

## Issues and Prospects of Russian Military Exports

*A. Kislov, A. Frolov*

AMID THE ONGOING FINANCIAL AND ECONOMIC CRISIS, the status of the export sector of the Russian economy is acquiring a special significance. The country's leadership considers military exports to be an important source of hard currency revenues, coming second after the export of oil and hydrocarbons, but unlike the last mentioned – mineral resources – this involves high-tech products.

According to official data, in 2008, Russian military exports totaled \$8.35 billion. Russia is making no secret of its plans to maintain this level in 2009 despite all crisis-related developments.

According to A. Fomin, deputy director of the Federal Service for Military and Technical Cooperation, in 2009, Russia plans to increase arms exports to \$8.5 billion, or by 6%.<sup>1</sup>

Nevertheless, the crisis will somehow or other also affect military exports, albeit to a lesser degree. As of right now, there are at least four groups of problems that can impact on its dynamics and prospects.

The first is connected with crisis related phenomena in the economies of those countries that import Russian weapons.

The second is linked to the actual situation of Russian arms manufacturers. The financial crisis can make it more difficult for them to obtain loans, as well as raw materials and components that are necessary for the manufacturing of their products.

The third group involves the art of the possible – the performance by the state intermediary agency on the world arms market, its ability to recognize new trends and changes, synchronize the efforts of the entire military-export mechanism, and look for new partners for cooperation.

The fourth set of problems, which arises from the preceding one, is intensification in competition on the world arms market.

---

**Aleksandr Kislov**, Head of the Center for Peace Studies, Institute of World Economics and International Relations, Russian Academy of Sciences; Professor, Doctor of Sciences (History)

**Aleksandr Frolov**, Senior Research Fellow at the RAS Center for Peace Studies, Doctor of Sciences (Political Sciences)

### **The Foreign Market**

IT WOULD BE QUITE LOGICAL to assume that crisis related developments in the economies of countries importing Russian weapons could eventually result in the abandonment of a number of earlier signed contracts and obligations, or limit the scope and extend the period of their implementation. It cannot be ruled out that in these conditions, some buyers of Russian weaponry will cut their budgets, including their defense spending. Since there are quite a few oil producing states among Russia's clients (while oil prices can be very unstable), many of them cannot but slash their budgets. The economies of other – non-oil producing – countries are also being negatively affected by the crisis – at any rate, it forces them to reprioritize their national development and security needs.

Not surprisingly, although Russian representatives announced a number of important meetings and negotiations, they failed to sign any new contracts at the Aero India-2009 exhibition, which

**In 2009, Russia plans to increase arms exports to \$8.5 billion, or by 6%.**

took place in February 2009. Nevertheless, the Indian leadership – and until recently, India was a major importer of Russian weaponry and military equipment – says that despite the crisis, it has no plans to reduce spending for the modernization of its military. According to Indian Defense Secretary P. Kumar, it will spend about \$30 billion on new military hardware and equipment until 2012. Judging by the latest reports, India is evidently not scaling down its military and technical cooperation with Russia, but is expanding it with other countries producing arms and military equipment to such an extent that the Russian share in Indian imports is showing a trend toward decline.

On the whole, the crisis has affected virtually all countries buying Russian weapons. Perhaps, it has less affected China – until recently another major buyer of Russian arms and military equipment. However, for a number of well-known reasons, Russian-Chinese military and technical cooperation is also showing a trend toward decline.

As for the oil producing Middle East and Persian Gulf economies, they are the world's main oil exporters and are currently working intensively to ensure the recovery of their banking systems. Southeast Asian countries – ASEAN members – are experiencing similar problems, and at their latest summit, at the end of February 2009, they were preoccupied with creating a \$120 billion anti-crisis fund.

The outlook is more or less favorable with regard to the Latin American countries, especially Mexico, with which Russia is committed to close cooperation. According to a report by the Inter American Development Bank and the Latin American Federation of Banks, the major Latin American banks are strong, reliable, solvent and liquid, in accordance with the requirements set out in the Basel Convention, which will enable them to overcome the crisis with minimum

losses.<sup>2</sup>

However, although there is a certain degree of inaction with regard to the signing of new contracts, there are current contracts. Generally, it should be borne in mind that this year and in the foreseeable future, military deliveries will be made on the basis of existing intergovernmental agreements and contracts, which will most likely be carried out or restructured somewhat. At the same time, Russia is faced with the real danger – as early as next year – of losing a number of contracts that are at different stages of discussion or finalization. However, until now there have been virtually no instances of a contract for the delivery of Russian arms and military equipment being broken due to the insolvency of a client. Moreover, the leaders of the majority of countries in the world, especially developing countries, which make up the bulk of Russian clients, are convinced that they must not economize on military spending.

Even so, FGUP Rosoboronexport, a state-run arms exporter, does not consider the decline in the scope of military and technical cooperation with China and India to be disastrous, hoping to compensate these “losses” by expanding cooperation with Algeria, Venezuela, Syria, and some other partners.

### **The Domestic Defense Industry**

ALTHOUGH THE RUSSIAN LEADERSHIP, as well as the leaders of many other countries, at this stage believes that “one must not economize on defense,” the ongoing crisis can affect a number of Russia’s positions. This primarily involves the link between military industrial enterprises and suppliers, for example, of raw materials or components, who have found themselves in a very difficult situation, as well as problems related to financial settlements and loans in the arms production sector. All of this can affect the ability of enterprises to ensure the implementation (servicing) of contracts with importing countries partially or completely.

Exports account for a substantial share of domestic arms production. All arms manufacturing enterprises are highly interested in the development of military exports. However, failure to carry out domestic contracts means that even if one element falls out of the production cycle, the end product will not be complete and will, therefore, be unfit for export. The fulfillment of contracts depends not only on funding, but also on the supply of raw materials and components from other enterprises, including from other than defense related sectors of industry, which are far more exposed to the effects of the crisis. Such problems existed before the crisis, but at the current stage they can become even worse.

At the start of the crisis, in November 2008, the Russian leadership assumed that the global financial crisis had already had a negative impact on defense industry enterprises, which had started running into difficulties with manufacturing to meet the Defense Ministry’s needs. A number of defense industry enter-

prises experienced an acute shortage of working capital to ensure the manufacturing of final products and their delivery to customers. Even though different enterprises were in different situations, the situation in general was rather painful for the sector. At the time, Deputy Prime Minister S. Ivanov, who oversaw the sector, accused Russian banks of raising interest rates on loans already issued, as well as of delaying the extension of new loans to defense industry enterprises, in a bid to derive extra profits. Furthermore, according to him, many banks were persistently attempting to change the basic terms of the loan agreements already signed, and raise annual interest rates from 9-12% to 15-18%. As for new contracts, state controlled banks increased their annual interest rates to 18%, while commercial banks pushed them even higher – to 20%.

There were also comments of a different kind. Thus, Russian Industry and Trade Minister V. Khristenko said that the crisis had not affected the defense industry, since the latter had access to state funding and government contracts. Furthermore, the defense industry was able to hedge its bets by manufacturing civilian goods. In May 2009, there were reports of some contracts for the delivery of modern arms to India being breached, in particular, contracts for freight aircraft and navy patrol planes. Russian military expert R. Pukhov believes that the Russian side was to blame for that, because it was behind with implementation or delivery terms.<sup>3</sup>

Plenty has been spoken about the interconnection between military exports and government defense contracts. The mechanism of arms exports cannot work effectively and productively if domestic enterprises do not have enough defense contracts. A state defense order is a kind of an indicator showing that the defense industry in a country exists and develops, or, quite the contrary, is in a state of stagnation. An increase in defense contracts will help substantially modernize and upgrade military hardware and equipment in the Russian Armed Forces, and improve the qualitative component of military exports as a whole. It was, therefore, not by accident that amid the ongoing crisis the Russian leadership decided to give a higher priority to this issue.

Last fall, it was announced that the 2009 state defense order would be increased by 70 billion rubles to a record high of 1.2 trillion rubles. There were plans to spend the lion's share of funds on the manufacturing and acquisition of new military hardware and equipment, in particular, for the Navy. In 2010, the state defense order is to be increased by 40 billion rubles and in 2011, by another 60 billion rubles. In all, a total of 4 trillion rubles will be earmarked for defense contracts in 2009 through 2011.<sup>4</sup> The state defense order will help stabilize the manufacturing of defense related goods and military equipment, maintain military production, retain personnel and specialists, and improve technological standards.

If these plans are carried out, as a minimum, Russian defense industry enterprises will be provided with orders for the next three years, and should be able to maintain their production levels. Defense contracts are already going to man-

ufacturers. In particular, according to some reports, the MiG aircraft-making firm has received 11 billion rubles worth of contracts out of a total of 17.3 billion ruble package.

The Russian government has instructed banks with a large share of state participation (Sberbank, VTB, Vneshekonombank) to issue loans to defense industry enterprises working on government contracts, provide them with working capital, including for the payment of wages, open credit lines on earlier agreements, and subsidize loan interest payments.

The crisis has forced the Russian leadership to review the situation. In late January, the government made one important clarification: State support during the crisis period will only be provided to those defense enterprises that are experiencing crisis related problems, not those that are planning thus to tackle long-standing problems or those that are not effectively managed. During a conference in Yekaterinburg to review the implementation of government defense contracts by enterprises in the Ural Federal District, the government expressed the intention to make a thorough selection of organizations that really need state support. An approximate number of enterprises was mentioned that could firmly count on state support (about 400).<sup>5</sup>

In early March 2009, speaking at a meeting of a governmental anti-bankruptcy commission, Deputy Prime Minister S. Ivanov said that the government not only would not reduce financial aid to strategic defense enterprises, but would provide them with additional 3 billion rubles to prevent unjustified, deliberate bankruptcy filings against them.

In February 2009, it was announced that to tackle defense industry problems as part of its anti-crisis package, the government had plans to earmark an additional 50 billion rubles to defense firms. Of that amount, 15 billion rubles is to be spent on subsidizing interest payments on loans granted by Russian banks, 12 billion rubles on compensating losses or a fall in revenues related to the manufacturing of goods under the state defense order, and 3 billion rubles on preventing the bankruptcy of strategic enterprises. Some 20 billion rubles is to be spent on the capitalization of individual defense industry enterprises. On March 26, Russian Prime Minister V. Putin signed a resolution on government loan interest subsidies for defense firms.

It is also noteworthy that amid the ongoing crisis, the Russian government made a decision to pass legislation on the state regulation of prices for arms, and military and special equipment, and to extend this mechanism to all government contractors. The fact is that until recently, various Russian manufacturers, especially those that had access to the foreign market, were setting arbitrary prices, which on the practical level sometimes led to the breach of contracts. At the same time, according to S. Ivanov, a new goal was set – i.e., to tighten antitrust regulation of suppliers of major types of materials and technical resources: raw materials, commodities, and components used for the manufacturing of arms and military equipment.<sup>6</sup>

### **The Art of the Possible**

RUSSIAN PRESIDENT D. MEDVEDEV formulated the main goals for the entire military export mechanism in the context of the ongoing crisis at a meeting of the Commission for Military and Technical Cooperation with Foreign States in February 2009. Firstly, he urged strict compliance with product quality standards, the quick preparation and finalization of contracts, and their effective implementation. Furthermore, in his words, contracts should be based on the real capabilities of defense enterprises, should not be “inflated and unsubstantiated,” while pricing should be realistic and transparent, which is especially important amid the tough competition on the world arms market. D. Medvedev urged for maximum attention to be paid to discipline: “There must be no delays in deliveries.” The president also advised state intermediaries to be more attentive toward markets and “look in different directions” – i.e., start cooperating with new countries while not losing their old partners.<sup>7</sup>

However, unlike other categories of goods, military deliveries are sometimes affected by politics. In early 2009, there was media speculation about the possible delivery of Russian S-300 antiaircraft missile systems to Iran, negotiations about which had been going on since 2005. The contract was estimated at \$1 billion as a minimum. Had the deal gone ahead, Russia would not have breached any of the existing international agreements. However, [the prospect of] those deliveries immediately drew a sharply negative reaction from Washington, since the United States was resolved to forcefully deal with Iran’s nuclear program. Russian missile defense systems were knocking out of the Americans’ hands a very important lever to exert pressure on Tehran in the form of the threat of force. But in light of the new trends in Russian-U.S. relations, linked to their “resetting,” the issue remains frozen. Russia’s official line is that it is not currently under consideration.

There was no change in its status even after Iranian Defense Minister M. Najjar made a visit to Moscow on February 18, 2009. Iran, which has in the past few years become one of the largest buyers of Russian military related products, is extremely interested in this deal, among other things, in order to exert pressure on the U.S. and if it fails to buy the S-300 systems, it could threaten to tear up other military contracts with Russia. Russia’s approach may encourage the Iranians to open negotiations with the U.S. But it remains uncertain whether the Russian move will be sufficiently appreciated in Washington.

What is not working out with Iran, Russia is attempting to accomplish elsewhere. In this respect, the long forgotten military and technical cooperation with neighboring countries appears to be very important. In February 2009, Kazakh Defense Minister D. Akhmetov said that his country had plans to buy a number of S-300 units.

Russia can also achieve good results by intensifying the search for new clients and developing or resuming military and technical cooperation with other

countries. Here, there is no need to chase “contracts of the century,” and often-times it is more productive to make do with smaller contracts. Rosoboronexport is starting to work more actively in this direction. In February 2009, the state intermediary agency said there was a possibility of establishing military and technical cooperation with Afghanistan, with a view to helping modernize the Afghan army. Signals were coming from the executive office of Afghan President H. Karzai. In April 2009, Iraqi Prime Minister N. al Maliki visited Russia. As it became known from Iraqi sources, ahead of the visit, the Iraqi Defense Ministry had discussed the possibility of resuming military and technical cooperation with Russia, making a positive decision.

The subject was discussed in the course of the Iraqi prime minister’s meetings with D. Medvedev and V. Putin. The Iraqi defense department is considering the possibility of buying 20 Russian helicopters of an unspecified type. Earlier, Mi-17 helicopters were under consideration. However, so far, the U.S. is becoming the main supplier of arms to Iraq. In the course of Yemeni President A. A. Saleh’s visit to Russia in February 2009, the parties also decided to develop military and technical cooperation. In April, negotiations were resumed with Turkey about the possible supply of Russian helicopter gunships and missile defense systems. Ahead of the Shanghai Cooperation Organization summit in Yekaterinburg in June 2009, President D. Medvedev announced Russia’s readiness to sell Su-34 warplanes to its neighbors.

Obviously, amid the ongoing crisis, the military export policy as such should become more flexible and brought as close as possible to a client’s needs. This can include loans and deferment of payments. Sometimes it can be appropriate to use old military delivery schemes that at one time were abandoned – for example, barter schemes. The head of Rosoboronexport has spoken out in favor of a flexible pricing policy and diverse forms of payment – from counter-deliveries of traditional national exports to Russian participation in the implementation of economic projects in these states to payments to be counted toward our country’s old debts. One such loan – worth \$1 billion – will be granted to such an important client as Indonesia, for the purchase of an assortment of weapons – from helicopters to submarines. Earlier, nine Mi-171Sh helicopters were transferred to Croatia as payment to be counted toward the FSU’s state debt. Nevertheless, payment in “cold hard cash” remains the most preferable option for Russia.<sup>8</sup>

One method of making military exports viable is a systemic organization of after sales servicing of Russian military equipment – however, not only the hardware and equipment delivered in recent months or the past one to two years, but the entire range of arms and military equipment supplied in the past. As is known, this aspect of trade in Russian arms and military equipment has not always received the due attention it deserves from the arms exporting companies. Nevertheless, some steps are already being taken in this direction. For example, there were some problems in military and technical cooperation with India over the delivery of spare parts, after sales servicing, and slow decision-making in the

centralized structure of Russian defense firms. The crisis, which has affected many producing countries has not affected India, creating an interesting picture. Delhi has become more demanding with regard to prices, pushing for their reduction as the prices of Russian arms and military equipment have been noticeably growing and approaching the prices of their Western analogues. Indian Navy chief S. Mehta, in particular, has complained that although Russian military hardware and equipment costs less than Western models, its subsequent maintenance and servicing is extremely costly.

In February 2009, a Russian-Indian intergovernmental agreement was drafted with the aim to improve the mechanisms of servicing the entire range of Russian-made arms and military equipment, and the regular and timely delivery of spare parts, tools, and accessories kits, which will probably help rectify the situation.

Amid the ongoing crisis, Russia's military export sector also needs support on the diplomatic level. In particular, as long as other countries use the so-called linkage methods – the United States links the deployment of a missile defense system in Europe to Russian supplies of missile defense systems to Iran, while Israel links this issue to the delivery of unmanned aerial vehicles (UAVs) to Russia – Russia could also link its cooperation programs with the United States and NATO countries, for example, on Iran and Afghanistan, to specific political steps by these countries, for instance, in respect to the Russian-Georgian conflict.

Among other lines of Russia's activity that have the potential to make it more competitive on the world arms market and that have already been tested, to some extent or other, the following should be singled out:

1. Adapting a part of Russian weapon systems to NATO standards, which can subsequently help expand Russian export opportunities.

2. Expanding the share of small scale projects that do not ensure quick and large profits, giving higher priority to the market of spare parts, modernization, upgrading, after-sales servicing, and dual-use and auxiliary equipment. In the foreseeable future, the spare parts market can bring revenues of up to \$2 billion a year.

3. Granting licenses to defense firms from other countries for assembling and partial production of components.

4. Reducing to a minimum the number of intermediary agencies that take away a significant portion of export earnings. Expansion of cooperation, including the creation of joint ventures with such production and research capabilities that can effectively help strengthen Russia's positions on the world arms market.

5. Reducing to a minimum competition between Russian manufacturers, especially on foreign markets.

6. Putting an end to the often unjustified reorganizations of the defense industry complex and its export component, creating an effective and transparent mechanism of military exports – from political decision-making to the practical implementation of decisions within realistic time frames.



7. Ensuring flexible reaction to clients' wishes with regard to configuration and lists of equipment. Arms manufacturers should give higher priority to making workstations of combat system operators more comfortable and convenient.

8. Ensuring the strict protection of intellectual property rights of arms and military equipment manufacturers.

### **Competition**

ACCORDING TO SOME EXPERTS, the global financial crisis can force the main competitors to operate even more toughly on the world arms market. This refers primarily to the United States, which is acting, basically, along two lines – attempting, through a variety of levers, to quickly fill all possible gaps in the world arms market, and at the same time weaken Russia's positions in its traditional markets.

The recent steps by the U.S. administration show that it is seeking to accelerate the flywheel of arms exports to the maximum degree possible, thus providing substantial support to its military-industrial complex. Amid the ongoing crisis, the United States is offering for export everything or a substantial part of what it is unable to sell on its domestic market. Thus, in March 2009, after the Pentagon made a decision to reduce the number of advanced F-22 fighters it buys for its armed forces, from 750 to 250, manufacturers threatened that in that case production of these aircraft would be halted, with subcontractors and associated firms sustaining losses, while the United States would lose thousands of jobs. As a result, a decision was made to take an unprecedented step – specifically, to export these aircraft as F-35 Lightning to allied countries – Japan, Australia, and Israel. Until then there had been no question about the export of F-22s, such aircraft being designed exclusively for the U.S. Air Force.

This year the United States intends to quickly occupy the Iraqi niche on the arms market. It is obvious that Iraq, which has lost a huge part of its armaments since the war with Iran, and then in confrontation with the United States, as a result of a war with the coalition force, is in need of rearmament. From 2005, the George Bush administration was planning to start rearming the Iraqi military and law enforcement agencies. However, evidently concerned that the level of stability in the country did not provide sufficient trust for the Iraqi defense, law enforcement, and security agencies, it took no action. The situation began to turn around as the crisis broke out, in the fall of 2008. At the time, the U.S. launched a program to provide arms and military services to Iraq, worth a total of \$10.9 billion. If the implementation of this program continues – and Washington is resolved to carry it through before the main part of the U.S. troops are withdrawn from the country, i.e., before August 31, 2010 – Iraq will become the world's No. 1 recipient of US weaponry, with the total volume of military deliveries to Iraq hitting \$20 billion.

In an apparent bid to sugar-coat the pill for Russia, the U.S. Defense

Department indicated that loans as part of the U.S. military export program could include the provision of up to 15% of funds to buy foreign (non-U.S.-made) arms and military equipment. According to J. Benkert, U.S. Assistant Secretary of Defense for Global Security Affairs, this can apply to Russian-made Mi-17 helicopters that Iraq said it would like to buy.

The U.S. is seeking to crowd Russia out of the Middle and Near East, especially from Persian Gulf markets, which are new or relatively new for it. This has affected, in particular, such an important buyer as the United Arab Emirates (UAE). In the 1990s, Russia delivered to the UAE 500 modern BMP-3 infantry fighting vehicles; in 2000, it signed a contract for the development and delivery of the Pantsir anti-aircraft missile and artillery, and had plans to supply more advanced systems, such as the Buk and even S-400 anti-aircraft defense systems. That could not but worry the United States, which, contrary to the mood in Congress (the majority of congressmen frown on the delivery of modern U.S. weapons to the Middle East that potentially can be used against Israel), struck yet another large-scale deal. On December 20, 2008, an agreement was signed for the delivery to the UAE of U.S. weapons, worth approximately \$9 billion, its central element being a \$3.3 billion modern Theater High Altitude Air Defense (THAAD) system. The other part of the deal includes radar stations from such multinational arms companies as Lockheed Martin and Raytheon, as well as military helicopters.

The Iran situation can also be regarded as an attempt by Washington to weaken the Russian positions in the country, with which the U.S. is seeking to establish dialogue. In the 1970s, with its massive deliveries of advanced (by contemporary standards) military equipment, the U.S. sought to turn Iran into a regional power. At present, however, Washington does not really want Iran to become such a power with the help of Russia or any other country. At the current stage, there is this hullabaloo over the delivery of Russian S-300 systems to Tehran. Moreover, Washington evidently believes that if the deal falls through, military and technical cooperation between Russia and Iran can also become complicated in a number of other areas. Washington is using different methods to this end – expressing outright discontent with this deal or attempting to make it a bargaining chip alongside the missile defense system in Eastern Europe. At the same time, the U.S. has absolutely no grounds to allege that Russia is violating any international agreements. The situation is quite obvious: If Russian missile defense systems are delivered, the possibilities for forceful pressure on Iran by the U.S. will sharply decline.

Even so, it would be wrong to say that in all situations, relations with the U.S. can only be based on competition. Russia should use every chance to find mutual understanding with Washington as long as both countries have similar goals. Joint steps to strengthen the Iraqi military and law enforcement structures are quite possible, especially considering that some indications to that effect have come from the U.S. capital, and the same goes for similar action in Afghanistan

and some other places. After all is said and done, it is necessary to work, in conjunction with the United States, to limit the regional arms race and build regional security systems that will effectively guarantee the prevention of the outbreak of local wars and armed conflicts.

---

NOTES

<sup>1</sup> www.infox.ru, February, 12, 2009.

<sup>2</sup> Korrespondent.net, February 13, 2009.

<sup>3</sup> www.vsesmi.ru, May 26, 2009.

<sup>4</sup> RIA Novosti, February 11, 2009.

<sup>5</sup> Praim taim, January 30, 2009.

<sup>6</sup> www.vesti.ru, February 25, 2009.

<sup>7</sup> See: *Komsomol'skaia pravda*, February 11, 2009.

<sup>8</sup> *Rossiiskaia gazeta*, April 10, 2009.