

**Svensk Tillväxtbarometer**

# What's at stake?

A geopolitical perspective on the Swedish  
economic exposure in Northeast Europe

Benjamin Ståhl & Johan Wiktorin  
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The core is a methodology where economic indicators are validated in a dialogue between business leaders. Participants at the Swedish Growth Barometer's meetings share their company-specific outlook for market developments and issues concerning drivers and trends affecting growth prospects. A Faculty is tasked with capturing these drivers and prioritize the commissioning of deeper analyses that are released as thematic reports, such as this one.

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*Benjamin Ståhl, Program Director of Blue Institute*

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This report was written by Benjamin Ståhl and Johan Wiktorin. Johan Wiktorin is the founder and CEO of the intelligence company Brqthrough. As a licensed Master of Competitive Intelligence and with broad military experience as an officer in the Swedish Armed Forces, Johan is frequently asked to comment on geopolitics, intelligence and security in national and international media. Benjamin Ståhl, Ph.D., is Program Director at Blue Institute, responsible for forecasting and research.

# Summary

This report deals with geopolitical risks and the Swedish economical exposure in Northeast Europe. Countries included in the analysis, besides Sweden, are Russia and all common neighbouring countries: Finland, Denmark, Norway, Poland and the Baltic states. The aim of the report is to stimulate discussion about the impact of security on economic growth prospects.

The report consist of three parts. The first describes Swedish companies' trade and investment exposure in the area, which provides a factual base concerning the economic activity at stake. The second part is an outline of the geopolitical realities and risks based on the evolving regional security environment. The third part presents three scenarios concerning the geopolitical developments and their possible consequences.

The overall conclusion is that Sweden's economic exposure is significant, despite the more limited direct exposure to Russia. The report shows that:

## ***1. The region is of great, and increasing, importance for the Swedish economy***

Trade with countries in the region has increased faster than with the rest of the world, and amounts to 475 billion SEK in exports annually. Direct investment in the region amounts to more than 800 billion SEK, which is 31 percent of total Swedish foreign direct investment.

## ***2. The Baltic states and Poland should be considered a "fourth Nordic neighbour"***

The economic exchange with the Baltic States and Poland has grown rapidly, especially in terms of direct investments and imports. Collectively these countries are as large a trading partner as each of Sweden's Nordic neighbours. They are also growing in importance. Given their proximity and higher exposure to Russian markets, geopolitical uncertainty can have bigger economic consequences than ever before.

## ***3. The geopolitical risk has escalated considerably since Russia's intervention in Crimea***

The Russian propensity to use military force to achieve political goals has profoundly upset the regional security environment. Despite Russia's economic difficulties, military expenditure continues apace through a redistribution of resources which further undermines stability in the region.

## ***4. Further deterioration of the security environment should not be ruled out***

We describe three risk scenarios: Disintegration, where the Russian centre is unable to maintain control of its periphery, and where the EU becomes similarly fractured; Ultra-nationalism, with an increasingly belligerent Russia that seeks to expand its territory to include Russian speaking enclaves in other countries, as in east Ukraine; and a Test of strength, an attempt to shatter NATO's credibility as an alliance through an incursion into the Baltic states.

## ***5. Heightened uncertainty requires companies to revise planning***

If the tensions in the region continues to rise, many companies will be affected. They need to prepare for compliance with further sanctions, review supplies of strategic goods and components, and ensure adequate security arrangements, particularly for IT security.

# Part 1. Sweden's economic exposure

The unfolding tension between Russia, Sweden and our common neighbours has consequences for the Swedish economy. These concern the direct effects of sanctions and counter-sanctions as well as indirect effects related to decreasing demand of goods and services in the region.

Assessing a company's international exposure provides an overview of different kinds of risks, such as exchange rate fluctuations, cyclical changes in foreign markets and political insecurity. It outlines the company's vulnerability, especially concerning factors beyond the company's control, and therefore also the foundations of strategies to deal with these risks with the help of, for instance, currency hedges or strategic diversification. In this report, we have taken a similar approach but applied it to "Sweden, Inc.". The exposure includes all Swedish foreign trade as well as foreign direct investment.<sup>1</sup>

Sweden is a small, open economy with a relatively high number of large, international companies. Most of Sweden's foreign transactions occur in the neighbouring area, especially with the Nordic countries and within the EU. The United States is also an important trading partner and China is of increasing, although still limited, significance.

In this context, it is common to regard Sweden's direct exposure to Russia as limited: exports to Russia constitute less than two percent of Sweden's total exports, and imports from Russia constitute five percent of total imports. However, the indirect exposure to Russia is considerably larger and has grown as a share of Sweden's total economic exposure. This

means that heightened uncertainty affect Swedish companies more than is commonly thought.

In fact, Northeast Europe is of great and of growing importance for Sweden's trade and investments. Some 340 billion SEK of total Swedish exports of 1 125 billion SEK in 2014, 30 percent, goes to the region. Imports from the region amounted to 350 billion SEK (31.4 percent of the total). The export of services to the area has followed the general trend in Swedish foreign trade, i.e. it has been growing faster than the trade in goods and especially so after the financial crisis. We estimate that export of services to the region was 135 billion in 2014.<sup>2</sup>

## Trade to region outpaced overall growth

The trade with the region has increased considerably in the last decade. Since 2001, exports of goods to the region has grown more rapidly than exports to the rest of the world. As shown in Figure 1, export growth has been considerably stronger to the region and the divergence compared to the rest of the world has remained through the financial crisis and has even increased since 2012.

There are several reasons for this development. For one thing, the entry of Poland and the Baltic states into the EU in 2004 drove exports. Another factor was the growth of the Russian market prior to the financial crisis. In addition, the Nordic countries have been more stable export markets than many others in the EU since the financial crisis. Finally, the internal devaluation of Baltic states in the wake of the financial crisis and their impressive recovery since has

*The selection of countries included in this analysis is made on geopolitical grounds. Due to escalating tensions between the West and Russia, the border zones in the Baltic Sea region as well as the Arctic, are of increasing strategic importance. We consider countries in the vicinity of Sweden that are directly affected by geopolitical tension and, in the worst case, armed conflict.*

*The countries included in this region, which we label Northeast Europe, include Sweden, Russia and their common neighbours: Denmark (via Greenland), Norway, Finland, Poland, Estonia, Latvia and Lithuania.*

*The region includes four important geopolitical areas:*

- 1. The Arctic and Murmansk, with ample energy assets and the base of Russian nuclear submarines*
- 2. St. Petersburg, Russia's trade hub of critical importance for sea transportation.*
- 3. The Baltic states and Poland, historical buffer zone between Russia and Germany.*
- 4. The Danish Straits, one of the world's most important shipping shipping chokepoints.*



Figure 1: Swedish exports (index, 2001=100)

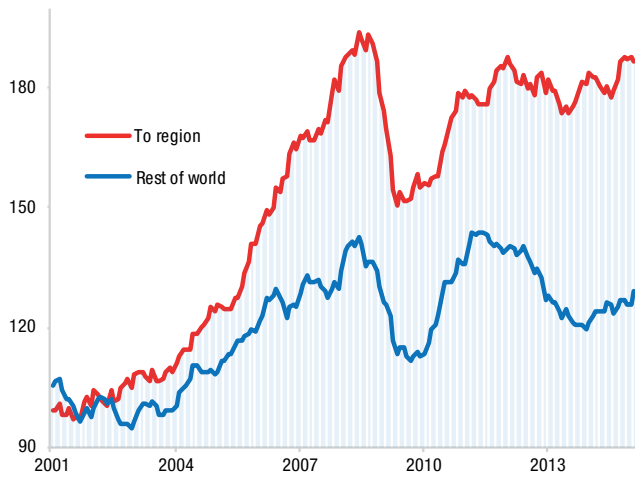


Figure 3: Swedish export of services by country (bn USD)

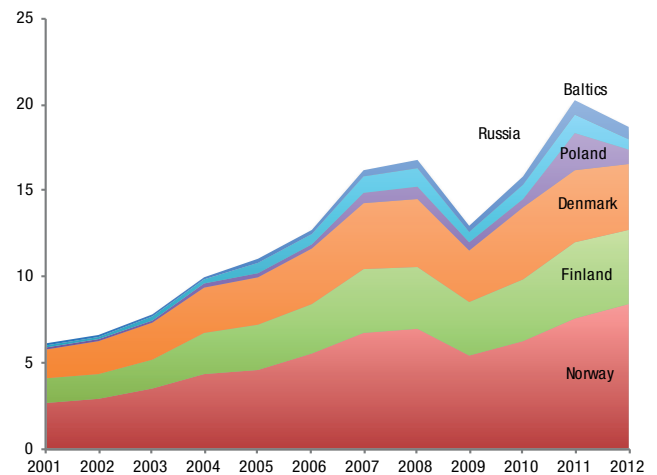


Figure 2: Swedish export of goods by country (bn SEK)

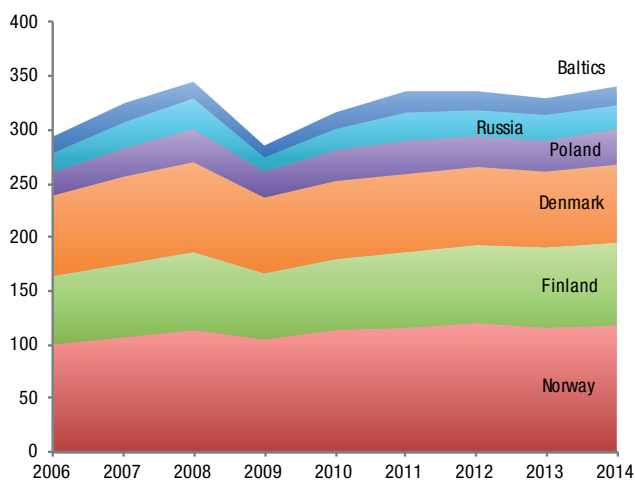
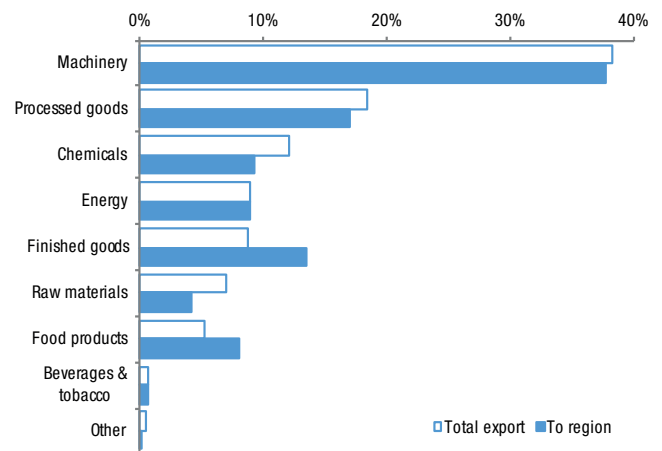


Figure 4: Swedish exports by category



contributed to the development the last two years.

However, in terms of exports, the Nordic markets are substantially larger than the non-Nordic ones in the region, displayed in Figure 2 and 3. On the other hand, the higher growth rate to non-Nordic countries means that Poland and the Baltic states can be seen collectively as a “fourth Nordic neighbour”. This is especially valid if exports of services are considered, as they were virtually non-existent a decade ago.

There are of course differences when it comes to the composition of exports per recipient country, but in general the distribution of exports to the region is similar to that of Sweden’s overall exports. The essential differences are that products such as clothes, furniture and consumer food products are exported to a greater extent, while chemical goods and raw materials are exported to a lesser extent.

Imports from the region have also increased at a faster rate than the rest of the world since 2001. Unlike exports, however, the gap has decreased in the last two years, which is shown in Figure 5.

Figure 6 shows that the non-Nordic countries are considerably more important to Sweden for imports, considered as a proportion of total imports. There are several explanations for this: factor costs, production in the countries by Swedish companies for the

Swedish market, and the dependence on Russian oil.

The development of Swedish foreign direct investment (FDI)<sup>3</sup> in the region similarly shows the non-Nordic countries’ growing importance for Swedish companies. In 2013, a third of Swedish companies’ foreign assets were located in the region.

Even though FDI in the region grew more slowly than total FDI in the last decade, the stock increased from 455 billion to 807 billion SEK. There

Figure 5: Swedish imports (index, 2001=100)

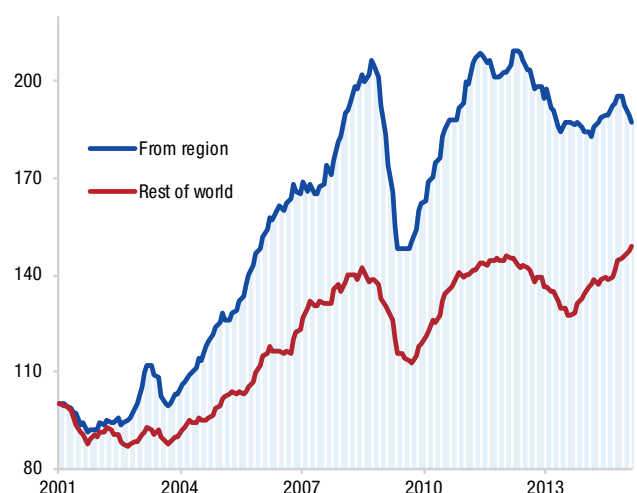


Figure 6: Swedish imports by country (bn SEK per month)

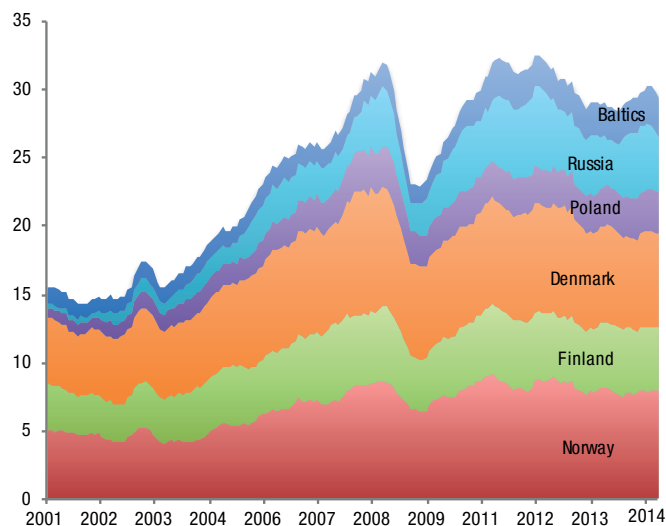
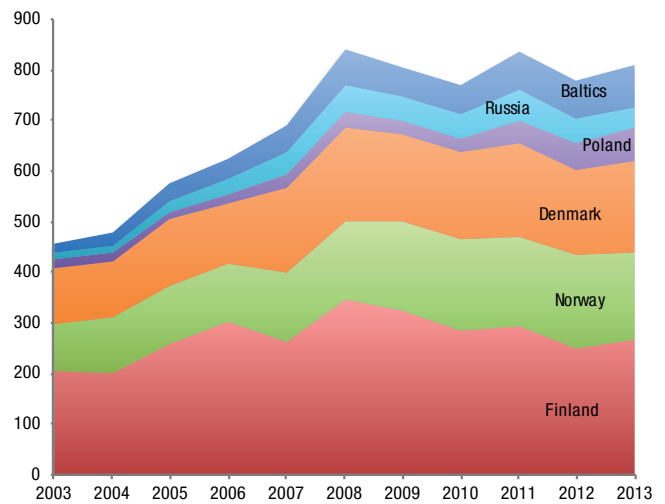


Figure 7: Swedish FDI by country (bn SEK)



is, however, a dramatic difference in development between the Nordic and the non-Nordic countries, as shown in Figure 7. FDI in the Nordic countries has a long history and the integration of the Nordic economies is well advanced, whereas FDI into Poland and the Baltic states is much more recent.

### FDI in the Baltics increased fivefold since 2003

Swedish companies' FDI stock in the Nordic countries increased by approximately 50 percent between 2003 and 2013, but it quadrupled in the other countries in the region. In Estonia, Latvia and Lithuania the assets increased almost five times. The FDI stock in Poland and the Baltic countries collectively is now in parity with that in Norway or Denmark. As displayed in Figure 8, this is an additional reason why they should be considered as a "fourth Nordic neighbour".

In comparison, China has two percent of total Swedish FDI, which is only half as much as in the Baltic states. It is also noticeable that Swedish investments in the Baltic states are a quarter of those in the United States, which has a population 50 times larger and considerably higher GDP per capita.

Swedish companies are established in the Baltic states in many sectors and for several reasons. Manufacturing companies are above all focused on production for the East European and the Global market (re-export), or on the production of components and inputs which are imported to Sweden for further processing. The countries are also an important destination for development activities, e.g. for software, and for service delivery to the Swedish market, e.g. in IT and customer support. Furthermore, activities targeting the Baltic markets are also common, especially in the financial sector, where Swedish banks dominate the market, and in telecom.

Russia is of lesser importance when it comes to FDI. The Swedish FDI stock in Russia grew quickly during the start of the 21st century, but the growth rate decreased in connection with the financial crisis and the war in Georgia. From the peak in 2011, the

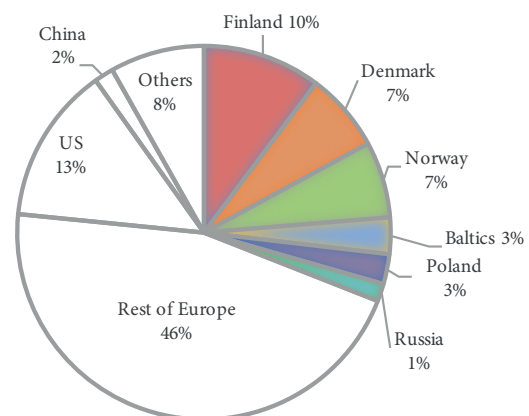
stock of FDI decreased by almost 40 percent by 2013, to 40 billion SEK.

### Trade deficit with Russia

The economic exchange between Russia, on the one hand, and all other countries in the region, on the other, is not equally distributed. Russia ran a trade surplus with all the countries in the region, apart from Estonia. In addition, the ratio of imports from Russia to total imports is higher for the countries in the region than it is for Russia in the opposite case. This means that the countries in the region are more dependent on imports from Russia than Russia is on imports from them; on the other hand it means that the value of access to these market is higher for Russia than vice versa.

Russian imports from the region mainly consists of machinery, vehicles, pharmaceuticals and food products (even after the embargo). Russian export to the region is dominated by oil and gas. Sweden, for example, gets 43 percent of its oil from Russia, a share that has increased in recent years. Russian gas constitutes the majority of gas deliveries to the Baltic states, Poland and Finland (although Finland's gas consumption is modest).

Figure 8: Swedish FDI stock (2013, total 2607 bn SEK)



The relative importance of imports from Russia differs a lot between the countries. As shown in Figure 9, Lithuania and Finland receive a large share of their imports from Russia. Countries like Denmark and Norway, on the other hand, receive only a small share from Russia. The share has for most countries fallen in the last few years, with the exception of Sweden where it has increased to 5 percent.

Decreasing the dependence on Russian imports is, moreover, an active strategy of several countries. For example, Lithuania, which receive 90 percent of their natural gas from Russia, has built an LNG terminal in order to decrease the dependence on Russian gas. Lithuanian imports from Russia overall have decreased dramatically, from 32 percent of the total to 21 percent, in just the last three years. The development is symptomatic of increasing trade tensions between Russia and the EU.

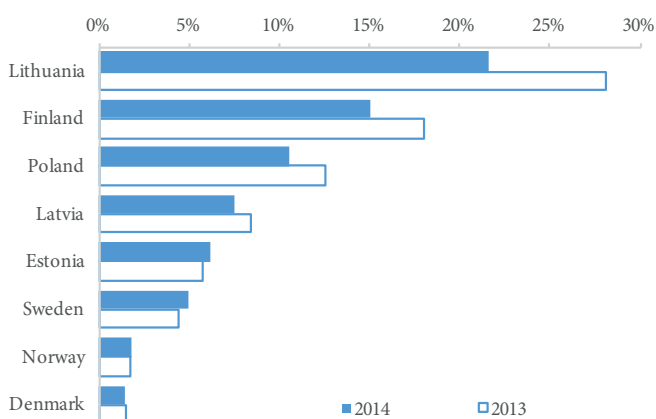
### Deteriorating EU-Russian relations

Considering the economic importance of the region for Sweden, the development of the EU-Russia relationship is cause for concern. The escalating conflict between the two parties and the increased insecurity in the region must, however, be regarded with the perspective of the extensive economic ties between them.

Trade development has been negative in the last few years, but as Figure 10 demonstrates, trade volumes increased fivefold between 2001 and 2008. With the financial crisis, trade fell drastically but then recovered and reached record levels in 2012. Nevertheless, because of the annexation of Crimea and the ongoing conflict in Ukraine, trade has decreased once more.

In March 2014, the EU Member States implemented sanctions against Russia, including entry bans for certain individuals, limited access to EU's capital market for Russian banks and for companies in the oil and gas industry, and export embargos for certain technologies which could be used for military purposes. Russia, in retaliation, has implemented an import embargo on certain food and agricultural products.

Figure 9: Imports from Russia as a ratio of total imports



The large fall in the oil price and a weakened rouble have increased the effects of the sanctions on Russia, with a contraction of demand and therefore trade in certain sectors, as a result. For example, the import of cars in Russia has plummeted, as has tourism from Russia (see Exhibit).

### Sanctions have moderate macro effects...

As relations have deteriorated and uncertainty increased, both direct and indirect economic effects are evident. The direct consequences are that the sanctions, and above all Russia's counter-sanctions, have decreased trade and increased the transaction costs. The indirect consequences are partly a result of the negative development of the Russian economy and partly a result of the excess capacity in certain production as Russia now imports less produce.

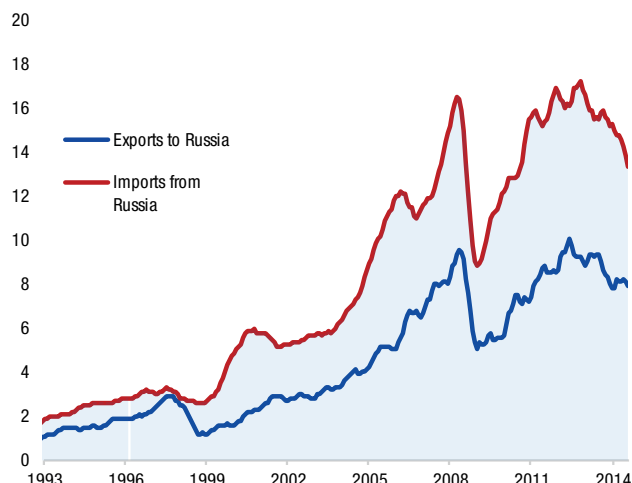
Moreover, the indirect consequences (weak demand) have a larger impact than the direct ones. However, from a macro perspective, the effects are still moderate, partly because the limited size of the Russian economy.

Countries with a higher degree of export are, of course, affected more severely. This is especially true of Finland and Lithuania, where the negative development of the Russian economy and counter-sanctions have decreased the demand of exports and of travel currency. For example, Russians consumed 1.2 billion EUR in Finland 2013. Nevertheless, the effects in Finland are estimated to be limited: according to the Finnish Ministry of Finance's analyses, it is estimated to be less than one percent of GDP growth.<sup>4</sup>

### ... but individual companies are affected

The EU sanctions entails an embargo for some products. This includes certain technology which can be used for the oil and gas industry and technology which can be used by the military (including "dual use" technology, which entails certain IT and telecom products). Swedish companies that deliver such products, like Atlas Copco and Sandvik, have stated that Russia only involves a fraction of their order value. They have, however, been subjected to an increased

Figure 10: EU trade with Russia (bn EUR per month)



administrative burden as export licenses have to be obtained, which makes it more complicated to do business with Russia.

Russian counter-sanctions has hit some parts of the food sector hard. Arla estimates that it has lost a billion in sales due to the Russian embargo in 2015.<sup>5</sup> For Finnish companies such as Valio the consequences are also noticeable: of the 430 million EUR that Finland exported in dairy products to Russia, Valio accounted for 350 million EUR. Polish companies are likewise affected. Furthermore, the counter-sanctions have affected dairy farmers in the region indirectly, since excess capacity in the market, which used to go to Russia, lowers prices. Reimbursement rates for milk are at an historical low.

The indirect effect of collapsing Russian purchasing power as well as the difficulties of Russian companies to finance investments is even more severe.

This affects a wide range of industries, from cars to technical infrastructure to consumer goods.

Many companies have experienced a decrease of sales of 30-50 percent in the Russian market. As a consequence, several companies have had to reduce their activities in Russia. For example, AB Volvo has closed a factory and Nordea has shut down its retail operation. Many more have suspended their expansion plans. How significant the effect is depends on the individual company's exposure to the Russian market.

Furthermore, if uncertainty remains and the insecurity escalates, there are probable spillover effects on proximate markets, particularly the Baltic states. In particular, it may result in a risk premium for investments and an overall situation where investment decisions are not made, mitigating growth in the entire region.

## What should companies do?

Whether tensions escalate and how states will act are external factors difficult to predict, and impossible to control, for companies. Nevertheless, regardless of the outcome, companies can and should ask themselves the following questions:

*What is our readiness to comply with existing and possibly extended sanctions?*

Sanctions applies to all companies, all citizens, and are implemented directly. An effective compliance function is critical, due diligence of contracts and customers should be carried out, and processes in place to handle additional permit administration.

*Is the supply of strategic inputs secured?*

Russia is a large producer of certain raw materials, such as nickel. Sweden is entirely dependent on imports of nickel, which is required in the production of stainless steel. Another strategic metal that Russia exports is palladium, which is used in the production of catalytic converters. Oil and other fuels are also critical in many process industries.

*Is the business protected from any improper intrusions?*

In "hybrid warfare" (see the next chapter), IT intrusions with the objective of interrupting operations and/or accessing data is a commonly used method.

*How are good relationships with customers maintained despite inter-state tensions?*

Trade with Russia is still substantial, sanctions are limited and the conflict is between governments. Despite a raised risk premium and possibly de-investment, existing customer relationships need to be maintained. Otherwise, there is a risk of losing market share to local or Asian competitors.



## Exhibit: How resilient is the Russian economy?

The aim of EU sanctions is to pressure Russia to resolve the conflict in Ukraine peacefully and reverse the annexation of Crimea. In order to achieve this, one important factor is to look at how resilient the Russian economy is.

Just a few years ago, Russia was the R in BRICs, in the company of Brazil, India and China. In other words, a group of countries then exhibiting exceptional growth rates and that therefore were considered attractive markets for investment. But Russia's growth potential has collapsed, as a consequence of the fall in oil prices but also because of Russian distancing from the West.

With a high oil price, Russia built one of the world's largest currency reserves, which was valued at 500 billion USD at its peak. However, during this growth phase, the underlying economy was not modernised and structural reforms were not made. These are sorely needed, not least because of the country's gloomy demographical future. Instead, corruption increased and the dependence on an ineffective oil and gas sector was entrenched. Technology transfer from the West is still a precondition for infrastructure and manufacturing, although turning to China can offset some of the deficits.

Russian intervention in Ukraine has led to capital flight: the currency reserve fell by 151 billion USD last year. In addition, Russian companies continued to borrow money abroad, even after 2011, when reserves ceased to grow. What's more, a considerable part of the currency reserve is not liquid and the actual availability of funds is substantially lower than what is reported. Restricted access to international capital markets coupled with a high interest rate limits the ability to finance investments.

As the price of oil has fallen, the rouble has followed. Despite the recovery in the oil price, export revenues will be significantly lower in 2015. As a consequence, Russia is in recession, with a high inflation, decreasing production and plummeting real wages. Despite this, expenditure on security continues to grow while social expenditure is slashed.

A weak Russian economy is not conducive to trade and investment. But it is an open question whether the weak economy will stop or turn Russia's distancing from the West, or if it will enforce it. To unite the people against an external enemy is an oft-used strategy to maintain power during harsh times.

Figure 11a: Russian currency reserve depleting fast (bn USD)

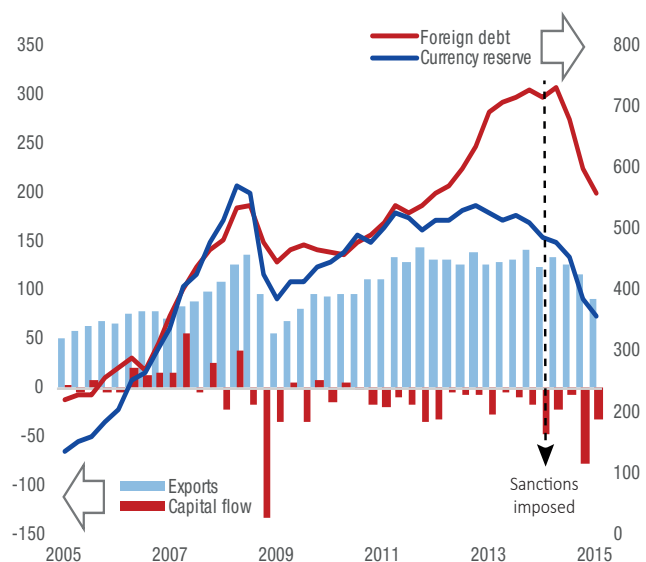
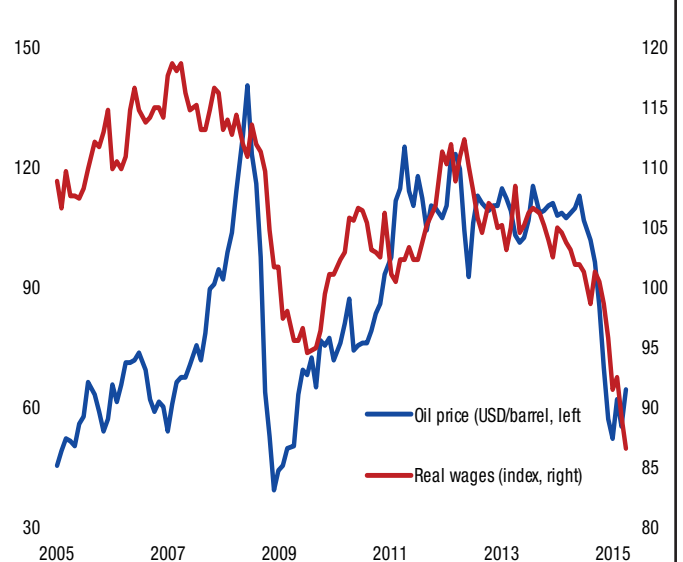


Figure 11b: Real wages follow oil price



## Part 2. Rising geopolitical uncertainty

Ever since the financial crisis and the war in Georgia, the security environment in our part of the world has changed dramatically. Russia is in the midst of an extensive rearmament programme, while Russia's neighbouring countries' military defence capability has weakened, with comparatively limited military expenditure across the board.

Building on the new Russian military doctrine of 2010, the Russian General Staff has begun to operationalise its new approach to conflicts. The approach was presented in a new model in 2013. Starting in Crimea and continuing in eastern Ukraine, the arsenal of methods employed in the conflict has been broadened. These include "green men", internet trolls, talk of nuclear weapons combined with actual rocket-artillery attacks against the relatively weaker Ukrainian army.

### The geopolitics of the region

Northeast Europe is very important from a geopolitical and strategic perspective. The region contains several border states between the Eurasian land mass, with several strong armies, and the Atlantic, with several strong navies.

Four areas in the region are of particular importance for the security environment and the relation between countries.

### The Arctic and Murmansk

In the north, the Arctic contains vast unexploited energy reserves, becoming more amenable to exploitation but which are also contested. Furthermore, in the Murmansk area, Russia has the most important part of their nuclear secondary-strike capability. The nuclear-equipped atomic submarines enjoy ice-free harbours and can patrol under protection of sea ice.

The secondary-strike capability is crucial for the credibility of the Russian nuclear deterrence. This means that the northern parts of Norway, Finland and Sweden are important areas of interest for Russia. To protect their nuclear capability there are, with all certainty, plans to expand the air and coastal defence of Murmansk by seizing key terrain in this area, in order to deploy advanced missile systems.

### St. Petersburg

The second area is St. Petersburg and the Gulf of Finland. St. Petersburg is the centre of Russian trade, especially oil exports, and an important base for the Russian Baltic fleet. With the enlargement of NATO in 2004, the southern part of the Gulf of Finland became controlled by NATO, through Estonia's membership. This goes a long way in explaining Russian resistance to Finland joining NATO, since the trade route to St. Petersburg would be in the hands of the West in case of conflict.

### The Baltic states and Poland

The next area comprises the Baltic states and Poland, a perceived buffer between the continental Europe (Germany and France) and Russia. From the Russian point of view, the territory is a potential deployment area for hostile troops or fleet landings. Based on historical experience, the Kremlin fears that such forces could advance against Moscow. Dominance over the Baltic states provides a control over a coherent coastal strip as a protection of St. Petersburg.

In this context, the islands and archipelagos in the Baltic Sea, particularly Gotland and Åland, are strategic assets in the same way as the northern area. Through an extension of their coast- and air-defence to these places, Russia could inhibit or delay Western reinforcements to the area.

The Kaliningrad exclave can be regarded as another island in the Baltic Sea. Without contact with the rest of Russia, the strongly fortified zone is dependent on provisioning by road and rail through Lithuanian territory. Kaliningrad could be supported by sea or air, but the railway is more effective.

Another important factor is the establishment of NATO's Ballistic Missile Defence (BMD) in Redzikowo, near the Polish coast. The advanced anti-missile complex should be in place by 2018, but an interim solution will be operational this year. The Russian resistance against the complex is fierce since the effect is that parts of the Russian strategic nuclear arsenal can be intercepted early, thus diminishing the credibility of the Russian nuclear deterrence.

### The Danish Straits

The fourth and last area is the Danish Straits. Denmark controls the Great and the Little Belt, and, together with Sweden, Öresund. Depending on the stage of conflict, and on perspective, the strategic imperative for sea traffic through the Straits changes.

In peace time, Russia has an interest to keep the Straits free for maritime trade. Should the West have an interest to restrict Russian trade, the Straits are the obvious choice, being one of the world's most important chokepoints. Before and during an armed conflict, however, the interest is reversed. NATO will then need to move maritime forces into the Baltic Sea, and Russia has an interest to block or delay such a possibility.

## Defence and security policy development in the region since 2008

### Swedish shift since 2009

Since the defence policy decision in 2009, Sweden has embarked on a shift of focus, from defence against invasion to creating an expeditionary force. The armed forces were to become professionalised and be

made expeditionary. Ability to act outside of Sweden became the norm, and much emphasis was put on interoperability with NATO systems.

Organisationally this shift will be completed in 2015, with the exception of logistics. No regiments or flotillas have been closed down during this period. However, the current structure is too small for the forces to expand quickly. There are no reserves of instructors, training facilities or equipment for an extension of the defence organization.

Operations in Kosovo, Libya and Afghanistan have provided a validation of leadership on the ground, as well as valuable experience of peace-keeping operations. However, the development of traditional warfare capabilities has become of secondary importance. The operational command has not practised on a larger scale since 2004, and larger unit drills have not been undertaken in a long time.

### **Lacking support systems means lower capability**

The renewal of equipment for the military forces has been a big priority by Swedish governments. Most weapon platforms have high quality, but many supporting systems have been downgraded. The result is a lower actual capability than the most qualified systems would indicate. In 2013, the Armed Forces stated that up to 50 billion SEK was missing in order to equip the forces in order to fulfil the government's demands.

On the personnel side, the restructuring is ongoing but lagging. Almost half of the war organisation still consists of conscripts. The new government of Löfven made a decision enabling the armed forces to call on conscripts for exercises, and this will commence on a small scale in late 2015. The Home Guard is relatively well established and has developed positively in the last four years, but it is not set up for qualified combat.

Altogether, the Swedish defence suffers from an imbalance between assignments and resources. The structural underfunding is estimated at six billion SEK per year. And this estimate is based on a perception in 2009 of what 2014 would look like, not on the actual developments in the security environment. In April 2015, an agreement was made between the government and parts of the opposition to increase the operational capabilities in the short term.

### **Closer cooperation with NATO**

Sweden adopted the Declaration of Solidarity in 2009, which states that Sweden will not be passive if a disaster strikes our neighbouring countries or members in the EU, and that we expect the corresponding support. This includes the ability to give and receive military support. The Swedish defence policy has been relatively stable until last year, when the new government made a policy statement which was perceived as "half a step back" to the policy of neutrality. The statement was however adjusted in the foreign

policy statement, released earlier this year.

The current policy is to continue on a path of increasingly closer cooperation with NATO, without actually joining. It is hard to see any change to this policy within the coming five years, even if the new parliamentary defence agreement includes an inquiry of Sweden's collaboration with NATO. The Swedish Parliament is expected to approve the Host Nation Support Agreement between the Swedish Armed Forces and NATO in April of 2016, an agreement that Russia can be expected to seek to influence.

A similar agreement is also in progress in Finland. Cooperation between Helsinki and Stockholm has been functioning stably the last few years, but has escalated to a new level. Each country's armed forces have submitted a report to their respective parliaments regarding possible collaborations, especially in times of crisis. The signals from the ministers of defence are that they are going to use joint operational plans to prepare for different situations, even if these plans are noncommittal in themselves.

A remaining uncertainty for the Swedish defence capability is export of military equipment. As Swedish defence spending has been decreased, the industry has successfully turned to international markets. A political committee (KEX-utredningen) has conducted an inquiry and have recently publicized their suggestions. How the suggestions will be implemented remains to be seen, but it is safe to say that the more restricted the rules regarding export become, the more expensive it will be to maintain Swedish defence capabilities.

### **Russian military capability greatly increased**

Russia has increased its military capacity significantly in the last decade. In August 2008, the Georgian army put down a separatist rebellion by entering Tskhinvali in South Ossetia, after Russian provocations. Russia responded by entering South Ossetia and threatened the Georgian capital Tbilisi. Eventually a truce was reached, but South Ossetia and Abkhazia are still not under Georgian control, and only Russia recognizes them as independent states.

Despite the Russian success, the war showed that Russian forces, with a few exceptions, were not very effective. As a consequence Russian authorities started reforming the armed forces and increased funding, with little impact on the treasury due to the rising price of oil.

In 2010 a new military doctrine was adopted, followed in 2011 by a gigantic rearmament plan for 2020. This included 19 000 billion RUB (630 billion USD at the time)<sup>6</sup>, with the aim to have 70 percent new equipment by 2020, and a military force mainly consisting of contracted personnel. This will enable Russia to engage in two wars simultaneously, in addition to a smaller peace keeping operation.

The new doctrine, adjusted somewhat in December 2014, was an attempt to integrate a plethora of

methods of engagement, for crises management as well as armed conflict and subsequent stabilisation operations.

### **Gerasimov's model and hybrid warfare**

In January 2013, the new Chief of the General Staff, Gerasimov, presented a new model (see next page) for the Russian view on modern warfare in a lecture at the Russian Academy of Military Science, which later was published in *Military Industrial Courier VPK*.<sup>7</sup> The model is an operationalization of the Russian military doctrine, often referred to as “hybrid” or “non-linear” warfare.

The notable feature of Gerasimov's model is that economic and information warfare coexist with military means. Information warfare in particular has been observed in connection with the Russian annexation of Crimea and in the ongoing armed conflict in East Ukraine.

It should come as no surprise that Russia has advanced capabilities in psychological operations, combining a strong literary culture with advanced research in propaganda during the Soviet era.

A preferred tactic seems to be flooding information channels with a mixture of lies, half-truths and facts, thereby overwhelming recipients, especially media in democratic societies. As the real identity of the personnel and equipment is withheld (the “green men”, or “soldiers on leave”), editorial desks dedicated to objective facts and objectivity find it hard to cope. In the absence of verified facts, democratic media is forced to use a more conscientious language. This leads to slower decision cycles in open societies, as claims of Russian involvement are denied.

This is one way that Russian cyber-capabilities are leveraged. In this field, Russia can also lean on a tradition advanced research in mathematics. Furthermore, Russian organised crime is probably the most active in international cybercrime, which is an indicator in itself.<sup>8</sup> Recently, the White House's servers were hacked by someone who is close to the Kremlin, according to American sources.<sup>9</sup> The attack is described as one of the most sophisticated ever experienced. There are indications that the Russian interests are trying to obtain knowledge for a cyber attack on the international financial system.<sup>10</sup>

The security and intelligence services are crucial for Russian efforts. They have a dual function, which is nowadays rare in the West: apart from obtaining secret information, they also have the mission to influence their antagonists through psychological impact, both in public and in private.

### **Economic sanctions seen as prelude to conflict**

Another important feature of Gerasimov's model is that Russia regards economic sanctions as part of an ongoing conflict, and as a prelude to armed conflict. In the West, sanctions are instead generally seen as an alternative to armed conflict.

Likewise, supporting political opposition in foreign countries is seen as an early stage of conflict. A common Russian *modus operandi* is to support the political opposition in foreign countries, regardless of who they are. That is why there have been attempts to bolster right-wing extremists and nationalist forces in the EU. Kremlin also tries to influence key persons within environmental movements and left-wing organisations for the same purpose. NATO's former Secretary-General Fogh-Rasmussen has warned that Russia is financing anti-fracking movements.<sup>11</sup> Through “mirror-thinking”, the West's modest support for the political opposition and human rights movement in Russia is seen as a direct and aggressive attempt to change the regime in Russia.

### **Looking to China**

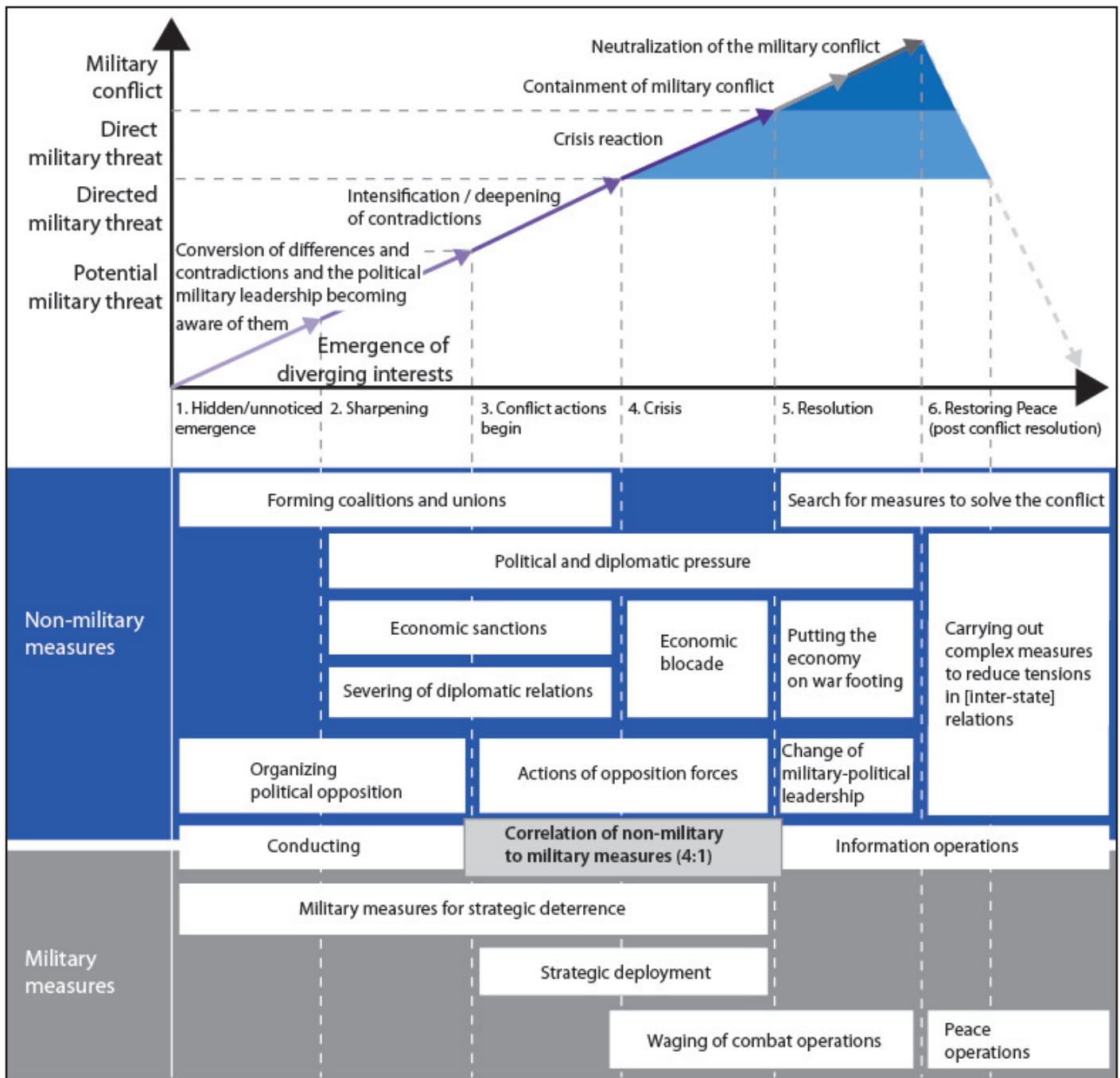
Shaping political alliances is an explicit method in the Russian doctrine. Above all, the Russian ambition to build closer ties with China is notable. The Chinese president, Xi Jinping, met with Vladimir Putin nine times during his first 18 months as president.<sup>12</sup>

The energy deal between Russia and China, agreed upon in 2014, provides China with access to Russian energy (at a good price) but furthermore aligns Chinese and Russian interests, especially to maintain political stability. Such an alignment is further cemented by military technology: Russia recently sold the sophisticated Air Defence System S-400 to China, strengthening the Chinese military capability and providing further means to deter American intrusion in zones outside the Chinese mainland. Joint exercises have also been initiated on an unprecedented scale, as witnessed by the joint fleet exercise in the Mediterranean.

### **New organization and rearmament**

In terms of organization, Russia has restructured its strategic and operative command. A national defence command centre has been established and rolled out in a readiness exercise involving 80 000 troops in March 2015. The operational theatres are led by five military districts, where the Northern military district for the Arctic recently came into use. Next year Russia should have a fully functional organisation. The army has been re-organised, from a division system to a brigade system.

The renewal of equipment is extensive. A special emphasis has been put on nuclear weapons, both strategic and tactical ones. New intercontinental missiles are developed for submarines and land-based silos. The tactical missile system Iskander is being modernised, and stationed for example in Luga outside of St. Petersburg from where Finland can be reached. The system can launch conventional ballistic missiles as well as nuclear weapons. Exercises where these systems are transferred to Kaliningrad, within range of Poland, Germany and Sweden, have been conducted.



Indications that Russia is defaulting on the INF agreement from 1987 are another worrying development. This agreement prohibits the possession of medium-range missiles with a range of 500-5500 km. By extending the range of the Iskander system, and also shortening the range of an intercontinental systems, Russia could gain access to this, prohibited, range. Although no solid evidence has been made public, Americans have indicated their concerns.

Such a development would put the White House in a difficult dilemma. Their options are then either to move nuclear weapons forward to East Europe, risking a similar debate as in the 70's and 80's about the Pershing missiles, or risk a debate on how the US abandons its commitment to European security.

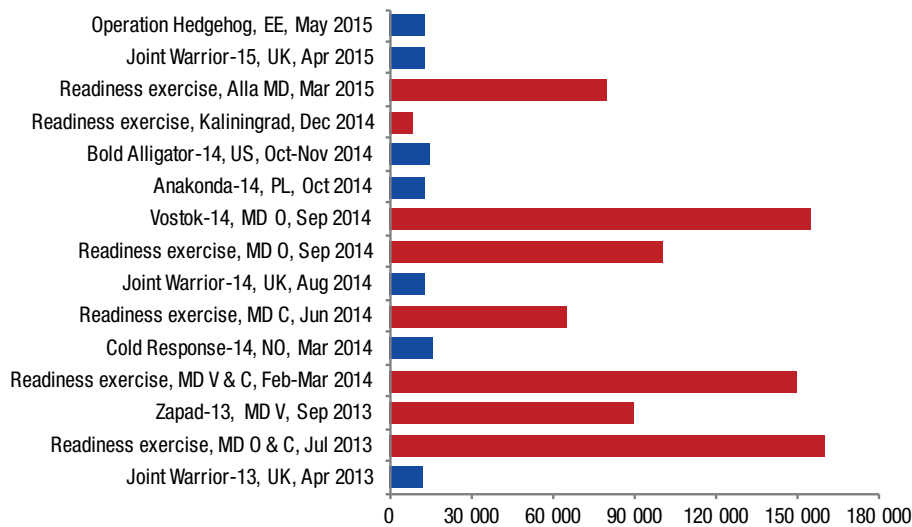
For the conventional Russian armed forces, the order of priority is on air power, naval power and finally the army. Russia has long been building advanced, long-range aircraft missiles. This is connected

to the shield against American nuclear weapons, but also with an analysis of the USAF's strength and the US long-range cruise missile capability. The effect of the Russian defensive construction is, for example, that air transports to the Baltic states are impossible, unless the air defence systems in Kaliningrad are neutralised.

Modifications of Russian fighter aircraft, and the development of new ones, are also ongoing. However, it is challenging for the Russians to design and manufacture fighter aircraft with stealth technology (T-50), but so far the development of aircraft and helicopters has progressed according to the plan.

On the maritime side, new submarines are being developed, both conventional and nuclear ones. An extensive shipbuilding programme will manufacture frigates with strong air defence capacity. Equipped with these, the Russian armed forces are able to extend their air defence zones.

Figure 12: Large exercises conducted the last two years, no. of participants



The Russian ability to build warships decreased substantially the first two decades after the fall of the Soviet Union. Therefore, the former minister of defence, Serdjukov, decided to acquire four amphibious assault ships of the Mistral type from France. Two would be built in France and two would be built under license in Russia. In that way, an injection of foreign know-how of shipbuilding would modernise the Russian ship building industry. In accordance with EU's sanctions, however, France has for the time being suspended the delivery of the first ship.

Despite Russian ambitions and expenditures, the maritime capability can be questioned. Most of the existing warships are old and will not be replaced at the required pace. It is not certain that Russia is capable of manufacturing large warships, such as cruisers or aircraft carriers, any more.

For the army, equipment investments are focused on combat vehicles, special vehicles and rocket artillery systems. The use of electronic warfare has increased dramatically in Ukraine, demonstrating the Russian skill in distorting and locating radio communication. Airborne units, which are the only ones who have kept a divisional structure, have top priority. New airborne infantry fighting vehicles (BMD-4) are supplied at a high pace.

### Shift to mission tactics

The biggest change, however, is not equipment but the introduction of mission tactics as a command method. This method, established in Germany between the two World Wars, is based on the idea that subordinates are given clear tasks, assigned resources and a specific purpose, but then execute the task with a high degree of autonomy. The opposite, directive leadership, with detailed top-down instructions of how to execute missions through several layers in the chain of command, previously severely limited Russian military capability. As the armed forces adopt mission tactics, military effectiveness will probably be greatly increased.

To achieve this, however, personnel provision needs to be solved. The current plans are an organisation of one million people: approximately 200 000 officers, 500 000 professionals and 300 000 conscripts per year.<sup>13</sup> Currently, the number of professionals is about 300 000, NCOs and specialists. The ability to keep so much personnel employed depends on keeping wages relatively low.

To develop actual capability, unexpected readiness exercises have increased in number the last years: six have been conducted in the last two years. These exercises are opportunities to evaluate the state of progress and make adjustments as needed.

To conclude, the ambitious Russian reform and strengthening of the fighting capability is progressing according to plan, although all aims have not been fully achieved. The deterioration of the economy (see Exhibit) has not slowed investment: instead, redistribution from other sectors has taken place. If other "power ministries" are included, 40 percent of the Russian federal budget is committed to security.<sup>14</sup> This includes the intelligence services, internal troops and the ministry of disaster management, among others. Furthermore, since 2007 private security companies have been liberalized and state-owned enterprises have access to vast security resources: Gazprom employs at least 20 000 security officers and operates qualified unmanned aircrafts (UAVs).<sup>15</sup>

### Norway looks north

Norway, a NATO member, has participated in several international operations with good results. The Norwegian defence efforts at home have increasingly emphasized the northern region. The armed forces are well integrated in NATO, and the country has a small but effective intelligence service. Recently, as the first country in the world, Norway introduced a gender-neutral conscription and operates mixed-gender personnel system.

The country maintains a minimal army, a modern fleet (with staffing shortages) and is in the process of

obtaining the American Joint Strike Fighter aircraft. This has threatened to break the defence budget, but the government has allocated extra funding.

### Denmark active internationally

Denmark has also been heavily involved in international operations, for example in the coalition in Iraq. The country has kept its earlier mixed system with professional NCOs and voluntary conscripts. Denmark also has a small and skilled intelligence service, and there are some efforts made in offensive cyber operations for the future.

The armed forces are structured in the same way as Norway, but with somewhat less modern equipment. Just as in Sweden and Norway, there are structural limits to expand military capability in the short term.

### Finland has the largest armed forces

Finland's armed forces are by far the largest after Russia's, and enjoy the full confidence and support in Finnish society. Finland uses a universal conscription system, and while the training is relatively short it is highly efficient. This means that favourable conditions are in place to rapidly expand military capability by calling in a large amount of troops.

The country participates moderately in international operations, but where they participate the results are good. The biggest challenge for Finland is the need of equipment renewal, the cost of maintaining a large army. Only a fifth of army units have modern equipment. Nevertheless, the army has a significant firepower, especially in terms of artillery systems.

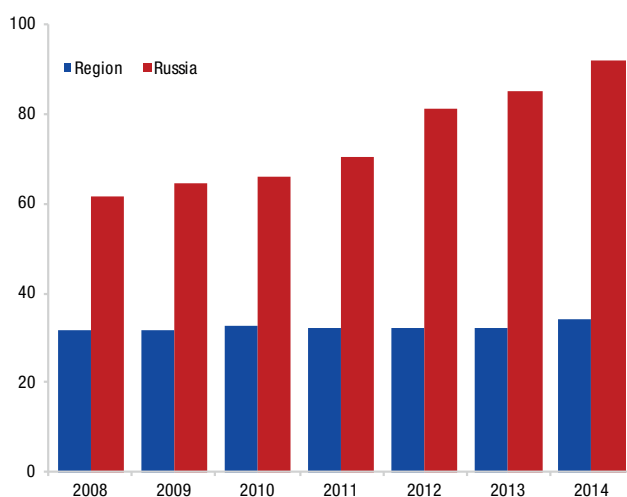
Finland's navy is small, effectively limited to coastal defence. The air force was modernised by the acquisition of the American F-18 Hornet fighter aircraft in the 90's, and recently their air-to-surface attack capabilities were strengthened by purchasing top modern cruise missiles.

### Baltic states committed but dependent on NATO

The Baltic States all have similar structure of their armed forces: a minimal army supplemented with lightly equipped local defence troops. The maritime elements are comparable with an armed coastguard, with a few exceptions. The air force has no combat aircrafts, only transport resources. Instead, NATO supplies the air defence through the Baltic Air Policing (BAP) program.

Estonia is one of the few countries in NATO which has maintained the two percent goal (defence spending as a proportion of GDP). Latvia and Lithuania, on the other hand, made drastic cuts in spending because of the financial crisis. Both countries has promised to reach two percent in the coming years, which may be deemed an important condition in order to receive military aid from the other members. The Baltic states have also contributed with troops in several international operations.

Figure 13: Military expenditure (bn USD, source:SIPRI)



Lithuania reinstated a decree of conscription earlier this year, as a reaction to the perceived threat from Russia. NATO has also located a large amount of smaller exercises in the Baltic states, where especially American troops are noticeable.

### Poland builds defence capability

Poland is the country which has increased its defence expenditures the most since 2008, in a direct response to Russian aggression in Georgia. Poland's participation in international operations is reminiscent of the Danish profile, with the exception of the operations in Libya where Poland refrained from participating.

The Polish defence forces have been restructured substantially since the Warsaw Pact was dissolved. The biggest changes are in the army, where the number of troops has decreased. Voices are being raised regarding the reinstatement of conscription.

The Polish government has launched a considerable rearmament programme, including a substantial modernisation of air-defence systems and warships. Poland's navy is relatively big, but outdated. Poland's primary naval base is located in the Bay of Gdansk. This is a problematic position due to the vicinity of Kaliningrad. The air force consists of battle-proven American F-16, but new helicopters are needed.

As Poland has a fixed resource allocation for defence spending, as a proportion of GDP, the defence budget will increase over time. The Polish defence industry has consolidated and there is an expressed will to become more self-sufficient. Poland has the ambition as well as the ability to become an important regional power, but only beyond 2020.

## Part 3. Geopolitical risks towards 2020

The main determinant for the development in the next five years is the Russian perception of threats to their own security and political stability. These perceptions, and expressions of them, can be manifested in words and actions, and how the West reacts to these can further increase tensions if they are misunderstood or underestimated.

It is important to understand that Russian security thinking is based on the idea of “legitimate” spheres of influence and international relations as a zero-sum game. The current Russian regime does not acknowledge the idea of common security. Furthermore, the fall of the Soviet Union is perceived as humiliating defeat of Russia at the hands of the West. Also, there is a belief that a strong political can compensate for structural weaknesses. Control of the media, above all public services, is seen as fundamental in order to communicate these perceptions.

In the following we present three scenarios for the next five years. They are not predictions of the future, and no probability is attached to either outcome: the most likely immediate future is a controlled situation reminiscent of the current state of affairs. Rather, they are to be seen as a foundation for evaluation of extreme, but possible, developments and starting point for discussion.

### Scenario 1: Disintegration

If the Russian economy continues to deteriorate and the regime continue to distance themselves from the West, the centre may not be capable to maintain legitimacy and keep the periphery together. Already, some regions and counties are highly indebted. In other parts, ethnic Russians are a minority.

Regions in eastern Russia, rich in raw materials, may look to China for funding. It is, however, probable that Beijing will not want to undermine the stability in Russia.

Closer to the region in focus in this report, Kaliningrad is an area that could distance itself from the Kremlin. Economic problems and security concerns form a background that could lead to a political uprising. A “Kaliningrad-Maidan” development is at the heart of this scenario. Triggers could also come from outside Kaliningrad, in or in the immediate surrounding of the Russian Federation, or from other factors such as severe pollution

The other countries in the region would in all probability remain cool in this situation, considering the county’s military importance for the Russian government. However, a mutiny like the ones in Kroonstad in June 1917, March 1921 or on the frigate *Storozhevoj* in November 1975 cannot be excluded.

Economic and political tensions in Europe could weaken the EU and worsen the development at the same time. A Greek withdrawal from the EU, trig-

gered by its exit from the Eurozone, could set such a movement in motion. A Podemos-led government in Spain could undermine confidence for the single market, at a time when Europe also faces the consequences of a highly unstable North Africa, with a large flow of migrants.

Attempts by Russia to influence certain members in the EU, such as Hungary and Cyprus, could sow further discord in the EU. At the most severe levels of disintegration, France could adopt policies effectively blocking EU and NATO response in a time of increased tensions. Britain may opt out of the union altogether, or be forced out if their demands for special status is rejected by the other member states.

In all varieties of disintegration, uncertainty concerning the control over the nuclear arsenals will increase. The US will become involved both diplomatically and financially in order to bring clarity and establish control over the arsenals. Should Russia, in that situation, ask for military support for this, it is highly probable that the US would acquiesce: such operations in other parts of the world were the object of joint US-Russian exercises just a few years ago.

### Scenario 2: Ultra-nationalism

If Russian domestic and international policy continues to become more radicalised, it might take ever more drastic forms. As the economy deteriorates, wages fall and shortages become common, a focus on nostalgic nationalism, using belligerent rhetoric and demonstrations of military power, could be used to deflect growing discontentment.

A logical target would be to “protect” zones which are perceived as Russian, e.g. where there are Russian ethnic minorities or even just Russian-speaking areas. Such rhetoric was and is used in the Ukraine.

The coming years will tell what the Russian ambitions are in the Ukraine. Offensives to secure and expand their supply lines, and weakening those of the Ukraine, are probable, and more ambitious plans, such as the opening of new directions in Kharkiv or Odessa, are possible. As a distraction, conflicts in Moldavia can be fuelled.

If the West, primarily the US, UK and Poland, support Ukraine with military means, the risk increases for further escalation of the conflict. Remaining passive, on the other hand, runs the risk that Russia perceives that it could act against other targets.

A second country that could be the target of Russian nationalism is Belarus. Judging by president Putin’s justification of the annexation of Crimea, Belarus would similarly be a legitimate candidate for “re-inclusion” in Russia.

There are indications that the regime in Belarus are worried about such a development and acting to thwart it. In late 2014, Lukashenko appointed a



new government, and has increased the emphasis on “Belorussian”. The fragmented (and thoroughly infiltrated) opposition has declared that it will not field candidates in elections this autumn, since they deem the threat of president Putin to be greater than of Lukashenko himself.

Belarus has also passed laws permitting prosecution of non-regular armed troops, as a consequence of the Russian method employed in the annexation of Crimea. In the economic sphere, Russia has complained that Belarus is profiting from sanctions against Russia.

Any attempts from Russia to enter Belarus’ with military means would probably not be met by any effective resistance from the Belorussian security apparatus. The opportunities for Russia are in some ways more favourable here than in Ukraine, due to the close cooperation between the countries’ armies and intelligence services. Passive resistance cannot be ruled out but would not mean much in a short-term.

However, tensions with other former Soviet Union republics, with the EU and with NATO would surely increase. Polish and Lithuanian forces would probably mobilize to counteract spillover effects. EU policy would be substantially revised. Belorussian citizens would attempt to flee, primarily to neighbouring Poland, Lithuania and Latvia.

The Russian government would also threaten the Baltic states, in order to undermine their economies and try to influence policy in these countries. Estonia, Latvia and Lithuania would be in a precarious situation. While they need to strengthen their civil and military defence, they must retain credibility with their allies and not be perceived as to exaggerate the Russian threat. The higher the tensions, the more sensitive the world is to psychological influence.

Russia would, in this scenario, also fan nationalism in other parts of Europe through political and financial support. West Balkan is particularly vulnerable, as the EU and the US have invested considerable political capital in the region with only mixed success. Bosnia, Kosovo and Macedonia have stagnated in their political and economic development with high levels of unemployment, political polarisation and even the establishing of Islamic fundamentalist cells: a fertile ground for nationalist movements.

Finally, Russian ultra-nationalism would also be directed inwards, with an escalated persecution of the domestic political opposition, independent media, and nationalisation of foreign assets. This will be combined with attacks on minority groups, especially on Jews.

This scenario could happen separately or as a precursor to the final, and most dangerous, scenario.

### **Scenario 3: Test of strength**

In this scenario, Russia would attempt to break NATO through challenging of one or more of the Baltic states. The objective would be to demonstrate

to alliance members that NATO’s response is too late and too weak.

A precondition for success is a distraction through a crisis by an intermediary, which would tie down especially American attention and resources. The distraction could come in many forms, e.g. by partnering with North Korea, fanning war in the Middle East, or even hidden support for terrorists.

If the current polarisation in US domestic politics continues, any reaction will be obstructed and delayed. An especially vulnerable window of opportunity is in the period between the presidential elections in November 2016 and the installation of the new president in January 2017, which could create a legitimacy problem for the American political system when it comes to the possibilities of directly confronting Russia quickly.

An attack on any Baltic state would directly affect Swedish territory and air space. In the worst-case scenario, it will happen immediately before open conflict with NATO.

The Baltic states each offer different opportunities for Russia, but they all have in common that they lack any strategic depth, which means that an open invasion would be accomplished in a few days, unless support from other alliance members is forthcoming.

Estonia, which is the most powerful of the three, both economically and military, poses as a potential threat to the trade over St Petersburg. To control the maritime traffic through the Gulf of Finland is an important motive for Russia to influence Estonian politics. The population of Estonia, with 25 percent ethnic Russians, could be used to legitimize action and as grounds for destabilisation, especially around the border town Narva where more than 90% of the population is ethnic Russian.

Latvia is the most vulnerable of the three states. The economy is weaker; the Russian minority is about the same as in Estonia; and Russian organised crime has a strong hold. Especially the eastern parts of the country are vulnerable to Russian influence.

Lithuania only have about six percent ethnic Russians and a stronger military tradition. On the other hand, Lithuania offers access to Kaliningrad. Lithuania’s attempts to decrease their dependence on energy from Russia has annoyed the Russian regime, as is evident in the harassments by the Russian navy of the cabling operation which will connect the Lithuanian grid to Sweden. There are also some tensions surrounding the Polish minorities in the country which Russia could exploit.

How fast Sweden will become involved depends on the extent of open, armed actions against one or all of the Baltic States.

If a confrontation occurs with non-regular or paramilitary means, maintaining dominance over Swedish territory and territorial waters will be in focus. The same will be the case for Finland, but Finnish action could be influenced by Russian fabri-

cation of tensions in Karelia, that Helsinki could be blamed for.

NATO would try to respond in a controlled manner, i.e. prioritizing transports by air and sea. This would mean greatly increased traffic in and over the Baltic Sea. Tensions will rise drastically, with increased risks of miscalculations on both sides. Sweden and Finland are expected to act together with the rest of the EU and the US. If no direct military threat emerges against Sweden, then Sweden cannot count on any enforcements from the rest of the world apart from mutual information exchange.

The instance that the citizens in the Baltic states perceive a risk of a Russian incursion, the probability is high that a flow of refugees will commence. From Lithuania, the biggest flow will be to Poland while Latvian will flee to Sweden, mainly Gotland. Refugees from Estonia can be expected to flee towards Finland or Sweden depending on where in the country they live and where they have relations or connections.

In the worst-case scenario, Swedish and Finnish territory will become an arena for hostilities. As Russian readiness exercises have shown, airborne and marine infantry could rapidly and with surprise occupy parts of Gotland and Åland. A possible option is also to mine the Danish Straits in connection with this.

By supplies of surface-to-air and anti-ship missiles, Russian forces can temporarily extend their air and coastal defence in the Baltic Sea, protecting an incursion by land into the Baltic states. NATO would be faced with a *fait accompli*. The invasion does not need to happen in all three states nor include the entire territory of a country. The only thing that is needed is a demonstration of NATO's inability to defend alliance members. This would establish a new security order.

Depending on the level of conflict that Russia would be willing to risk, air and navy bases in Sweden and Finland could be struck with missiles from the ground, air and sea. It is, however, likely that the governments would be issued an ultimatum to remain neutral, with only a few hours to comply. Public announcement of the ultimatum would put immense pressure on the political system and weaken resistance. Such diplomatic tactics could be reinforced by forced cyber attacks on the electricity and telecommunication networks. During the coldest months of the year, the vulnerability would be the highest.

At the same time, Sweden would be expected to support their Western partners' need for transports into the theatre of action. If Russia would close the Danish Straits, any military support to the Baltic states would need to move over Swedish territory; such as air support Norwegian air bases or aircraft carriers in the Norwegian Sea. There would also be demands to clear of mines in Oresund, and possibly for al-

lowing equipment and troop transports to harbours on the east coast for further transport across the Baltic Sea. The Swedish to such demands would have consequences for generations to come.

If Gotland would not be occupied by Russian forces, NATO would demand to set up bases on the island. The smallest indication of acquiescing to such demands would have the Russians racing to the island.

Furthermore, Russia would coordinate activities in the far north, with submarines of all kinds and possibly even direct action in northern Finland and even in northern Sweden, in order to expand Russian air defence.

Faced with the risk of direct confrontations between Russian and American forces, Russia could mount land-based as well as amphibian operations in the north of Norway and on Svalbard, to improve the defence of Murmansk. Following a similar strategy, occupying parts of Bornholm would make it more difficult for NATO to support their members. This is probably not necessary, but it is a possible option.

In most people's minds, there is a sharp line between the Baltic states' eastern borders and Russia, the crossing of which is unconceivable. By first gaining the control over Gotland and Åland, the Russian General Army Staff could circumvent a mental Maginot line, in the same way as Germany attacked France through Benelux in May 1940.

Russian success in this scenario hinges on speed and the ability to contain the conflict. The first message to Washington will entail the understanding that this is not a direct conflict between the US.

For Russia, the uncertainty is therefore how US interests are perceived from an American perspective. For the US, it is not just the credibility of NATO that is at stake but also the unity of the EU. This has global connotations since allies (and enemies) in the Middle East and Asia will also form assumptions regarding the willingness and ability of the US to act in order to protect their allies. The risk is obviously that Russia miscalculates and underestimates the difference between, for instance, the departing presidential administration perceptions of US security interests on the one hand with the wider US security establishment's perception of these on the other.

During the whole process, the threat of nuclear strikes would hover over all decision makers, which increases the degree of uncertainty. Nuclear tests in the period before a test of strength cannot be ruled out, especially since Russian emphasis on nuclear deterrence could loose credibility over time. Direct threats of using the nuclear weapons is, however, completely excluded in this scenario.

More plausible are attempts to disturb the financial system on a larger scale by cyber attacks, particularly since perpetrators are difficult to identify.

The consequences of Russian dominance over the Baltic states for the security environment would

be profound. Sweden would be forced to drastically upgrade its defences and ally itself to the US and the UK in order to guarantee its security. The cost of such an upgrade would be at least 60 billion SEK annually, assuming that a capability equal to that existing in the early 90's were to be achieved. The alternative, to appease Russia, is unlikely given Sweden's trade profile and political integration in the EU.

The consequences for Sweden's economic exposure against the region are both direct and indirect. Investment assets and trade relations would be affected directly, in varying degrees, by rising tensions or conflict in the region. Indirectly, investors' perception of the probability of increasing uncertainty and rising tensions affects decision making. On the whole, many may judge that there are less uncertain regions in the world to invest in.

## Endnotes

1. We disregard portfolio investments and pure financial exposure.
2. 2012 is the latest year for which data is available for export of services by country. Based on the assumption that exports of services to the region has developed similarly as total exports of services, we estimate that it amounted to 135 billion SEK in 2014.
3. Foreign direct investments pertains to direct or indirect ownership exceeding 10 percent in a foreign company or commercial property.
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