

Russia's Military Spending Is Out of Control

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On May 9, Russia held its largest military parade since the Soviet era. In the tradition of that era, Red Square was filled with the army's latest equipment, including the new T-14 Armata tank. And, also in the tradition of that era, ordinary people were quick to joke when the tank stalled during the parade rehearsal: "The Armata truly has unprecedented destructive power; a battalion can destroy the entire Russian budget!"

The joke, though an exaggeration (each tank costs about \$8 million), highlighted another throwback to Soviet life: overspending on the military.

There is now no question that the Kremlin's military spending is threatening Russia's fiscal position, which has already been undermined by low world oil prices and the West's economic sanctions. And this spending spree shows no sign of slowing. In recent months, growth in military expenditure has accelerated rapidly, exceeding the authorities' already ambitious plans.

The 2015 budget that Russia developed last summer was based on the assumption that oil prices would remain at \$100 per barrel, with annual gross domestic product growth and inflation at about 2 percent and 5 percent, respectively. Then oil prices plummeted, the economy contracted and inflation reached double digits. Russia's government was slow to accept reality, with President Vladimir Putin signing a revised budget only last month.

The good news is that the new budget is much more realistic, as it cuts spending by about 2 percent in nominal terms. Given annual inflation of at least 11 percent, this amounts to roughly an 8 percent real reduction in planned spending.

Nonetheless, as lower oil prices and economic contraction undermine budget revenues, the deficit will increase from 0.5 percent to 3.7 percent of GDP. This is a major problem, given that Russia, despite its miniscule sovereign debt of only 13 percent of GDP, cannot borrow on global financial markets, owing to Western sanctions.

As a result, the Russian government's only option for financing its deficit is to tap its Reserve Fund, which is meant to cushion the economy against shocks.

With the fund amounting to only about 6 percent of GDP, Russia can maintain a 3.7 percent deficit for less than two years before it either has to withdraw from Ukraine to gain relief from Western sanctions, or undertake a major — and, for Putin, politically dangerous — fiscal adjustment.

But even this scenario may be too optimistic. According to just-published budget data, during the first three months of 2015, non-defense spending amounted to 16.5 percent of quarterly GDP, as planned; but military expenditure exceeded 9 percent of quarterly GDP — more than double the budgeted amount.

In other words, Russia has already spent more than half of its total military budget for 2015. At this rate, its Reserve Fund will be emptied before the end of the year.

The fact that the Reserve Fund is now being consumed in this way represents a decisive step in a protracted debate over Russia's military spending. That debate began in 2011, when then-President Dmitry Medvedev proposed raising military spending by \$600 billion, taking it from under 3 percent to above 4 percent of GDP, over 10 years. When then-Finance Minister Alexei Kudrin — who had presided over budget surpluses, helped to build up the Reserve Fund and cut state debt considerably — argued that Russia could not afford such an increase, he was fired. The plan was adopted soon after.

But sacking Kudrin did not change the facts. The Kremlin's goal was extremely ambitious, both by Russian and global standards. Most European countries now spend less than 2 percent of GDP on defense. China spends slightly more than 2 percent and the United States spends about 3.5 percent. According to the World Bank, only nine countries in the world, including Saudi Arabia, the United Arab Emirates and Israel, spend more than 4 percent of GDP on their militaries.

Russia simply cannot sustain the allocation of such a large share of its budget to defense spending. Moreover, its defense industry lacks the capacity to produce modern equipment as quickly as the plan anticipated.

Since the plan's adoption, scandals involving overpricing and corruption have multiplied, with many defense executives losing their jobs. And still, until this year, actual defense spending remained at about 3 percent of GDP.

Against this background, Russia's recent military spending binge is all the more notable, for it suggests that the government, desperate to retain popular support amid declining economic performance, is less interested in investing in the most modern equipment than in showing its support for the rebels in eastern Ukraine, even at the price of further economic hardship.

The Kremlin might even be preparing a major offensive for the coming months. Alternatively, it may have no strategy, with unusually high military spending simply reflecting the higher-than-expected costs of the conflict.

In any case, Kudrin's economic and financial logic is even more valid today than it was at his dismissal from office. If Russia could not afford a 4 percent-of-GDP defense budget in good times, it cannot possibly manage such a high rate of military spending now, when it confronts rock-bottom oil prices, Western sanctions and economic recession.

Of course, the government could be betting on an oil price resurgence; after all, prices have historically bounced back when Russia was in need. But, like the T-14 in Red Square, Putin's luck may be about to give out.

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