

# RUSSIAN FOREIGN POLICY - INTERESTS VECTORS AND ECONOMIC IMPACT

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*Abstract - In recent decades, Russia's foreign policy was shaped by both a number of internal factors (government strategy, political elites, culture, economics and demography) and external ones (international treaties, changes in the structure of the international power balance). In the post-soviet era Russian foreign policy was radically different from that of other major economic powers. One of the factors that influenced decisively Russia's external strategies was the collapse of the USSR as a superpower (phenomenon described by the president Vladimir Putin as "the most powerful geo-political catastrophe of the XXst century"). The shift from the former communist regime (a totalitarian one) to an authoritarian oligarchy (the current regime) was followed by the transition to a market economy, a phenomenon that coincided with Russia's military and political diminished influence in the international arena. Our research aims to assess the main interest vectors that shaped Russian Foreign Policy considering the main events that constitute milestones: Russia's emerging as a great energy power, the Crimean crisis and Western international economic sanctions that followed. Our paper will base the main assumption on a joint analysis both qualitative and quantitative, using main international economic indicators (GDP, FDI flows, trade flows, general government balance and general gross debt) and the most relevant approaches in the literature in the field.*

*Key-Words: Russian Foreign Policy, Crimean crisis, geo-strategic approach*

*JEL Classification: F, F5, F 59*

## 1 Introduction

In recent years Russia's foreign policy has been driven by two major objectives: recovering country's status as a superpower in the global arena and regaining the same level of influence in international affairs as in the period previous to USSR's collapse. It should be noted that Russian efforts to be "reborn" as a major global actor has occurred amid significant changes of international political system<sup>1</sup>. Although during the Vladimir Putin's regime, military spending as a share of GDP have constantly increased (see Graph 1) and through the export of hydrocarbons (see Graph 2) Russia was able to maintain a stable economic growth, the country failed to exercise the same level of influence in the international arena as during the Cold War period.

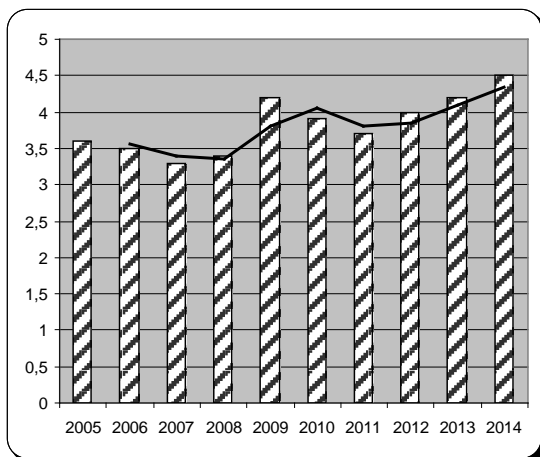
Following these developments, Russia's foreign policy initiatives undertaken after the Vilnius Summit (culminating with the annexation of Crimea in 2014) should be perceived in the context of its efforts to rebuild itself as a geopolitical power at a comparable level to that registered during the Cold War era. Some analyses (Lo, 2015) show that the annexation of Crimea by the Russian Federation was "one of the biggest geo-strategic shocks" of the last 25 years. For the Western states, the annexation of Crimea has marked the end of illusions concerning the predictability of Russia's actions in the foreign policy field. Through its involvement in the Ukrainian crisis, Russia has demonstrated its will to reshape the geopolitical map of Europe, derailing the cooperation based on common economic interests with the West and regressing to the tensions during the Cold

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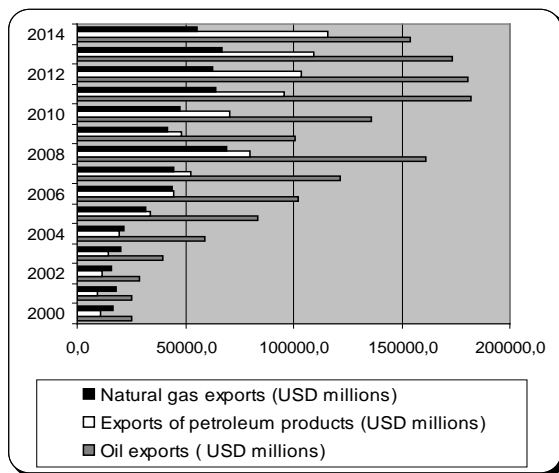
<sup>1</sup> After the end of the so called "Cold War" (conflict that occurred during 1945-1990 between the Soviet bloc and the Western states) followed by the disintegration of the Warsaw Pact, the international political system has been significantly reshaped, and Russia's influence as the second pole of global power has decreased.

War times. Hence, Russia has become the "central actor" in a global drama that started with the political and economic sanctions enforced by the West. Some analysts (Chifu, 2014) shows that there is a relationship of direct dependence between the foreign policy of Russia and the deepening of political and military tensions worldwide. Some analyses (Buzan, 2014) are emphasizing that the strategy of Moscow authorities regarding regional and international politics reflect a very different vision compared with the Western one. The Western states have counted on the pressure that Russia's isolation in the international arena might exercise, leading to the renunciation of its territorial claims in Crimea. On the other hand, the Russian authorities believed that by their actions they would achieve a new shape of the multipolar global order, diminishing the USA and EU leadership status worldwide. In this context, it should be noted that the Russia has proven itself to be capable of new strategic alliances and a new growth strategy as we will assess in the following sections of our analysis.

**Graph 1: Russia's military expenses<sup>2</sup> during 2005-2014 (GDP %)**



**Graph 2: Russia's hydrocarbons exports during 2000-2014**



Source: Author based on World Bank data.

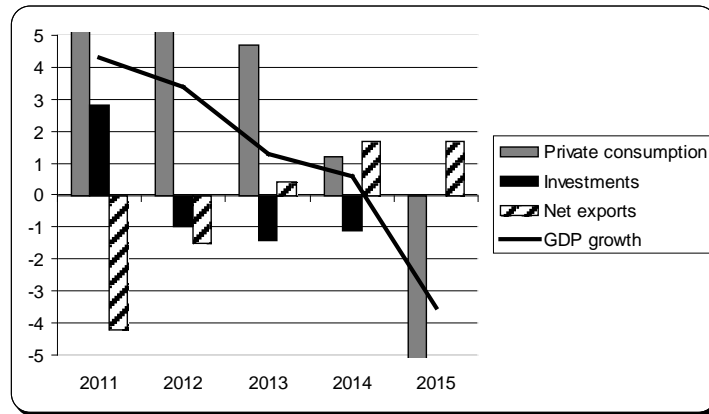
## 2 The impact of international geo-political tensions on the Russian economy

After a noticeable decrease of economic growth in the previous years, in 2015, the Russian economy registered a sharp decline caused by the downturn in net exports, investment and private consumption (see Graph 3).

According with some analyses (IMF, 2015) the new created geo-political tensions with the West risk to deep damage Russia's economy in the future, starving it of foreign funds and technological know-how (as the West has banned military and drilling technologies exports and closed the international capital markets for Russia).

**Graph 3: The evolution of GDP and its main contributors during 2011-2015 (%)**

<sup>2</sup> According to NATO, military expenditure as % of GDP refers to all expenses for armed forces, including peacekeeping forces, Defense Ministry and other government agencies engaged in various defense projects. These costs include gross wages for active military personnel and former military pension's Fund.



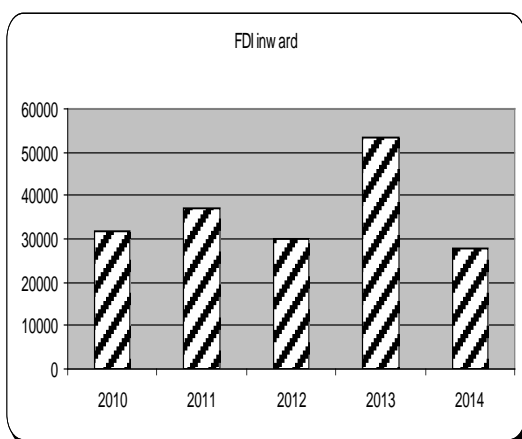
Source: Author based on World Bank and IMF data

It could be argued that Russia's new foreign policy of territorial claim occurred in a crucial moment when the country growth model based on energy exports proved its vulnerabilities. According to the latest IMF report (IMF, 2015), the evolution of Russian economy was set on a downward trend even before the onset of the crisis in Ukraine. Russian's economy decline occurred due to a lack of economic diversification and an increased dependence on oil and other energy products exports. The decline in growth occurred amid oil price collapse and the economic sanctions imposed by the international community, both phenomena leading to the instability of the Russian economy.

According to World Bank analysis, the investment and private consumption decline occurred amid withdrawal of massive external capital flows, as a consequence of the imposed sanctions, which have led to an increase of borrowing cost on foreign markets after the European Union "has closed" its financial markets for Russia. As some recent analyses pointed out (OECD, 2015) investments in Russia are expected to fall sharply in 2015 reflecting constrained access to Western capital markets, elevated borrowing costs and a deteriorated business environment.

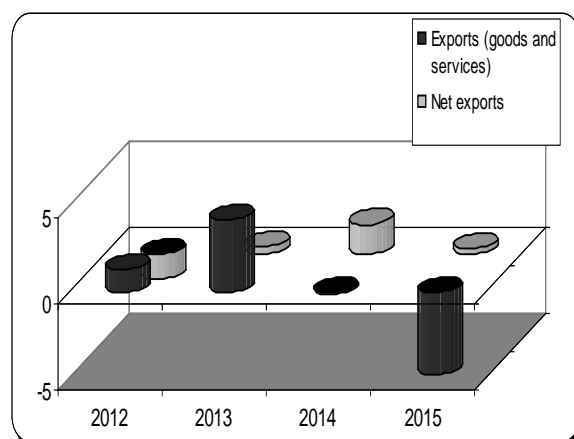
Moreover, as the restrained access to foreign capital, reduced bank lending and deteriorated economic confidence weigh on the economy's export potential, export growth will turn negative in 2015, as structural bottlenecks and failing inward FDI prevent Russian firms to benefit from a weaker rouble (see Graph 4 and Graph 5).

**Graph 4: Inward FDI flows in Russia (USD millions)**



Source: Author based on OECD and EC data.

**Graph 5: Exports growth in Russia (annual percentage change)**

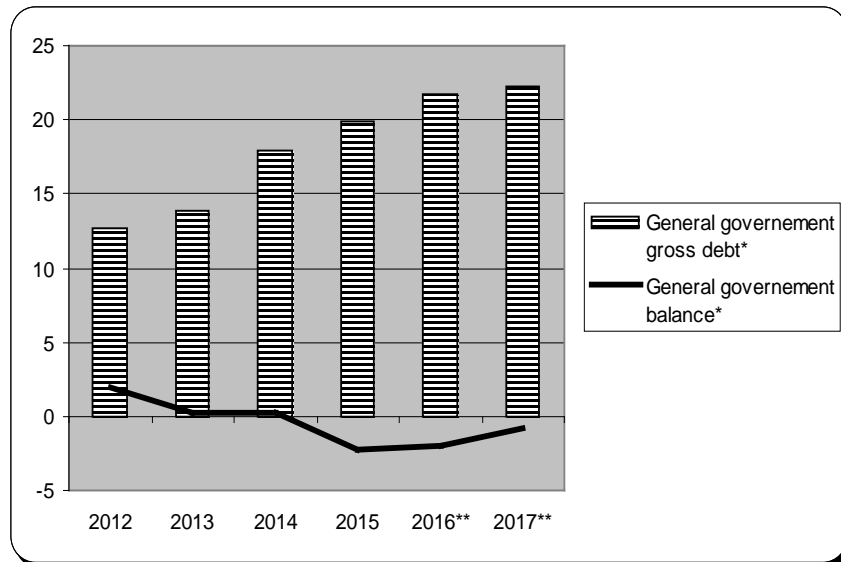


Moreover, in 2016, a further decrease in FDI inflows is possible to occur due to the downgrading of the Russian economy by Moody's from "unstable" to "junk" (not recommended for investors). Rating agency Moody's downgraded the rating of Russian economy due to the economic effects of sanctions imposed after the Ukrainian crisis, the oil price decrease and the depreciation of the rouble.

As a result, it is possible that the outlook of the Russian economy continue to deteriorate throughout 2016, given that the state financial equilibrium will be challenged as a result of fiscal pressures and continuous decrease of foreign exchange reserves.

For the period 2015-2016, the European Commission (EC, 2015) estimates a worsening of the fiscal situation of Russia (budget deficits of 1.8% of GDP in 2015, and 1.4% of GDP in 2016) amid negative effects of the economic downturn, but also due to the national anti-crisis plan (with an increase of public expenditures) that will reflect negatively on the balance of public finances (see Graph 6).

**Graph 6: General government balance and general gross debt (annual percentage change)**



Source: Author, based on EC data. \* As a percentage of GDP; \*\* Forecast

Faced with the difficult economic situation due to Western sanctions the Russian authorities are trying to find new ways to stimulate growth.

In the years before the Ukraine crisis, Russia simulated poorly the development of national industry and agriculture, basing its growth mainly on energy exports. As a result, Russia became dependent on imports of certain agricultural products and Western technologies. Hence, the export prohibition of certain goods (military products, weapons, drilling technologies) brought by the Western sanction is likely to jeopardize its economic development.

In order to stimulate domestic production and reduce technological imports dependence, Russian authorities have accelerated the modernization of industrial enterprises in the public sector and have also stimulated the local and foreign entrepreneurs in order to strengthen the business environment.

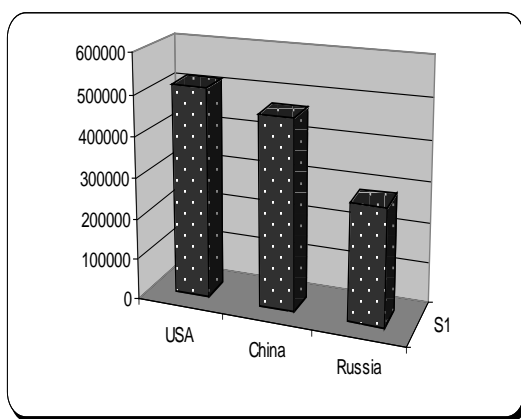
In 2015, the law creating a special fund to finance the scientific researchers and local builders entered into force. These funds may be used for obtaining advantageous loans, with a low interest rate. Also, in order to boost economic recovery, Russia has established (for the 2015–2018 period) a fund of 18.5 trillion rouble for stimulating national industry to replace by own production the technical components imported previously from the EU and other Western countries. Despite these efforts the situation of Russian economy remains volatile. Russia's biggest problem could be the risk of insolvency: while the external debt (public and private) amounts to USD 600 billion, the national foreign currency reserves are estimated only around USD 300 billion. IMF experts estimate that Russia's difficult situation illustrates the importance of cooperation between central banks and their crucial role in supporting expansionary policies of different administrations. Currently, Russia may not hope that other central banks will put pressure on their banking systems to provide a new financing for existing debt. Also, there is no possibility of an external loan from the International Monetary Fund, as happened in 1998 during the emerging markets crisis. The tense political relations with the EU and the USA have left Russia all alone and in need to find its own solutions to overcome the current economic crisis.

### 3 The new geopolitical game implications for Russia's new approach on external cooperation

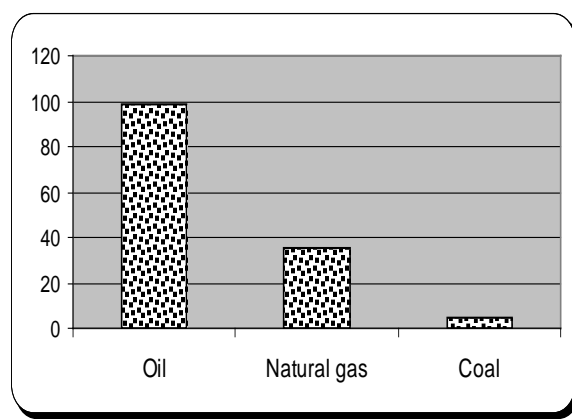
#### 3.2. The European Union – Russia relations: A shattered cooperation

Russia's involvement in the Ukrainian conflict has severely affected the trade and political cooperation with the European Union. Consequently, although in 2013 (before the Ukrainian crisis), Russia was European Union's third trade partner (see Graph 7) and the main supplier of oil and natural gas (see Graph 8), in response to the illegal annexation of Crimea and deliberate destabilisation of a neighbouring sovereign country, the European Union has imposed restrictive measures against Russia.

**Graph 7: European Union's main trading partners in 2013 (EURO million)**



**Graph 8: The value of European Union's imports of energy products from Russia in 2013 (EURO billion)**



Source: Author based on EUROSTAT data.

One of the first measures taken by the European Union (EU) aimed at suspending new EU–Russia Cooperation Agreement. The EU-Russia summit was also cancelled and bilateral talks with Russia on visa matters were suspended. In addition, most of the bilateral and regional cooperation programmes were stopped, the only one maintained was related to the projects dealing exclusively with cross-border cooperation and civil society. Additionally, EU implemented a series of measures "targeted" against the Russian economy including: the blocking the Russian banks access to European capital markets, banning the export of military weapons, military goods and technology and non-military technologies susceptible to be used for military purposes.

Both European Bank for Investment and European Bank for Reconstruction and Development have suspended their credit lines for Russia. Additionally, EU companies may no longer buy or sell new bonds, equity or similar financial instruments with a maturity exceeding 30 days, issued by major state-owned Russian banks or their subsidiaries outside the EU and.

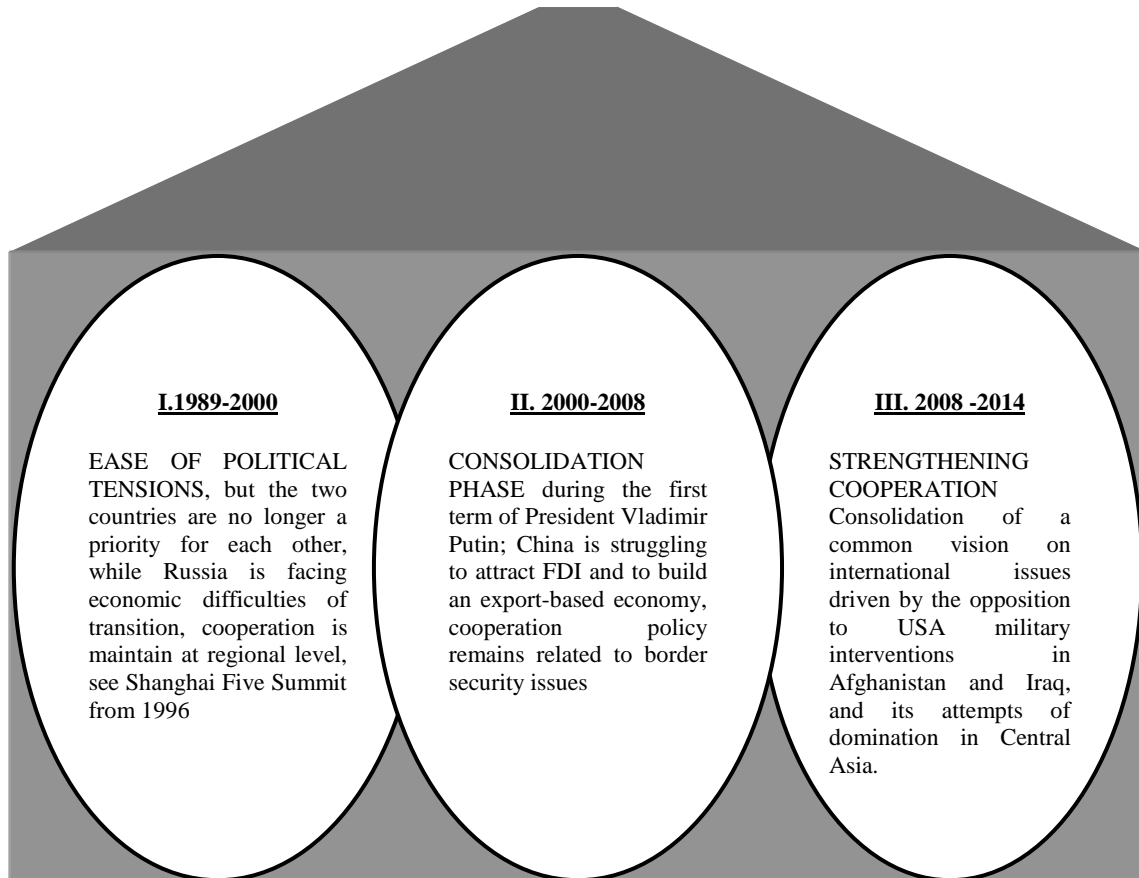
In response to these sanctions, Russian authorities decided to impose themselves an embargo on the import of agricultural and food products from EU, US and Canada, this measure causing important losses for the European agricultural sector (approximately EURO 5 billion). Consequences of the import ban imposed by Russia are not to be neglected. Because of the loss of an important export market the European farmers were affected significantly (before the embargo, the Russian Federation imported 29% of total European production of fruits and vegetables, 33% of the cheese and 28% of the dairy). The embargo has generated a destabilizing domino effect on the European agricultural sector due to the fact that it occurred in full harvest season and the targeted products were perishable by their nature. The European Commission estimates that the restrictions imposed by Russia have affected the incomes of 9.5 million people.

#### 3.2." The soft alliance": Russia – China cooperation

Some analyses (Gabuev, 2015) shows that because of the relative "freeze" occurred in foreign relations with both EU and USA after the Ukraine crisis, the Russian authorities turned their attention to strengthening

economic and strategic partnership with China. To understand the complex implications of this new status we need to assess briefly the history of Russian-Chinese relations. While China and Russia (the former USSR) were in cold relations after the Sino Soviet conflict in the sixth decade of the twentieth century<sup>3</sup>, this enmity began to lessen after the death of Mao Zedong in 1976, but relations were poor until the fall of the Soviet Union in 1991. After the end of Cold War, relationship between Russia and China may be divided into three distinctive periods (see Figure 1).

**Figure 1: Russia – China foreign relations in the post-Cold War era**



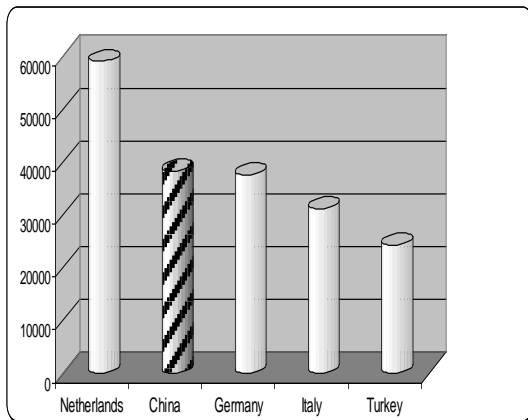
Source: Author based on studied literature in the field.

After USA and the European Union have imposed economic sanctions in response to Russian annexation of Crimea, the Moscow authorities have reoriented their foreign strategy to strengthen the trade partnership with China. It can thus be said that for China, the Ukrainian crisis represented a unique opportunity to gain access to the natural resources of the Russian Federation, especially those related to energy, natural gas, for example. Moreover, by strengthening the economic partnership with Russia, China has won several contracts on infrastructure, while Russia has gain an important market for the export of its products (see Graph 9 and 10). Gabuev (2015) shows that although it is unlikely to develop a military alliance in the future, China and the Russia could form a "soft alliance" that would allow Russian authorities to reduce the negative effects of the Western sanctions, supporting al the same Beijing authorities efforts to become influential both at regional and global level. In this respect, it should be noted that Russia dramatic turn towards China was obvious while a 400 USD billion deal to export gas to China and a 24.5 USD billion currency swap agreement were concluded

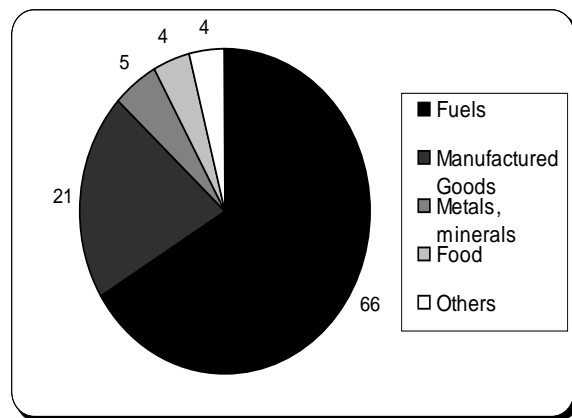
<sup>3</sup> They were competing for the control of the worldwide Communist movement. There was a serious possibility of a major war in the early 1960s and a brief border war took place in 1969.

between the two countries. This strategy is called by some authors (Gabuev, 2015) the “Asian pivot initiative” and represents Russia’s way to strengthen the vulnerable parts of its economy: dependence on the energy export on the European market, dependence on Western capital markets, and dependence on Western technologies. This new formed partnership could become more consolidated in the future if the USA and EU will push even further to isolate Russia on international arena. Some analyses (DIIS, 2015) have pointed out that if the United States continuously pushes Russia through NATO and China through its “rebalancing” in the Asia Pacific, it will certainly drive Russia and China to become closer. Such an alliance could even cease to remain “soft” evolving toward a deepening economic and security cooperation between the two nations that will not only beef up their military capabilities, but will also create a military platform for alliance formation.

**Graph 9: Russia's main exports destinations in 2014 (USD million)**



**Graph 10: Russian export structure by product group in 2014 (% of total)**



Source: UNCTAD – *Key Statistics and Trends in International Trade*, 2014

It could be argued that the new strategy of Russia to strengthen the partnership with China is the effect of a series of analyses carried out by some Kremlin experts (Krasnopresnenskaya Embankment, 2014) who studied the systemic effects of other economic sanctions imposed by the West (for instance those imposed against North Korea and Iran). The analyses undertaken by the Russian experts have revealed the existence of some structural weaknesses of the Russian economy among which the most significant were: the critical dependence of imported technologies for offshore drilling, liquefied natural gas (LNG) plants or telecoms sector. In the same time, the Chinese authorities found that although the crisis in Ukraine could have some negative implications for Chinese interests<sup>4</sup>, opportunities are still outweigh these risks. Some analyses (Cioculescu, 2014) have highlighted that the strategic alliance between China and Russia is based on a shared vision regarding a more balanced international system. It should be noted that both countries relate critically to international system “unipolarity” under the US dominium.

Moreover, even prior to the Ukrainian conflict, energy represented an area of major importance in the cooperation between Russia and China, while the revenues from the sale of oil on international markets represented (according to national estimates from 2013) 70% of Russia’s federal revenues. Meanwhile, after becoming a net importer of oil (in 1994), China has been constantly interested in securing its supply of energy resources considered to be vital for the country’s dynamic growth. The latest developments related to Russia – China cooperation in the energy sector are related to the acquisition by China National Petroleum Corporation (CNPC) of Russian oil fields from Vanke. Also, Chinese authorities’ plans to secure country’s energy supply involve building electricity factories in Eastern Siberia - a project that involves the Chinese companies Sanxia, Yangtze Power Group and State Grid Corporation.

<sup>4</sup> Russian annexation of Crimea and the new postulated rhetoric of nationalism and self-determination were perceived as threats that could worsen the already complicated status of Taiwan and Xinjiang, given the fact that there is an important Russian minority in both provinces.

But perhaps the most important aspect of the new Sino Russian cooperation is related to the gas production and respectively its export by the Russian Federation in China. The long-awaited agreement in the gas sector was concluded in May 2015 when Gazprom signed with CNPC a contract to supply gas from two fields of production in Eastern Siberia (Kovykta and Chayanda). The gas will be delivered via new pipeline "Sila Sibiri" ("The Power of Siberia" a.n.<sup>5</sup>) which will deliver 38 billion cubic meters annually, by 2030. Although the two countries did not disclose the transaction price, its total cost is estimated around USD 400 billion. It is important to note that such strategic economic agreement would not have been possible without political negotiations. However, some analysts warn that the contract could bring only a marginal profit for the Russian authorities because infrastructure costs are high. According to Gazprom estimations the new pipeline construction involves a total cost of 55 USD billion. In order to support this financial effort of the Russian company, president Vladimir Putin has committed to introduce a more favourable tax regime. This action is justified given the fact that the construction of this pipeline will be able to secure an adjacent income in the future (similar with case of Soviet-German pipeline construction from 1960 which currently allows Gazprom to obtain high revenues from selling gas to the European market).

Although China energy partnership with Russia will bring undeniable long-term benefits, the financial liquidity problem of Russia is of a much more pressing nature. By introducing sectoral sanctions in July 2014, the EU has cut Russia's access to Western capital markets. Hence, many state owned financial institutions from Russia faced real financing difficulties. This has increased the country's risk while driving away the foreign investors. As a result, Russian companies have been isolated from the financial centres of London and New York and faced with the need to find alternative capital resources. In May 2014, a Russian official delegation including Minister Igor Shuvalov visited China to discuss the possibility of replacing Western financial loans with credit lines from the Chinese financial institutions. Chinese partners, led by Vice Premier Zhang Gaoli, committed to support the Russian banks. During this meeting the necessities of increasing the role of national currencies in bilateral trade was also discussed, since such a future development could reduce both countries dependence on the US dollar. A solution was found through according some additional loans by Chinese state banks to Russian companies.

So far, this new cooperation in the financial sector has demonstrated both its benefits and limitations. The most important challenge is related to the possibility of using national currencies in bilateral transactions between China and the Russia. During the visit made by Li Keqiang in Moscow in October 2014, the Central Bank of the Russian Federation and the People's Bank of China signed a three-year swap agreement worth 150 RMB billion (approximately 24.5 USD billion). This Agreement is the 20th of its kind for China, which currently uses currency swap agreements with major trading partners to promote a stronger RMB worldwide. For both China and Russia, this agreement represents a step forwards in fulfilment the joint strategic goal of achieving at least 50% of their bilateral trade in their national currencies. The logic of this approach is not only a political one. Bilateral trade in national currencies can be advantageous for both Russian and Chinese avoiding risks related to currency conversion. However, the limited convertibility of the RMB, which still has a controlled exchange rate, represents an impediment to the full success of this type of transaction. In this context, it is not irrelevant to note that major Russian companies that have converted part of their foreign financial assets (because they feared that a new "package" of sanctions could lead to blocking them) chose rather to transform these funds in Hong Kong dollars (with an exchange rate linked to the US dollar) rather than RMB. However, it should be noted that in the event that both Russia and China would decide to trade goods of major importance (such as oil or natural gas) in their national currencies, the impact on the international capital flow will be a major one. Such a scenario seems possible given that, according to a statement made by president Vladimir Putin, from November 2014, Chinese authorities have already expressed their plan to purchase oil from the region Vanke paying with RMB, which the Russian side (the company Rosneft) might later use to purchase Chinese drilling equipment.

However, to reach such an agreement, it is necessary to find a solution regarding the exchange rates of RMB, establishing the type of exchange rate used, the "onshore one" (with an exchange rate more controlled) or the "offshore one" (with a freer exchange flotation used for trade conducted through Hong Kong). The benefits of achieving such an agreement are obvious for both sides. Such agreement would enable Russia to reduce the risk of being over-exposed to fluctuations of the euro and US dollar, while for China could be a step along the road to promote the RMB as a global currency

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<sup>5</sup> Author's note.



## 4 Conclusion

One year after the Ukrainian crisis, it can be concluded that the Russian Federation has undergone strong isolationist pressures in the international arena coupled with economic sanctions. However, Russia's strategies for economic revitalization should not be underestimated, especially given that the Russian authorities have shown willingness to refocus on increasing strategic partnership with China - a global player with a growing importance. As regards to regional policy regaining economic and political influence in the former Soviet space remains a strategic priority for Russia. To achieve this goal, the Eurasian Union project (which became effective from 1 January 2015) remains a vital one. However, this project is subject to a series of centrifugal forces of which the most important is represented by the involvement of Moscow in the Ukraine (Moagăr-Poladian&Drăgoi, 2015). A major input for the Eurasian project success might be to secure Iran membership. With regard to this possible development, Iranian Foreign Minister Ali Akbar Salehi stated, in 2015, that Iran does not reject the possibility to join the Eurasian Union. Such outcome would allow Iran to break free of its isolationism, also contributing to strengthening the Russia – Iran cooperation in the energy field. However, in order to secure Iran as a Eurasian Union member, Russia should give priority to the principle of equality and renounce at its hegemonic claims, giving other members the ability to exercise significant powers (following the EU model of co-decisions and joint responsibility).

Russian efforts to overcome its isolationist status in the foreign affairs field are visible and if we analyse its recent military interventions in the Syrian conflict. Although during 2014-2015, the Russian economy has experienced a visible downturn, its recovery remains possible in the light of new cooperation with China in the field of energy trade and financial swap agreements. If the Russian authorities will manage to better capitalize their energy resources by targeting China, this outcome could boost Russia's economic recovery.

Another way to strengthen the global influence of Russia is represented by its catalytic role in BRICS. In 2015, the meeting of both BRICS and Shanghai Cooperation Organization (an alliance of an important economic and military significance) took place in Moscow. During those reunions Russia expressed its support for the launching of BRICS Bank conceived as a counterweight to the Western financial domination.

BRICS Bank will have an initial capital of 50 USD billion (which will later be expanded to 100 USD billion). It is stated that BRICS Bank could become second as global importance after World Bank and will play a crucial role in financing emerging economies, while reducing the founding countries' (Brazil, Russia, India, China and South Africa) dependence on Western capital flows.

We may conclude that in the new multipolar reality, Russia has directed its efforts toward finding new economic and political alliances, trying, even if indirectly, through its involvement in the Syrian conflict, a reconstruction of the relationship with the West. From all these strategies come off its major long-term goal: asserting itself as a powerful global actor, while regaining its influence in the former USSR geopolitical space. If the involvement in the Ukrainian crisis brought indisputable economic disadvantages for Russia, we cannot ignore the fact that some long-term benefits could emerge from the new reinforced partnership with China. The power of the alliance between Russia and China should not be underestimated. In the new geopolitical game if the Western tries to isolate Russia even further will enable the success of soft Sino-Russian partnership rather than conserve their hegemony in the global arena.

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