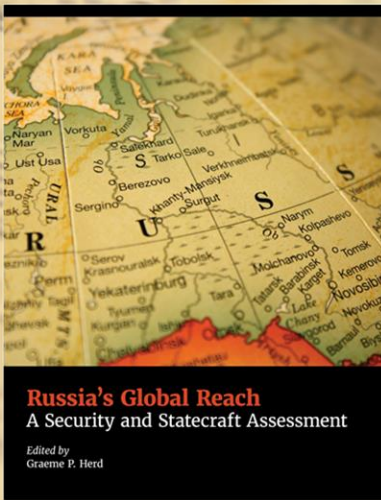


Chapter 12

Russia's Economic Engagement: Realities, Pitfalls, and Perils



By Pál Dunay

Introduction: Russian Strategic Economic Ends

The Russian Federation is an unevenly developed Great Power. Russia has the world's largest nuclear weapons arsenal with the size of its armed forces and the world's largest arsenal, a well-educated diplomatic corps, well-staffed intelligence and associated services, and most recently it has developed its public communication apparatus. But Russia also experiences significant weaknesses, including a relatively small and declining population unevenly distributed across its vast territory, and a small economy, including the very limited production of internationally marketable and competitive consumer goods. Countries that have such a large gap between their strengths and weaknesses usually reallocate resources to address the shortcomings in order to have a broader-ranging and more diverse power base (horizontal strengthening). When states have abundant resources they also address sources of power where they are strong (vertical strengthening). It is an open question to what extent Russia follows this pattern, and it seems horizontal strengthening left the economy largely unaffected.

The total nominal gross domestic product (GDP) of Russia is somewhat less than two per cent of the world's, and it is less than three per cent in terms of purchasing power parity (PPP), leaving Russia's economy as the eleventh largest in the world, the sixth in PPP terms. Russia's aspiration to be among the five largest economies of the world in PPP terms is realistic, although current trends do not move in this direction.

Given its weak economic foundations and the importance Russia attaches to its prestige and status as Great Power, Russia needs to "punch above its weight" in the international system, that is, attain more influence internationally than the size its economy suggests is merited. President Putin managed to achieve this from 2000-2012. However, since 2012 the Russian economy has stagnated and currently its primary commodities face shrinking markets and falling (or at least not increasing) prices. We can identify those factors that indicate how the economic performance will contribute or hinder Russia from acquiring the status it aspires to have in the international system.

Lilia Shevtsova identified a central shortcoming: "The Russian economy is not diversified and is built on the commodity market."¹ Russia's economy is over dependent upon the production and export of natural resources and energy and other primary commodities. German Gref, the CEO of *Sberbank*, noted: "Russia has failed to adapt to economic and technological change and has fallen into the ranks of 'downshifter' countries that will catastrophically lag behind their more advanced rivals ... We must honestly admit that we have

¹ Lilia Shevtsova, "Russia at the Fork Again: To Tighten the Screws or to Open the Windows," *Quaderni di Relazioni Internazionali*, No. 9, March (2009), 9, <https://www.ispionline.it/sites/default/files/publicazioni/QRI9.pdf>.

lost to competitors, ... the era of oil [is] over and ... in the new technology-driven world the difference between the leaders and losers [will] be ‘larger than during the industrial revolution.’”² Russia’s current political leadership that is strongly stability-orientated and risk-averse and views potential structural economic reform as a threat to political stability, as well as in opposition to their interest in continuing to reap the benefits of a corrupt system they control. Stability for the elite has greater currency than a modernization agenda, competitiveness and the well-being of the people. The absence of change also reflects a strong preference for stability shared by a large part of the population that in light of the economic liberalization of the 1990s and to the fact the Russian economy is prone to crisis.³ While the Russian economy stagnates, macro-economic stability, large currency reserves and little external debt suggests that such stagnation is sustainable. Indeed, Russia’s economy contracted less in 2020 (4.0-4.1%) than many western countries and the Russian economy can bounce back in 2021, registering as it does a higher than usual estimated growth rate of 2.8 percent.

The awareness of the problem occasionally results in nervous reaction. For instance, President Putin, when responding to a question at his annual press conference in December 2020 emphasized “Seventy percent of the Russian federal budget comes from non-oil and gas revenues now.”⁴ The answer prompts follow on questions: What is the long-term role of the production of natural resources in the Russian economy? What is and what should be the share of the production of energy bearers and natural resources in the Russian GDP overall? What should be the share of those commodities in the export of the country?

The Russian Economy in the Great Power Competition

The Russian Federation faces a number of problems that it will have to address if it wants to have better economic foundations making it more competitive overall: demography, state influence in the economy based on ownership or other channels, and corruption. Russia’s demographic situation presents challenges that the country’s leadership recognizes. The worst years of the 1990s when the population shrank fast are behind it. Life expectancy fell by approximately five years between 1990 and 1995 (from 69.2 to 64.5 years) and in this decade in some years the population fell by close to one million (in 2000 it was 958.5 thousand). Immigration partly compensated the loss, reaching four million between 1997 and 2016 (6.5 million immigrants and 2.6 million emigrants). According to a UN average estimate, Russia will be the 13th most populous country by 2050 with approximately 135 million people.⁵ This entails a loss of about ten million people in three decades (if the population of Crimea is not included). The sources of potential immigrants “depleted” and may be confined to three Central Asian states (Kyrgyzstan, Tajikistan, Uzbekistan) from where labor migrants may lastingly settle in Russia.

² German Gref spoke at the Gajdar Forum in January 2016 and the full text of his presentation “disappeared” from the web not much later. Interestingly, the reaction was classic: Instead of seriously contemplating the weight of Gref’s words, a vice-speaker of the Duma called on Gref to be dismissed for his views. Now only a few excerpts of the speech are available in some western media reports. See Michelle A. Berdy, “Shifting Gears, Russian-Style,” *The Moscow Times*, January 21, 2016, <https://www.themoscowtimes.com/2016/01/21/shifting-gears-russian-style-a51510>.

³ Anders Aslund and Leonid Gozman, “Russia After Putin: How to Rebuild the State,” Atlantic Council of the United States, February 24, 2021, in particular pp. 10-13, <https://www.atlanticcouncil.org/in-depth-research-reports/report/russia-after-putin-report/> and Anders Aslund, *Russia’s Crony Capitalism: The Path from Market Economy to Kleptocracy* (New Haven and London: Yale University Press, 2019), 69.

⁴ Vladimir Putin’s Annual News Conference 17 December 2020, http://en.kremlin.ru/events/president/transcripts/press_conferences/64671.

⁵ See UN Department of Economic and Social Affairs, *World Population Prospects 2019* (New York: United Nations, 2019).

This will reduce the available labor force and the size of the internal market, two factors usually associated with a state's competitive advantage. To increase the share of the working population, in 2018, the age of retirement was raised. Cash payments to boost fertility from current levels of 1.6 children per family to a reproduction rate of 2.1 have not resulted in a breakthrough. Personal satisfaction levels and expectation of good life prospects is also important. The Russian national census, postponed in 2020 due to the Coronavirus, takes place in April 2021 and will provide a clearer picture of trend lines.

Given that the Russian state has significant influence on the economy, it is surprising that only approximately thirty-five percent of the GDP runs through the budget. Understandably, the share increased in 2020 (to 37.3 percent) when the state had to take more responsibility and contribute to social stability in the context of COVID-19.⁶ Other estimates calculate that the share of the state is actually approximately twice as high, as the revenue of the twenty-six largest state owned companies are included. The state fully owns companies, like *Rosatom*, *Rostec*, *Rusnano*, the Russian Post, the Russian Railways and *Vneshekonombank*. It has a majority share in *Aeroflot*, *Gazprom*, *Rostelekom*, *RusHydro*, *Sberbank*, *VTB Bank*, and a few other major enterprises, and fifty percent share in *Rosneft*.⁷ In some cases, the state owns companies indirectly, via intermediaries.⁸

Unceasingly high levels of corruption characterize Russia. Transparency International's corruption perception index usually evaluates Russia with the lowest or one of the lowest standings in Europe. However, this does not prevent the Russian media from regularly pointing to the high level of corruption in Ukraine without mentioning that in the last five years Russia was lagging behind its south-western neighbor. On a scale that rates approximately 180 states over the last five years, Russia was either the worst-performing European state (with a rank between 129 and 145, twice in a tie with Azerbaijan or Ukraine respectively) or—in 2017—followed only by Azerbaijan. In the preceding five years (2011-6), the “competition” for the lowest position in Europe was won by Ukraine; this was an “achievement” of President Yanukovich's regime.

Due to various factors, first and foremost its natural resources, Russia will always attract foreign direct investment (FDI). However, investment in the manufacturing industry remains volatile and oscillates significantly. Foreign direct investment reached USD \$13 bn in 2018, 31.7 bn in 2019 and de facto collapsed in 2020, equaling US\$ 1.1 bn. When taking a closer look at the pros and cons for investment, a complex picture emerges. Abundant natural resources, political stability, skilled labor, relatively low labor costs are positive factors. Among the weaknesses, we can list: over-dependence on the prices of hydrocarbons and raw materials, the presence of economic sanctions, the low level of confidence in the legal system, infringements of intellectual property rights and a number of strategic sectors closed to FDI.

The Russian state accounts for a large number of economic shortcomings. Given a large portion of profit related to the export of natural resources disappears in the system, or is used to maintain some level of social cohesion, capitalization requires boosting FDI. This in turn requires reform, with elites reluctant to change the status quo. Current FDI into Russia comes from Cyprus, the Netherlands, Bermuda, Luxembourg, the UK, and Ireland. At least in three cases, if not more, we observe primarily the reinvestment of Russian capital that had left the

⁶ Russia: Ratio of government expenditure to gross domestic product (GDP) from 2015 to 2025, <https://www.statista.com/statistics/275349/government-expenditure-as-share-of-the-gross-domestic-product-gdp-in-russia/>.

⁷ World Bank Group, *State-Owned Enterprises in the Russian Federation: Employment Practices, Labor Markets, and Firm Performance*. June 2019, <https://elibrary.worldbank.org/doi/abs/10.1596/32098>.

⁸ 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*, vol. 3, no. 1, (2017): 1-23, www.rujec.org.

country. Russia systematically resisted erecting administrative barriers against capital flight even in 2014-5 when there was external expectation that it would introduce such measures. It did not and now it partially benefits from the reinvestment of escaped capital.

Some Elements of the Energy Sector

Russia is a major natural resources and energy producer and exporter. Its economy benefits from high energy prices and is disadvantaged when prices drop. It would be wrong, however, to assume that the Russian Federation is amongst those states that most heavily depend on oil rent (rent is the difference between the market price and the production costs). Russia, compared to some other oil producing and exporting countries has a large population and a developed economy that reduces the share of rent, which has never exceeded thirteen percent of the GDP and recently it was ten percent.⁹ In this respect, Russia lags behind another twelve oil-producing countries, including Kuwait, Iraq, Saudi Arabia, Azerbaijan, and Kazakhstan. Additional rent is derived from selling gas, although there the rent due to the larger production costs and the more sophisticated technology applied is smaller than in the oil sector.

The Russian Federation followed the Soviet Union in compensating for the fall in oil prices by increasing exploitation and export. However, in recent times Russia coordinates its position with the Organization of the Petroleum Exporting Countries (OPEC) generally and with a few of its large members, specifically. Russia is aware that it is part of a risk-sharing community and with its high exploitation costs (compared to Saudi Arabia and a few other states) it is in its best interest to behave as a responsible stake-holder. In a “free” competition, Russia would lose against countries that have more favorable production conditions. Moreover, Russia’s oil reserves are slowly running out, production costs in the new (replacement) fields soar and oil demand is in lasting decline. Russia gradually focuses on gas, a commodity where its reserves are far more significant. This is indicated by the construction of modern gas infrastructure, including new pipelines across the Black Sea (Turkish Stream) and further to south-eastern Europe, as well across the Baltic Sea, where Nord Stream 2 will complement the also modern Nord Stream 1 pipeline in operation since late 2011.

The pipelines have generated heated debates relating to broader strategic issues and are characterized by limited information and political prejudice. For some, the pipelines are viewed as instruments of leverage which Moscow can use to make states strategically dependent on it, reducing their political choices, and opening them to blackmail. As the Russian Federation has serially violated international law since 2014 and also committed highly objectionable actions, including the carrying out or attempting of extra-judicial killings (Nemtsov, the Skripals, Kangoshvili, and Navalny), a business as usual approach to Moscow has been stressed. For others, the pipelines are simply business ventures. In the case of Nord Stream 2, it is also emphasized that there is not a single penny of government funding involved. Russia also regularly claims that U.S. opposition serves its own self-interest, as the U.S. wants to sell Liquefied Natural Gas (LNG) in Europe at a price higher than the Russian gas supplied via pipelines.

Could Russia blackmail its partners by cutting or disrupting the supply? As the gas market has become global and Europe can receive alternative LNG, the blackmailing potential no longer applies. Indeed, European LNG terminals are not used to capacity and hence the supply of LNG can be quickly increased. Following disruptions to gas supply in 2006-9, European consumers remain suspicious of Russia and a repeat performance would seriously undermine Russian interests. In addition, the capitalization of the largest Russian gas company,

⁹ World Bank, Oil rents (percent of GDP), <https://data.worldbank.org/indicator/NY.GDP.PETR.RT.ZS>.

Gazprom, a major contributor to the Russian budget, has shrunk and gas income cuts would lead to further economic deterioration. These factors mitigate against the risk of blackmail, though the West may seek to stop Nord Stream 2 as a sanction against Russia for its regular illegal actions.

The Russian Federation also builds nuclear power plants abroad. One of its modern reactors began generating power in the summer of 2020 in Belarus. It had to be temporarily switched off on a number of occasions. Other reactors are being built in Finland, Hungary, and Uzbekistan. The one built in Finland suffers massive delays as it does not meet some of the safety requirements. In other cases, delays are due to other factors, including the meeting of EU safety requirements and also the translation of the full package of Russian documents into one of the EU's official languages. However, the performance of *Rosatom* is not reassuring – potential partners choose not to opt for Russian reactors.

Russian Arms Industry

The Russian Federation as well as its predecessor, the Soviet Union, has been a major arms producer and exporter. Following the dissolution of the Soviet Union, the Russian armed forces did not represent a priority as many other matters were more urgent and given higher priority. Russia did not modernize its armed forces and consequently did not buy the products of its own arms industry. Times have changed. Although Russia's arms export data are still not particularly impressive, the occasions when its import partners occasionally returned armaments and equipment, as Algeria did in 2008 (MiG-29 aircraft) or expressed dissatisfaction with timely delivery, as India did in 2007 (T-90 battle tanks) are gone.

The fact Russia did not buy its own weapons resulted in a major loss of economy of scale and a challenge for arms export. With the relatively fast increase of GDP at the beginning of the 21st century, the country boosted its defense budget and also launched an ambitious defense modernization program, to the value of USD\$ 700 bn in a ten-year period. The ten-year State Armament Plan of 2011-20 focused on the modernization of the navy and aerospace forces. Although not completed fully, it gave way to a less ambitious plan of USD\$ 330 bn for the period between 2018 and 2027. It prioritizes Russia's ground forces and improving its rapid reaction forces, including elite Spetsnaz, Naval Infantry, Airborne, and Air Assault Troops (VDV). In particular, strengthening mobility and command and control remains a focus, as well as implementing lessons learned from Russian interventions in Ukraine and Syria—such as the importance of reconnaissance and heavy artillery.¹⁰ Due to the resources allocated to the programs, Russia modernized its armed forces, purchased armaments and equipment and also used them in operations in Syria, Libya, and (of course) in Ukraine. The Russian arms industry increased its competitiveness and a growing volume of exports followed. However, the value of arms export did not exceed USD\$ 13 bn (that was once already reached in 2012) and Russia struggles, China has become a competitor and ceased to be a major market. A pragmatic armament export policy is Russia's attempt to compensate for that loss, selling some of the competitive pieces of armaments and equipment ranging from S-400 surface-to-air missiles to Sukhoi and MiG aircraft and many other items in countries, like Algeria, Egypt, India and many others.

¹⁰ Congressional Research Service, "Russian Armed Forces: Military Modernization and Reforms," *In Focus*, July 20, 2020, <https://fas.org/sgp/crs/row/IF11603.pdf>.

Economic Sanctions

Coercion is not alien to international economic relations and the Russian Federation (and its predecessor the Soviet Union) was at both ends of the application of sanctions. Russia applied sanctions through interrupting gas supply to East-central European and South-east European states and stopping gas transit through Ukraine (and once also through Belarus) between 2005-2010 and so-called counter-sanctions since 2014. The west applied sanctions against the Soviet Union and the Russian Federation under the Jackson-Vanik amendment to the trade act of 1974, and the so-called Magnitsky Rule of Law Accountability Act of 2012 and in reaction to the annexation of Crimea and support to Ukrainian separatists in the Donetsk and Luhansk areas. Whereas the two former applications were related to human rights enforcement, the sanctions in force since 2014 have been introduced due to a fundamental violation of the prohibition of the use of force, including the violation of the territorial integrity and the political independence of another sovereign state.

The variety of enforcement measures is limited. They usually include the following: travel bans for ranking officials, including commanders of law enforcement agencies and certain entities (companies); diplomatic measures, such as the suspension of Russia's participation in the G-8 and returning to the G-7 format, the suspension of the accession talks of Russia with the OECD and the International Energy Agency (IEA). The EU also stopped holding bilateral summits with Russia. Export and import bans, banning or at least limiting investment, including the access to technologies, and limiting financial relations, including the providing of credits, are also notable. It is always a delicate political decision to put together an adequate package that fulfills a variety of objectives from enforcing compliance (reversal of the illegal acts), deterring from further violation, subversion, international and domestic signaling. In the last few decades, it was increasingly important not to hurt the population of the country under sanctions severely and thus apply sanctions that primarily hurt the interests of the leadership.

In case of the sanctions related to Russia's actions in Ukraine, a fairly limited package was put together very quickly following the occupation of Crimea, including a general import ban from Crimea, a partial export ban in the opposite direction, and a prohibition to supply services, including tourism. In addition, a general import and export ban was introduced for arms and an export ban for dual-use goods. The access to certain technologies that can be used in oil production and exploration has been curtailed.

The value of trade between the U.S. and Russia is relatively small. In 2019, the total trade in goods and services was USD\$ 34.9 bn (10.9 bn export and 24 bn import) indicating significant trade deficit on the U.S. side.¹¹ The value of trade between the EU and Russia equals € 270.7 bn, approximately 8.5 times more.¹² This means curtailing trade relations between the U.S. and Russia would not hurt either party very much, whereas the damage would be much greater for the EU and Russia. As the U.S. has significant influence on other western actors, it may influence European partners to reduce economic interaction to change Russian strategic behavior, though the political will in European capitals to accept economic costs is questionable. Several state owned Russian banks *Sberbank*, *VTB*, *Gazprombank*, *Rosselkhozbank* (Russian agricultural bank), and *VEB* (Russia's state-owned development bank) no longer could receive long-term financing under the sanction regime. The EBRD suspended development loans to Russia as well. The net result is that credits become more expensive for those Russian banks and their customers. Bearing in mind, interest rates have been low in the international markets for a

¹¹ Office of the United State Trade Representative, U.S. – Russia Trade Facts. <https://ustr.gov/countries-regions/europe-middle-east/russia-and-eurasia/russia>.

¹² European Commission, "Countries and Regions: Russia," <https://ec.europa.eu/trade/policy/countries-and-regions/countries/russia/>.

long time, Russia, has not experienced particular difficulties in this area. The U.S. has tightened its sanctions during the last few years, in particular with the Countering America's Adversaries Through Sanctions Act (CAATSA) adopted in 2017. This sanctioned any actor that knowingly engaged in a "significant transaction" with Russia's security sector.¹³ U.S. secondary sanctions applied against western entities appeared ambiguous and were not welcomed in Europe.

Nevertheless, the unity of the West was preserved as far as the application of sanctions. The U.S. introduced more severe sanctions than the EU, in particular those that were energy-related (this is fully understandable as the U.S. has become a gas and more recently a petroleum exporter), and the U.S. support for secondary sanctions (applying sanctions against companies doing business with Russia) outstripped that of the EU, relatively insignificant economic relations between the U.S. and Russia, compared to the EU.

The Russian Federation, in the name of "reciprocity," responded with counter-sanctions even in areas where it suffered losses. In light of the economic power difference between Russia and the West, counter sanctions did not cause lasting and systemic difficulties. But the sanctions had an important domestic function: they provided a signal to the population that the leadership would not let Russia be humiliated. It was also important for the protection of domestic production in certain sectors, first and foremost in agriculture. The agricultural sector realizes somewhat less than USD\$ 30 bn export revenue and with this more than twice that of the defense industry. It negotiated a certain "guarantee" with then-Prime Minister Medvedev so that the Russian counter-sanctions would not be unexpectedly lifted, i.e., the domestic agricultural market could be protected from external competition. It is of course open to question to what extent Russia lost on responding if not retaliating by counter-sanctions.

The economic sanctions resulted in some GDP loss to Russia. In the beginning, it was assumed to be between 0.5 to 1.0 percent that increased later to approximately 1.2 percent annually. Other estimates show a 1.5 percent annual loss between 2014 and 2017.¹⁴ Since 2017 two tendencies have been noticeable. First, further sanctions complemented the earlier ones and this resulted in more severe consequences. Second, Russia became accustomed primarily to the trade sanctions and could mitigate their effects. Unlike in the case of Iran and North Korea, the sanctions never sought to break the back of the Russian economy. It was more important to signal western dissatisfaction with Russia's malign strategic behavior in the hope of behavioral change. The limitations placed on access to certain technologies mean that the Russian economy loses competitiveness. Consequently, Russia either loses its market share or its profit margin narrows. Either way, the cumulative effects of sanctions will reduce its competitiveness. Apparently, Russia miscalculated the consequences of its actions, in particular as far as the staying power, unity and solidarity of the West.

Strategic Choices

The Russian Federation has been a rival of the West for the last two decades. The rivalry has deepened. Moscow's disrespect for the sovereignty of other states, the violation of the prohibition of the use of force and illegal activities addressing certain individuals both inside the Russian Federation and beyond its borders, have increased tensions. The comparatively small size of its economy and its insufficiently diversified economic structure has made Russia vulnerable in its rivalry with far larger and economically better-positioned protagonists. Russia's

¹³ Countering America's Adversaries Through Sanctions Act (CAATSA). Public Law 115-44. August 2, 2017, <https://www.govinfo.gov/content/pkg/PLAW-115publ44/pdf/PLAW-115publ44.pdf>,

¹⁴ Iikka Korhonen, "Economic Sanctions on Russia and Their Effects," *CES ifo Forum*, ifo Institut – Leibniz-Institut für Wirtschaftsforschung an der Universität München, München, Vol. 20, No. 04, 2019, 20-1, <https://www.econstor.eu/bitstream/10419/216248/1/CESifo-Forum-2019-04-p19-22.pdf>.

might and its aspirations cannot be realized on the basis of economic weakness. This structural factor indicates that there may be opportunities for more powerful external economic actors to use economic means to induce and coerce Russia.

The U.S. faces strategic choices. It should not exclusively rely on coercive means. When using coercion, the U.S. must persuade partners to accept this approach and be ready to follow and support them. While in the Trump administration this approach was not always adopted. If the Biden administration seeks to reestablish U.S. leadership, this requires the acceptance by partners and allies, which in turn suggests a balanced approach: partners of the U.S. will not accept losing economic opportunities if the U.S. extorts but does not lead. The Biden administration has stated that it prioritizes countering corruption and (euphemistically put) “illiberal” regimes. Russia is at the epicenter of this agenda. Russian corruption spreads beyond its borders and is at the persuasive heart of many of its international business deals. If the U.S. plans to address the two matters systemically, then Russia matters. However, Washington also has to avoid generating unintended consequences in Russia, such as a “rally around the flag” effect in Russia and the toughening of its autocratic domestic position due to its disinterest in the views of the world at large, in particular the West. Russia “self-victimizes” itself with respect to the West and uses the besieged fortress narrative to “externalize” many of its shortcomings and weaknesses.

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