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How Putin Spooks Investors

By Sergey Guriyev

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The debate around Crimea is no longer centered on international law. President Vladimir Putin has publicly recognized that he does not feel bound by it and does not care if the rest of the world deems Russia's actions illegal. What is not clear is whether Russia's economy can bear the burden of Putin's objectives in Ukraine.

Regardless of the West's response to the Crimean crisis, the economic damage to Russia will be vast. First, there are the direct costs of military operations and of supporting the Crimean regime and its woefully inefficient economy. Given the uncertainty surrounding Crimea's future status, these costs are difficult to estimate, though they are most likely to total several billion dollars per year.

A direct cost of this magnitude amounts to less than 0.5 percent of Russia's gross domestic product. Russia can afford it. It just spent $50 billion on the Sochi Olympics and plans to spend even more for the 2018 World Cup. It was prepared to lend $15 billion to former Ukrainian President Viktor Yanukovych's government and provide $8 billion annually in gas subsidies.

Then there are the costs related to the impact of sanctions on trade and investment. Though the scope of the sanctions remains uncertain, the effect could be enormous. A significant decline in foreign direct investment, which brings not only money but also modern technology and managerial skills, would hit Russia's long-term economic growth hard. And denying Russian banks and firms access to the U.S. and possibly European banking system — the harshest sanction applied to Iran — would have a devastating impact.

In the short run, however, it is trade that matters much more than investment. Russia's annual exports are worth almost $600 billion, while annual imports total almost $500 billion. Any nontrivial trade sanctions would be much more painful than the direct cost of subsidizing Crimea. Of course, sanctions would hurt Russia's trading partners, too. But Russia's dependence on trade with the West is certainly much larger than vice versa.

Moreover, the most important source of potential damage to Russia's economy lies elsewhere. Russian and foreign businesses have always been worried about the unpredictability of the country's political leadership. Lack of confidence in Russian policymaking is the main reason for capital flight, low domestic asset prices and declining investment and an economic slowdown that the Crimea crisis will almost certainly accelerate.

Since the crisis began, Russia's leaders have repeatedly contradicted their previous statements, backtracked, reversed decisions and denied easily verifiable facts. All of this indicates that the country's leaders have no strategy and do not foresee the consequences of their decisions. It is also clear that the decisions to violate international law, despite the risk of economic isolation, were made in an ad hoc fashion by Putin's innermost circle.

Regardless of whether the Kremlin is irrational or simply uninformed, its policy in Crimea sends an unmistakable signal to investors: Russia's political leaders are impossible to predict. This will further undermine Russian and foreign investors' confidence and increase capital flight, which could not come at a worse time. With credit-fueled consumer spending, the engine driving GDP growth since 2010, now running out of steam, the economy is stagnating.

Meanwhile, investment is still below its 2008 peak. Despite a wealth of opportunities across the Russian economy, the country's hostile business climate has weakened Russian and foreign investors' incentive to start new projects or expand existing ones. The realization that Putin has "entered another world," to quote German Chancellor Angela Merkel, will only make matters worse.

Will Russians notice the economic costs of the Kremlin's irrationality? GDP growth has already slowed and may turn negative. The stock market has already fallen sharply and may fall further. Although most Russians do not even follow market indices, increased capital flight will directly affect the ruble's exchange rate, something all Russians care about. On the Monday after Putin's Crimea adventure began, the Central Bank reportedly spent $11.3 billion to prop up the ruble. Such support is clearly unsustainable.

Worries about a Putin who has "lost touch with reality" imply not only a lower or even negative GDP growth rate, but also a weaker currency that will drive up prices of imported consumer goods — something that will hurt all Russians. Whether that will bring their president back from his world to this one is another matter.

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