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Under the leadership of Vladimir Putin, Russia has been re-establishing much of its lost Soviet-era strength. This has given rise to the possibility - and even the probability - that Russia again will become a potent adversary of the Western world. But now, Russia is yet again on the cusp of a set of massive currency devaluations that could destroy much of the country's financial system. With a crashing currency, the disappearance of foreign capital, greatly decreased energy revenues and currency reserves flying out of the bank, the Western perception is that Russia is on the verge of collapsing once again. Consequently, many Western countries have started to grow complacent about Russia's ability to further project power abroad.

But this is Russia. And Russia rarely follows anyone else's rulebook.

The State of the Russian State

Russia has faced a slew of economic problems in the past six months. Incoming foreign direct investment, which reached a record high of \$28 billion in 2007, has reportedly dried up to just a few billion. Russia's two stock markets, the Russian Trading System (RTS) and the Moscow Interbank Currency Exchange (MICEX), have fallen 78 and 67 percent respectively since their highs in May 2008. And Russians have withdrawn \$290 billion from the country's banks in fear of a financial collapse.

One of Moscow's sharpest financial pains came in the form of a slumping Russian ruble, which has dropped by about one-third against the dollar since August 2008. Thus far, the Kremlin has spent \$200 billion defending its currency, a startling number given that the currency still dropped by 35 percent. The Russian government has allowed dozens of mini-devaluations to occur since August; the ruble's fall has pushed the currency past its lowest point in the 1998 ruble crash.

The Kremlin now faces three options. First, it can continue defending the ruble by pouring more money into what looks like a black hole. Realistically, this can last only another six months or so, as Russia's combined reserves of \$750 billion in August 2008 have dropped to just less than \$400 billion due to various recession-battling measures (of which currency defense is only one). This option would also limit Russia's future anti-recession measures to currency defense alone. In essence, this option relies on merely hoping the global recession ends before the till runs dry.

The second option would be to abandon any defense of the ruble and just let the currency crash. This option will not hurt Moscow or its prized industries (like those in the energy and metals sectors) too much, as the Kremlin, its institutions and most large Russian companies hold their reserves in dollars and euros. Smaller businesses and the Russian people would lose everything, however, just as in the August 1998 ruble crash. This may sound harsh, but the

Kremlin has proved repeatedly -- during the Imperial, Soviet and present eras -- that it is willing to put the survival of the Russian state before the welfare and survival of the people.

The third option is much like the second. It involves sealing the currency system off completely from international trade, relegating it only to use in purely domestic exchanges. But turning to a closed system would make the ruble absolutely worthless abroad, and probably within Russia as well -- the black market and small businesses would be forced to follow the government's example and switch to the euro, or more likely, the U.S. dollar. (Russians tend to trust the dollar more than the euro.)

According to the predominant rumor in Moscow, the Kremlin will opt for combining the first and second options, allowing a series of small devaluations, but continuing a partial defense of the currency to avoid a single 1998-style collapse. Such a hybrid approach would reflect internal politicking.

The lack of angst within the government over the disappearance of the ruble as a symbol of Russian strength is most intriguing. Instead of discussing how to preserve Russian financial power, the debate is now over how to let the currency crash. The destruction of this particular symbol of Russian strength over the past ten years has now become a given in the Kremlin's thinking, as has the end of the growth and economic strength seen in recent years.

Washington is interpreting the Russian acceptance of economic failure as a sort of surrender. It is not difficult to see why. For most states -- powerful or not -- a deep recession coupled with a currency collapse would indicate an evisceration of the ability to project power, or even the end of the road. After all, similar economic collapses in 1992 and 1998 heralded periods in which Russian power simply evaporated, allowing the Americans free rein across the Russian sphere of influence. Russia has been using its economic strength to revive its influence as of late, so -- as the American thinking goes -- the destruction of that strength should lead to a new period of Russian weakness.

Geography and Development

But before one can truly understand the roots of Russian power, the reality and role of the Russian economy must be examined. From this perspective, the past several years are most certainly an aberration -- and we are not simply speaking of the post-Soviet collapse.

All states economies' to a great degree reflect their geographies. In the United States, the presence of large, interconnected river systems in the central third of the country, the intracoastal waterway along the Gulf and Atlantic coasts, the vastness of San Francisco Bay, the numerous rivers flowing to the sea from the eastern slopes of the Appalachian Mountains and the abundance of ideal port locations made the country easy to develop. The cost of transporting goods was nil, and scarce capital could be dedicated to other pursuits. The result was a massive economy with an equally massive leg up on any competition.

Russia's geography is the polar opposite. Hardly any of Russia's rivers are interconnected. The country has several massive ones -- the Pechora, the Ob, the Yenisei, the Lena and the Kolyma

-- but they drain the nearly unpopulated Siberia to the Arctic Ocean, making them useless for commerce. The only river that cuts through Russia's core, the Volga, drains not to the ocean but to the landlocked and sparsely populated Caspian Sea, the center of a sparsely populated region. Also unlike the United States, Russia has few useful ports. Kaliningrad is not connected to the main body of Russia. The Gulf of Finland freezes in winter, isolating St. Petersburg. The only true deepwater and warm-water ocean ports, Vladivostok and Murmansk, are simply too far from Russia's core to be useful. So while geography handed the United States the perfect transport network free of charge, Russia has had to use every available kopek to link its country together with an expensive road, rail and cana

I network.

One of the many side effects of this geography situation is that the United States had extra capital that it could dedicate to finance in a relatively democratic manner, while Russia's chronic capital deficit prompted it to concentrate what little capital resources it had into a single set of hands -- Moscow's hands. So while the United States became the poster child for the free market, Russia (whether the Russian Empire, Soviet Union or Russian Federation) has always tended toward central planning.

Russian industrialization and militarization began in earnest under Josef Stalin in the 1930s. Under centralized planning, all industry and services were nationalized, while industrial leaders were given predetermined output quotas.

Perhaps the most noteworthy difference between the Western and Russian development paths was the different use of finance. At the start of Stalin's massive economic undertaking, international loans to build the economy were unavailable, both because the new government had repudiated the czarist regime's international debts and because industrialized countries -- the potential lenders -- were coping with the onset of their own economic crisis (e.g., the Great Depression).

With loans and bonds unavailable, Stalin turned to another centrally controlled resource to "fund" Russian development: labor. Trade unions were converted into mechanisms for capturing all available labor as well as for increasing worker productivity. Russia essentially substitutes labor for capital, so it is no surprise that Stalin -- like all Russian leaders before him -- ran his population into the ground. Stalin called this his "revolution from above."

Over the long term, the centralized system is highly inefficient, as it does not take the basic economic drivers of supply and demand into account -- to say nothing of how it crushes the common worker. But for a country as geographically massive as Russia, it was (and remains) questionable whether Western finance-driven development is even feasible, due to the lack of cheap transit options and the massive distances involved. Development driven by the crushing of the labor pool was probably the best Russia could hope for, and the same holds true today.

In stark contrast to ages past, for the past five years foreign money has underwritten Russian development. Russian banks did not depend upon government funding -- which was accumulated into vast reserves -- but instead tapped foreign lenders and bondholders. Russian

banks took this money and used it to lend to Russian firms. Meanwhile, as the Russian government asserted control over the country's energy industries during the last several years, it created a completely separate economy that only rarely intersected with other aspects of Russian economic life. So when the current global recession helped lead to the evaporation of foreign credit, the core of the government/energy economy was broadly unaffected, even as the rest of the Russian economy ingloriously crashed to earth.

Since Putin's rise, the Kremlin has sought to project an image of a strong, stable and financially powerful Russia. This vision of strength has been the cornerstone of Russian confidence for years. Note that STRATFOR is saying "vision," not "reality." For in reality, Russian financial confidence is solely the result of cash brought in from strong oil and natural gas prices -- something largely beyond the Russians' ability to manipulate -- not the result of any restructuring of the Russian system. As such, the revelation that the emperor has no clothes -- that Russia is still a complete financial mess -- is more a blow to Moscow's ego than a signal of a fundamental change in the reality of Russian power.

The Reality of Russian Power

So while Russia might be losing its financial security and capabilities, which in the West tend to boil down to economic wealth, the global recession has not affected the reality of Russian power much at all. Russia has not, currently or historically, worked off of anyone else's cash or used economic stability as a foundation for political might or social stability. Instead, Russia relies on many other tools in its kit. Some of the following six pillars of Russian power are more powerful and appropriate than ever:

Geography: Unlike its main geopolitical rival, the United States, Russia borders most of the regions it wishes to project power into, and few geographic barriers separate it from its targets. Ukraine, Belarus and the Baltic states have zero geographic insulation from Russia. Central Asia is sheltered by distance, but not by mountains or rivers. The Caucasus provide a bit of a speed bump to Russia, but pro-Russian enclaves in Georgia give the Kremlin a secure foothold south of the mountain range (putting the August Russian-Georgian war in perspective). Even if U.S. forces were not tied down in Iraq and Afghanistan, the United States would face potentially insurmountable difficulties in countering Russian actions in Moscow's so-called "Near Abroad." Russia can project all manner of influence and intimidation there on the cheap, while even symbolic counters are quite costly for the United States. In contrast, places such as Latin America, Southeast Asia or Africa do not capture

much more than the Russian imagination; the Kremlin realizes it can do little more there than stir the occasional pot, and resources are allotted (centrally, of course) accordingly.

Politics: It is no secret that the Kremlin uses an iron fist to maintain domestic control. There are few domestic forces the government cannot control or balance. The Kremlin understands the revolutions (1917 in particular) and collapses (1991 in particular) of the past, and it has control mechanisms in place to prevent a repeat. This control is seen in every aspect of Russian life, from one main political party ruling the country to the lack of diversified media, limits on public demonstrations and the infiltration of the security services into nearly every aspect of the

Russian system. This domination was fortified under Stalin and has been re-established under the reign of former President and now-Prime Minister Vladimir Putin. This political strength is based on neither financial nor economic foundations. Instead, it is based within the political institutions and parties, on the lack of a meaningful opposition, and with the backing of the military and security services. R

Russia's neighbors, especially in Europe, cannot count on the same political strength because their systems are simply not set up the same way. The stability of the Russian government and lack of stability in the former Soviet states and much of Central Europe have also allowed the Kremlin to reach beyond Russia and influence its neighbors to the east. Now as before, when some of its former Soviet subjects -- such as Ukraine -- become destabilized, Russia sweeps in as a source of stability and authority, regardless of whether this benefits the recipient of Moscow's attention.

Social System: As a consequence of Moscow's political control and the economic situation, the Russian system is socially crushing, and has had long-term effects on the Russian psyche. As mentioned above, during the Soviet-era process of industrialization and militarization, workers operated under the direst of conditions for the good of the state. The Russian state has made it very clear that the productivity and survival of the state is far more important than the welfare of the people. This made Russia politically and economically strong, not in the sense that the people have had a voice, but in that they have not challenged the state since the beginning of the Soviet period. The Russian people, regardless of whether they admit it, continue to work to keep the state intact even when it does not benefit them. When the Soviet Union collapsed in 1991, Russia kept operating -- though a bit haphazardly. Russians still went to work, even if they were not being paid. The same was

seen in 1998, when the country collapsed financially. This is a very different mentality than that found in the West. Most Russians would not even consider the mass protests seen in Europe in response to the economic crisis. The Russian government, by contrast, can count on its people to continue to support the state and keep the country going with little protest over the conditions. Though there have been a few sporadic and meager protests in Russia, these protests mainly have been in opposition to the financial situation, not to the government's hand in it. In some of these demonstrations, protesters have carried signs reading, "In government we trust, in the economic system we don't." This means Moscow can count on a stable population.

Natural Resources: Modern Russia enjoys a wealth of natural resources in everything from food and metals to gold and timber. The markets may take a roller-coaster ride and the currency may collapse, but the Russian economy has access to the core necessities of life. Many of these resources serve a double purpose, for in addition to making Russia independent of the outside world, they also give Moscow the ability to project power effectively. Russian energy -- especially natural gas -- is particularly key: Europe is dependent on Russian natural gas for a quarter of its demand. This relationship guarantees Russia a steady supply of now-scarce capital even as it forces the Europeans to take any Russian concerns seriously. The energy tie is something Russia has very publicly used as a political weapon, either by raising prices or by cutting off supplies. In a recession, this lever's effectiveness has only grown.

Military: The Russian military is in the midst of a broad modernization and restructuring, and is reconstituting its basic warfighting capability. While many challenges remain, Moscow already has imposed a new reality through military force in Georgia. While Tbilisi was certainly an easy target, the Russian military looks very different to Kiev -- or even Warsaw and Prague -- than it does to the Pentagon. And even in this case, Russia has come to rely increasingly heavily on its nuclear arsenal to rebalance the military equation and ensure its territorial integrity, and is looking to establish long-term nuclear parity with the Americans. Like the energy tool, Russia's military has become more useful in times of economic duress, as potential targets have suffered far more than the Russians.

Intelligence: Russia has one of the world's most sophisticated and powerful intelligence services. Historically, its only rival has been the United States (though today the Chinese arguably could be seen as rivaling the Americans and Russians). The KGB (now the FSB) instills fear into hearts around the world, let alone inside Russia. Infiltration and intimidation kept the Soviet Union and its sphere under control. No matter the condition of the Russian state, Moscow's intelligence foundation has been its strongest pillar. The FSB and other Russian intelligence agencies have infiltrated most former Soviet republics and satellite states, and they also have infiltrated as far as Latin America and the United States. Russian intelligence has infiltrated political, security, military and business realms worldwide, and has boasted of infiltrating many former Soviet satellite governments, militaries and companies up to the highest level. All facets of the Russian government have back

ed this infiltration since Putin (a former KGB man) came to power and filled the Kremlin with his cohorts. This domestic and international infiltration has been built up for half a century. It is not something that requires much cash to maintain, but rather know-how -- and the Russians wrote the book on the subject. One of the reasons Moscow can run this system inexpensively relative to what it gets in return is because Russia's intelligence services have long been human-based, though they do have some highly advanced technology to wield. Russia also has incorporated other social networks in its intelligence services, such as organized crime or the Russian Orthodox Church, creating an intricate system at a low price. Russia's intelligence services are much larger than most other countries' services and cover most of the world. But the intelligence apparatus' most intense focus is on the Russian periphery, rather than on the more expensive "far abroad."

Thus, while Russia's financial sector may be getting torn apart, the state does not really count on that sector for domestic cohesion or stability, or for projecting power abroad. Russia knows it lacks a good track record financially, so it depends on -- and has shored up where it can -- six other pillars to maintain its (self-proclaimed) place as a major international player. The current financial crisis would crush the last five pillars for any other state, but in Russia, it has only served to strengthen these bases. Over the past few years, there was a certain window of opportunity for Russia to resurge while Washington was preoccupied with wars in Iraq and Afghanistan. This window has been kept open longer by the West's lack of worry over the Russian resurgence given the financial crisis. But others closer to the Russian border understand that Moscow has many tools more potent than finance with which to continue reasserting itself.

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