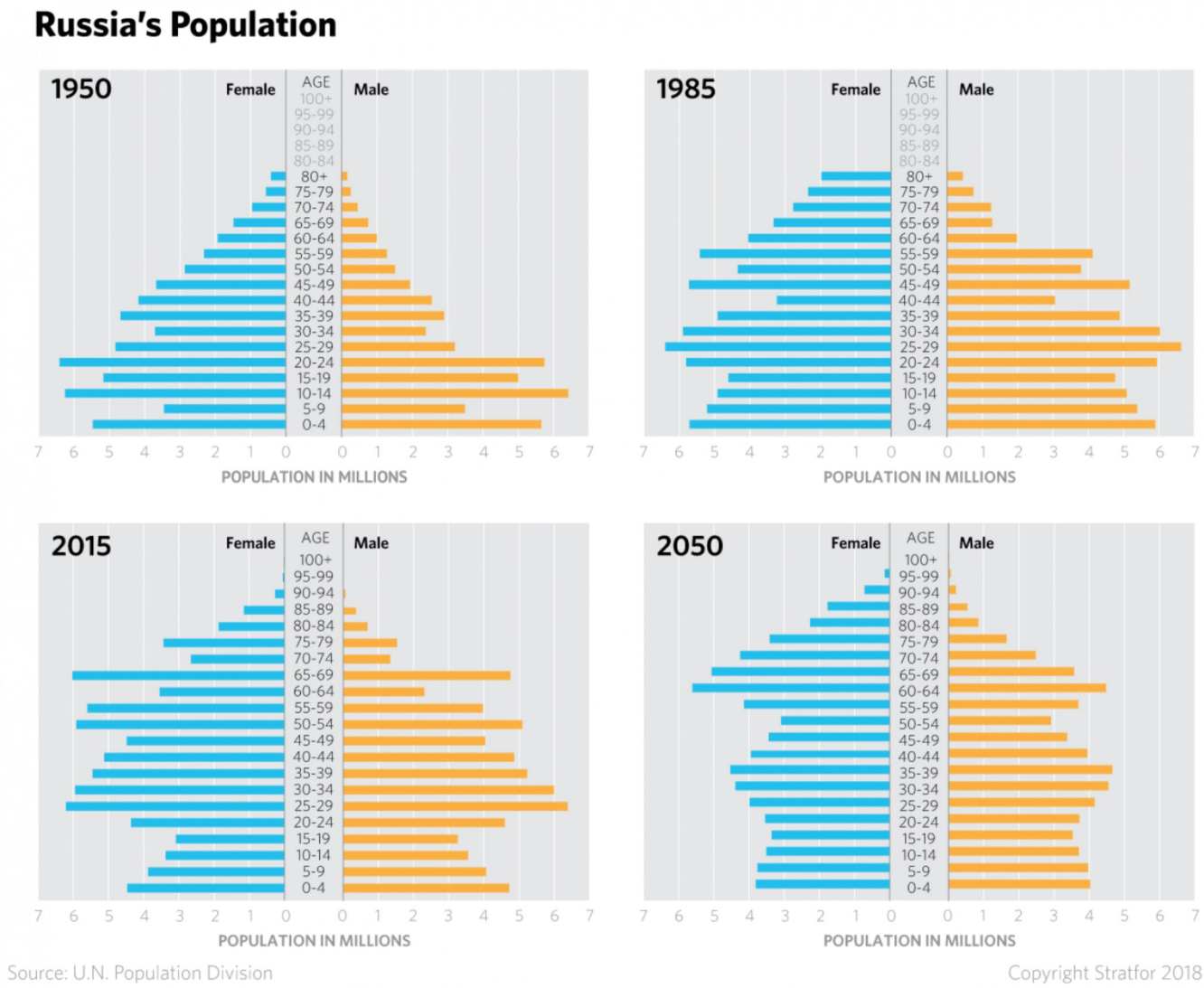
Russia's re-emergence as a global power in the late 2000s prompted other countries, particularly in the West, to return to a containment policy reminiscent of the Cold War. The European Union and NATO have expanded to Russia's borders, and Moscow has reacted in kind by working to firm up its ties with – and its military presence in – its former Soviet neighbors. The revival of tensions with the West has compounded the country's inherent fragility. Russia, after all, still depends on three large export sectors to drive its economy and has limited financial resources to cope with disruptions to those industries. To make matters worse, the current Russian government is facing a new problem that its Soviet and imperial predecessors didn't have: a waning population. These considerations have compelled Moscow to try to project power in Eurasia and around the world wi
also crafting a trade strategy that protects the country's economic weaknesses.



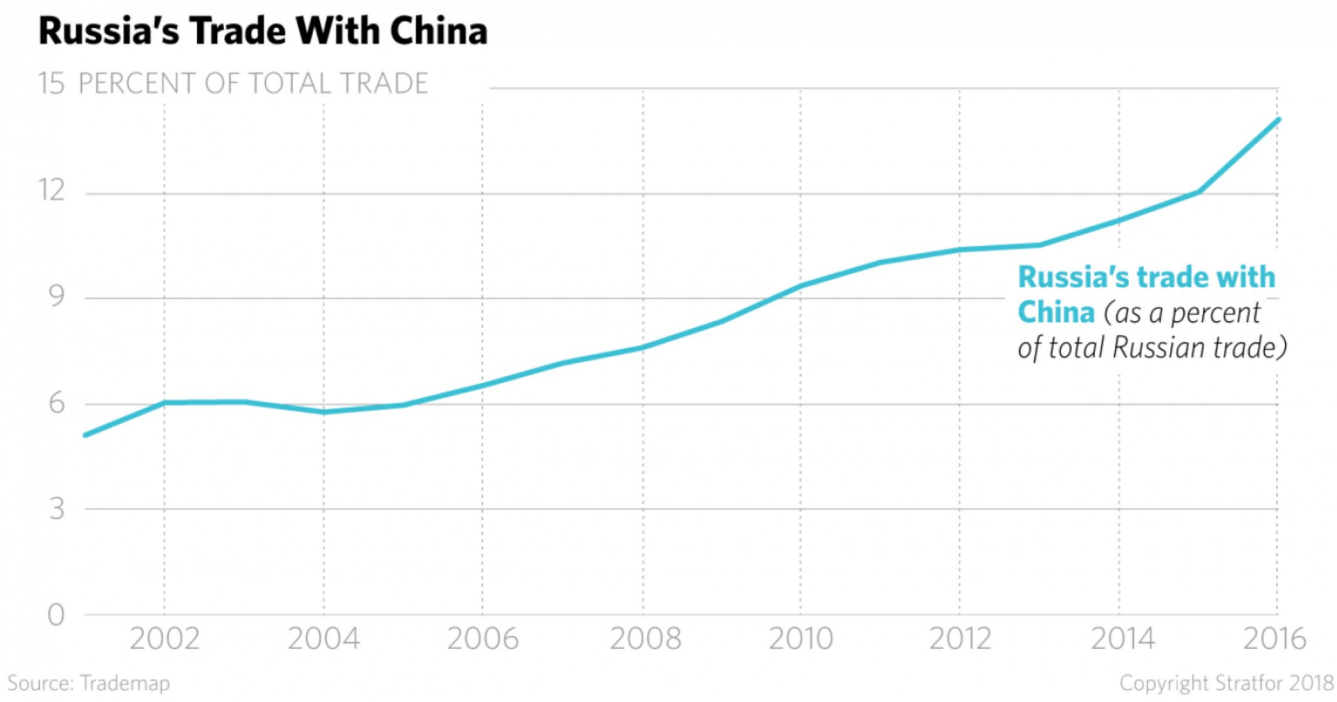
Trade Strategy

Russia today relies on three primary trade strategies, which are mostly defensive. First, it has worked to shore up its domestic industries to protect against sanctions and isolation from the West. The country is currently increasing production in sectors such as food processing, farming and industrial manufacturing to curb its imports; it will continue that effort throughout this year.

In addition, Russia maintains a series of economic associations to provide an alternative to Western trade groups, forge strategic alliances and create a buffer along its borders. The two primary vehicles for this strategy are the Eurasian Economic Union (EAEU) and the Shanghai Cooperation Organization (SCO). The

EAEU evolved from various post-Soviet economic cooperatives and currently includes Kazakhstan, Kyrgyzstan, Armenia, Belarus and Russia, while Moldova holds observer status. (The bloc has discussed expanding to include Tajikistan as well.) Though conceived mainly for political reasons, the EAEU also aims to integrate its members into a single market to facilitate the free movement of goods, capital and policy. The SCO – which started off as a way for Moscow and Beijing to respect the territorial integrity of Central Asia, an area of mutual interest – has expanded its scope and membership over the years. Pakistan and India are now members, alongside Russia, China, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan, and the organization has become a platform for development investment across the region.

Russia's third strategy is to maintain a strong export market in the West, while also courting new trade partners to give Moscow greater flexibility. The Asia-Pacific region has become a centerpiece of this endeavor. In 2010 Germany lost its title as Russia's top trade partner for the first time in history – to China. Exports of Russian oil eastward, likewise, have risen from 6 percent in 2006 to 30 percent in 2017; Moscow plans to follow suit with natural gas exports starting in 2019. Investment also has grown between Russia and its partners to the east over the past several years. China has pumped billions of dollars into many of Russia's strategic projects in energy, transportation and cybersecurity, and Moscow is boosting its investment to the Asia-Pacific region, South Asia and the Middle East.



Offensive Interests

Today, Russia's economy depends as ever on commodities. Energy exports make up one-third of GDP, while agricultural and arms exports each account for a little under 4 percent. The volatility of these markets leaves Russia's economy prone to upheaval. What's more, the Russian state, which controls the majority of the three strategic sectors, lacks the financial means and technology to modernize them and instead devotes only enough resources to them to maintain their stability. Russia will continue working to expand its market share abroad for these goods, but in the long run, Moscow understands that its prized export sectors will fall behind the competition.

Defensive Interests

At the same time, Russia is closing itself off to imports and foreign investment to protect its fragile economy from outside influence. But this protectionist approach forces the state to choose which of its flagging sectors gets the funds and assets it needs. As Russia's population continues to plummet, moreover, the country's resistance to foreign support will leave it with dwindling labor capital. The Russian workforce is shrinking by 1 million people each year. Although millions of people have come to work in Russia from the former Soviet states, they are mostly unskilled or low-skilled workers. The demographic, financial and technology

crunch could eventually cause the country to deviate from its protectionist strategy. For now, however, it is reinforcing Moscow's defensive trade stance.

Russia's Strategy	Russia: Rebuilding an Empire While It Can	The Past, Present and Future of Russian Energy Strategy

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