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Disorder: the War and Russia's Economic Statecraft

J. Alexander Thew, Daniel Fiott, Frank Finelli and Mickey P. Strasser | 2 May 2023

Key Issues

- Western states have imposed stinging sanctions on Russia and this policy should continue to dent the Kremlin's economic power base, as well as support Ukraine.
- Russia has developed ways of weathering the economic storm through a form of economic statecraft that draws on its experiences during the Soviet era.
- Although Russia and China pose a military challenge to global order, the West should not overlook how Russia and China will collectively enhance their economic statecraft strategies.

Since Russia's invasion of Ukraine in February 2022, Western countries have looked to support Kyiv and impose crushing economic measures on the Russian economy. These measures have punctured a hole in Russia's war fighting machine, but there are fears that the Kremlin has been able to use a form of economic statecraft to weather the storm. For example, while Europeans have drastically reduced their dependence on Russian energy sources, Moscow still exports to global markets at nearly the same pre-war scale, which helps it generate the revenue needed to support the Russian economy and "weaponise" energy flows to new export markets – as it once did in Europe.

If Ukraine is to defeat Russia, and if the West is serious about denting Russia's ability to wage future war, then a greater focus on Russia's economic statecraft is required. This Policy Brief focuses on how Russia has adapted to changing economic circumstances and it details important aspects of the Kremlin's approach to economic statecraft. What is more, the Policy Brief looks at the growing Sino-Russian partnership and how it is likely to alter the global economic order that has prevailed for decades.

Our arguments in this Policy Brief are based on observations made at an international security seminar held at the US Military Academy, West Point, on 9-10 February 2023. During this seminar, the authors were part of panel discussions as moderators, speakers, discussants and rapporteurs and they exchanged views on the evolution of geo-economics and global strategic competition. In this regard, this last piece in a series of three Policy Briefs from the international seminar provides a window into the growing importance of economic statecraft. Needless to say, we write here in our personal capacities and none of the content herein can be attributed to our respective employers.

The ruble in the rubble?

Quite understandably, the West's support for Ukraine in the wake of Russia's military invasion has minds focused largely on the military effort. We are confronted with scenes on a daily basis of brave Ukrainian soldiers fighting in drenched trenches reminiscent of the First World War. Yet, beyond the fighting fields in Ukraine there is a wider story of Russia's attempts to increase its power status. While it is true that territorial landgrabs through military force is a key component of Russia's geopolitical strategy, we cannot overlook its wider interest in competing with the West more generally, and the United States (US), in particular. Russia is interested in diluting the power of the US and the West by supporting rival blocks and carving out "spheres of interest" for itself. Yet, its military is not the only method through which it seeks to compete with the West: its economy is another.

While there is rightfully confidence that the sanctions imposed on Russia will drastically constrain the Russian economy at some point, Western countries have to be wary of Russia's ability to adapt to changing economic circumstances. To this end, Russia makes use of a sophisticated pool of macroeconomic specialists that were educated and cultivated during the Cold War – a time when the Soviet economy was also undergoing economic pressures despite being one of two global powers at the time. Individuals such as Elvira Nabiullina – the governor of the Russian central bank – are often depicted as economic modernisers, but she earned her spurs working in economic development, trade and industry during the post-Soviet period and the rise of Putin.

Without overly mythologising such individuals, their ability to help stabilise the Russian economy in the wake of unprecedented Western sanctions bears some reflection. In essence, such individuals have been able to use the peculiarities of the Russian economy to their advantage – at least for now. In Russia, market relations between firms and the government are tightly organised and this gives central government far more scope to manipulate the economy for geopolitical ends. Even though Russia cannot be likened to the centrally planned economy under the Soviet state, the so-called "market economy" in Russia is in fact largely concentrated in the hands of a few state-controlled oligarchs. In this sense, the strong linkages between state planners, political officials and economic actors is more reminiscent of the Chinese system.

While Western countries should continue to impose its far-reaching sanctions, Russia has been able to weather the economic storm so far by distinguishing between *real capital* and *money capital*. In practice, this means that the Russian state is able to protect the physical elements of production in critical economic areas such as agriculture, raw materials and energy. To this end, Russia is seeking to shield itself from Western sanctions and divestment by protecting its means of production. Thus, while Russia is excluded from international finances via SWIFT, Moscow has been able to stabilise the ruble and ensure that the most basic needs of society are still met. In fact, the ruble appreciated to $/RUB50 last July, nearly six months into the war – the strongest level since late 2014. What is unclear is how sustainable Russia's reliance on a current account surplus – worth some $227 billion in 2022 – will be over the medium- to longer-term, especially as it tries to rebuild and modernise its military.

For Western countries, it is important not to fall into the trap of measuring Russia's economy through the favoured metrics of liberal economists (e.g. GDP). Indeed, if Russia is able to adjust to economic pressures by protecting its critical industries and trading international in Chinese yuan, this causes a major issue for the West's future relations with Russia and China. The Kremlin's ability to wage war in the future is conditioned on the health of its productive capacities. True, Russia will likely lose access to critical Western-sourced technologies, but it still might largely retain its ability to produce the means of war. In this sense, Russia is not just a major energy producer but it has a raw material base that makes it a continued danger to NATO and neighbouring countries.

"It's the geo-economy, stupid!"

One of the more direct lessons from the war on Ukraine is that Western countries cannot measure Russian actions through its liberal mindsets and its own norms. Another lesson is that Russia will surely try to compensate for its lacklustre military performance in Ukraine by focusing on its geo-economic power over the longer-term. Cultivating its industry and using the power of the state to give direction to its economic relations with the world poses a particular challenge for the West. While many have become comfortable with the notion that free market societies are more resilient than state-controlled economies, this does not make authoritarian states and economies any less dangerous. This can be seen in the way that Russia continues to trade with countries such as China, Turkey, India and Central Asia.

However, one of the growing issues facing the West is how Russia may seek to offset some of the economic damage it has experienced since the war on Ukraine through closer ties with China. We know that Russia and China agreed to a "no-limits" partnership in early February 2022, and since the war countries such as China and India have replaced Germany as the world's leading importer of Russian oil and gas. We also know that both Vladimir Putin and Xi Jinping have world views that were forged through their upbringing in communist systems. For both China and Russia, power is not simply about military force but mobilising the industrial base to erode the West's economic dominance: keep in mind that for such leaders the economy means more than just growth, for it links to ideologically informed understandings of inequality and development. As Xi Jinping stated during a speech to senior Chinese officials in February 2023, China's economy must be more efficient than Western capitalist economies and it should seek its own, non-western, route to economic development.

We have already seen Russia and China become closer in relation to capital flows, with Moscow keen to gain access to China's money markets and capital investment. Closer financial and economic ties between Russia and China could eventually undermine the dominant role of the US dollar, and we have seen how the two countries have announced plans to create a parallel capital transfer system to SWIFT largely based on China's existing Cross-Border Interbank Payment System (CIPS). True, some caution that China and Russia do not presently have the financial reach of SWIFT and that capital and payment transactions under CIPS still only represented 6% of the global total in 2020. However, it is unclear today to what extent CIPS will become the major transactions system in the Indo-Pacific in the future, with countries such as India – with huge existing and future financial stakes – reportedly interested in a rival payments system to the dollar and euro.

Of course, economic statecraft involves the instrumentalisation of technology and the fundamentals of economic life such as energy and food. We have, therefore, seen bold steps in Western countries against the use of services offered by Chinese companies such as Huawei and TikTok. Yet, a focus on how Russia and China develop strategies to potentially up-end the West in capital markets is equally, if not more, important than the more blatant instruments of economic statecraft.

> **"Western countries cannot measure Russian actions through its liberal mindsets and its own norms."**

One of the major concerns for the West is that, at a time when the Communist Party has exerted far greater control over the Chinese economy, Western investments in the country continue. While investment confidence in China has started to wane, firms continue to invest in areas like vehicle battery technology and high-tech components. This marks a core vulnerability for Western businesses that could be exploited by authorities in Beijing. Incidentally, this is an issue that is also recognised by senior leaders in the EU with the President of the European Commission calling for the Union to de-risk its diplomatic and economic relations with China, in addition to calling for a new economic security strategy for the EU.

However, it would be a mistake to only view Russia's approach to economic statecraft through the prism of closer Sino-Russian ties. In fact, there is evidence to show that Russia has been using its current account surpluses to lend to capital-starved borrowers in the non-Western world. Such investments did not begin with Russia's war on Ukraine, but the crisis has lent greater credence to Russia's need to generate economic dependencies globally. Thus, research has shown how Russia has been prepared to invest in countries even China largely avoids, including Cuba, Bolivia, Ecuador, Nicaragua, Tanzania, Venezuela, Zimbabwe and more. Russia seeks to invest in fragile countries for a multitude of reasons including raw materials and using economic ties to undermine Western interests in international fora, all while using para-military organisations like Wagner Group to ensure the stability of investments and the political narrative of "anti-colonialism".

Towards a Western strategy of statecraft?

In this last Policy Brief in a three-part series, we have argued that Russia's economic statecraft gives Western countries even more reason to out-compete authoritarian states. There is today no coherent Western blueprint for economic statecraft, even if the contours of an approach are becoming clearer. This can be seen in the steps to "reshore" or "near-shore" critical industrial capacities back in the West and to lower dependences on authoritarian states. In the specific case of energy, we saw how Europe moved quickly to cut its fossil fuel dependency on Russia. Yet, the EU is only getting started on understanding the scale of Russian state-backed assets held in European banks. Europe can still place more economic pressure on Russia but the challenge posed by growing ties between Russia and China requires a rethink about how Western countries protect their economic interests.

Clearly, Washington increasingly recognises that the federal government has an important role to play in ensuring that US economic interests are safeguarded. This is the logic behind the Inflation Reduction Act, which seeks to support US industry and jobs through financial incentives worth some $500 billion and tax incentives for clean energy. In February 2023, the EU also came up with its own strategy but without committing any real or new finances, even if its more than €750 billion "NextGenerationEU" effort is directed towards the digital and green transitions. The risk facing the US and EU is a "subsidies race" that, while helping to address climate change, may lead to missed opportunities to strengthen transatlantic supply chains and technology cooperation.

While the EU and US are discussing their mutual efforts to avoid any undue economic harm, the reality is that the EU has been historically far too cautious with investing in major strategic industries. In all of the high- and critical-technology areas where the US dominates today, successive governments and industry have been willing to take a risk on investment and they have taken an active political decision to strengthen strategic industries. If the EU is the 'world's trading superpower' that it thinks it is, then it needs to be bolder on investments in key critical sectors.

However, the US and EU will not be able to simply invest their way out of competition with China and Russia: more transatlantic unity on critical raw material supplies, technology control and countering harmful foreign investment is required. This Policy Brief has outlined some of the ways in which Russia is using economic statecraft to offset its, as yet, poor military performance in Ukraine. Western countries cannot be lured into a sense of comfort over Russia's military deterioration; more than likely, Russia will use economic tools to menace its neighbours.

ABOUT THE AUTHORS

J. Alexander Thew

J. Alexander Thew is a U.S. Army Major and assistant professor of economics at West Point's Department of Social Sciences. He has served as an infantry officer in operational units including 2d Cavalry and the 82d Airborne. He earned an MBA at the Yale School of Management. Professor Thew's research interests include economic statecraft and nuclear enterprise and strategy. @jalexanderThew

Daniel Fiott

Dr Daniel Fiott is Assistant Professor and Head of the Defence and Statecraft programme at CSDS, Brussels School of Governance, Vrije Universiteit Brussel. He is a Non-Resident Fellow at the Real Elcano Institute. @DanielFiott

Francis A. Finelli

Francis A. Finelli, CFA, is an investment professional, who currently serves on the Board of Directors of Business Executives for National Security (BENS) in Washington. He is a retired Army Lieutenant Colonel and former Assistant Professor of Economics at the U.S. Military Academy and legislative assistant with the Senate Armed Services Committee. frankfinelli@alum.mit.edu

Mickey P. Strasser

Mickey P. Strasser is a Finance Senior Fellow in the Department of Social Sciences at the US Military Academy. A career finance professional, Mickey is a Managing Director with more than 30 years of experience in global institutional financial services and is an active leader in a variety of initiatives that impact and support military veterans. mickey.strasser@westpoint.edu

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BRUSSELS SCHOOL OF GOVERNANCE

Visitor's address:
Pleinlaan 5, 1050 Brussels, Belgium
Mailing address:
Pleinlaan 2, 1050 Brussels, Belgium

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info_bsog@vub.be

www.brussels-school.be