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Energy Empire:

Oil, Gas and Russia's Revival

Fiona Hill

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49 Chalton Street
London
NW1 1HY
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Email: info@fpc.org.uk

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About the Author

Dr. Fiona Hill is a Senior Fellow in the Foreign Policy Studies Program at The Brookings Institution. She has published extensively on a diverse range of issues related to Russia, relations among the states of the former Soviet Union, the Caucasus region, Central Asia, ethno-political conflicts in Eurasia, and energy and strategic issues. Her book with Brookings Senior Fellow Clifford Gaddy, *The Siberian Curse. How Communist Planners Left Russia Out in the Cold*, was published by Brookings Press in December 2003. Other recent publications include: 'The Caspian Region: Pipelines for Politics, Peace and Prosperity?' *Georgetown Journal of International Affairs* (Winter/Spring, 2004); 'Central Asia and the Caucasus: The Impact of the War on Terrorism', *Nations in Transit* (Freedom House, 2003); 'Seismic Shifts in Eurasia: The Changing Relationship Between Turkey and Russia, And its Implications for the South Caucasus', *Journal of South Eastern European and Black Sea Studies* (2003); 'Does Saudi Arabia Still Matter? Differing Perspectives on the Kingdom and its Oil', (with Shibley Telhami) in *Foreign Affairs*, November/December 2002; and 'Fueling the Future: The Prospects for Russian Oil and Gas', (with Florence Fee) in *Demokratizatsiya*, Fall 2002.

Hill was Director of Strategic Planning at the Eurasia Foundation in Washington, DC, from 1999-2000, and continues to serve as an advisor to the Foundation's president. From 1994-1999, she was Associate Director of the Strengthening Democratic Institutions Project (SDI) at Harvard University and, from 1991-1994, she was Director of Harvard's project on Ethnic Conflict in the former Soviet Union and Coordinator of Harvard's Trilateral Study on Japanese-Russian-U.S. Relations. Hill is also a Trustee of the London-based Institute for War and Peace Reporting; on the Advisory Board of the Central Eurasia Project of the Open Society Institute in New York; a Board Member of the Russian language international news service, *Washington ProFile*; and on the editorial boards of *Demokratizatsiya* and the *Journal of Southeast European and Black Sea Studies*. She is a member of the Council on Foreign Relations.

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Disclaimer

Abstract

Russia is back on the global strategic and economic map. It has transformed itself from a defunct military superpower into a new energy superpower. Energy revenues no longer support a massive military-industrial complex as they did in the Soviet period. New oil wealth has been turned more into butter than guns. And after five years of economic growth, Russia has a new 'soft power' role that extends far beyond its energy resources. Instead of the Red Army, the penetrating forces of Russian power in Ukraine, the Caucasus, and Central Asia are now Russian natural gas and the giant gas monopoly, Gazprom, as well as Russian electricity and the huge energy company, UES – and Russian culture and consumer goods.

A range of new Russian products, a burgeoning popular culture spread through satellite TV, a growing film industry, rock music, Russian popular novels, the revival of the crowning achievements of the Russian artistic tradition, and new jobs in the private and service sectors, have made Russia an increasingly attractive state for the region around it. Millions of people from the Caucasus, Central Asia, and rest of Eurasia have flooded into Moscow, St. Petersburg and other Russian cities in search of work – and a better life. As a result, since 2000, Russia's greatest contribution to the security and stability of its vulnerable southern tier has not been through its military presence on bases, its troop deployments, or security pacts and arms sales. Rather, it has been through absorbing the surplus labor of regional states, providing markets for their goods, and transferring funds in the form of remittances (rather than foreign aid). Migration to Russia has become Eurasia's safety valve.

Russia's economic growth and government budget revenues have been tied to high world oil prices and increased oil production since 1999. Energy now underpins the Russian economy and domestic stability, and boosts Russia's international status. But according to most forecasts, in spite of enhanced recovery methods and new technologies introduced, Russian oil production will reach its peak around 2010, plateau, and then begin to taper off – if no new fields are developed. New fields and new reserves will be hard to recover as they are in colder, more remote regions with poorly developed

infrastructure. Although Russia's energy resources are not likely to "run out" anytime soon, without a major redirection of industry effort toward exploration, new field development, and the construction of new energy transportation infrastructure, Russia will see a decline in production.

Strengthening Russia's energy sector for the future is now a critical issue not just for Russia, but for the much broader region of Eurasia, as well as for the primary consumers of Russian energy in Europe, Asia, and increasingly in the United States. And any sudden decline in production and economic slow-down will jeopardize Russia's efforts to take advantage of its new soft power potential and affect regional stability.

CONTENTS

Introduction

Russia is back on the global strategic and economic map. As one of the world's most energy-abundant countries, Russia has since 1999 benefited immensely from the combination of international concern about energy security, instability in the Middle East, and dramatically rising oil prices. It has regained the prominence in global energy markets it enjoyed in the 1970s and 1980s when the USSR, not Saudi Arabia, was the pre-eminent world oil producer. As a result, Russia has transformed itself from a defunct military (although still nuclear) superpower into a new energy superpower. The Russian economy has also bounced forward on a wave of high oil prices and increased oil production.[1] Although Russia's economy may still be the size of a minor league Brazil or Mexico, its energy resources seem to give it a shot at the premier league in the future, especially if oil prices remain high.[2]

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[1] In 2003, Russia's real GDP growth was 7.3 per cent, with an average annual GDP growth of 6.7 per cent over the period from 1999-2003. (Source: Economist Intelligence Unit, 'Country Report: Russia', *EIU Viewswire*, June 2004, www.viewswire.com). The government boasted a healthy budget surplus equivalent to 2.4 per cent of GDP, having run a surplus for four years in a row. (Source: Russian Federation Ministry of Economic Development and Trade, 'Osnovnye parametry sotsial'no-ekonomicheskogo razvitiya Rossiyskoy Federatsii na 2005 god i na period do 2007 goda', (Moscow, June 2004), p.1, at www.economy.gov.ru). In addition, the current account surplus reached 11 per cent in 2003 and reserves were at an all time high of $86 billion in February 2004. As a team of economists from the World Bank noted in assessing Russia's progress since the financial collapse of 1998: 'Russia [found] itself in an excellent position at the beginning of 2004 … and growth shows no signs of abating'. (Source: The World Bank, *From Transition to Development: A Country Economic Memorandum for the Russian Federation*, April 2004.)

[2] In 2003, according to the Economist Intelligence Unit ('Country Report: Russia', June 2004), Russia's economy reached $433.5 billion, close to Brazil's GDP of $492.1 billion. Although Russia's GDP per capita at purchasing power parity (PPP) was $8,280 in 2003, in comparison with $9,220 in Mexico, Russia's overall GDP was smaller than Mexico's ($626.1 billion) by 44 per cent (see *EIU Viewswire* reports for the respective countries). In a 2004 article in *Foreign Affairs*, American scholars Andrei Shleifer and Daniel Triesman made an interesting comparison of Russia with both Brazil and Mexico and described Russia as a normal middle-income country like both of these states, see Andrei Shleifer and Daniel Triesman, 'A Normal Country', *Foreign Affairs*, Volume 83, No. 2, March/April 2004, p.20.

The striking growth of the economy since 1999 has begun to change the nature of Russian power and the way it is exercised. Although Russia has retained many of the vestiges of Soviet 'hard power' – including nuclear weapons and a massive conventional army – and is now regaining the USSR's position in energy markets, it is not the superpower of old. New energy revenues have not been used to boost military spending or to revive Russia's defence industry at the expense of every other sector as in the Soviet period.[3] Oil wealth has been transformed more into butter than guns.

Russia's 'Soft Power' Revival

Since 2000, Russia has gradually begun to eschew the old Soviet approach of emphasizing the maintenance and deployment of its military power to ensure its geopolitical position. Instead, Moscow has moved in the direction of first building up and now starting to

[3] As a result of the growth of the Russian economy from 2002-2003, Russian annual defence spending as a proportion of GDP fell slightly from 2.72 per cent in 2002 to 2.64 per cent of GDP in 2003. The economic growth masked actual increases in defence spending as a proportion of the total Russian federal budget expenditure, from 14.38 per cent in 2002 to 14.69 per cent in 2003. On a range of different indices, Russia's defence spending remains roughly comparable to other major military powers like India, Japan, France and the United Kingdom. For more detailed information on Russian defence spending and military budgets, see, for example, The Stockholm International Peace Research Institute, *SIPRI Yearbook 2003: Armaments, Disarmament and International Security* (Oxford University Press, 2003), pp. 305-308, 319. Increases in defence spending over the last two years have primarily been aimed at addressing critical and previously neglected areas, such as improving pay and living conditions – especially housing – for servicemen; advancing military education and specialist training; reducing troop numbers and covering the costs of new military pensions; and boosting research and development for new weapon systems. Because of the high costs involved in moving to a modern, fully voluntary and professional military, Russia still maintains the conscript-based military and paramilitary forces it inherited from the Soviet Union. Military reform has made little real headway over the last decade. Russian President Vladimir Putin, in his May 2004 annual national address, stressed that modernization remained the main priority for 2004-2005, and that 'a transparent military economy' with a clear idea of precisely how and where money was spent, and military property accounted for and managed was the 'necessary condition for reform'. See Vladimir Putin, 'Annual Address to the Federal Assembly of the Russian Federation', May 26, 2004, at www.kremlin.ru/eng/speeches/2004/05/26/1309_type70029_71650.shtml.

utilise its economic resources to encourage neighbouring states to associate more closely with its regional policies. At the same time, Russia's growing economy, the persistence of the Russian language as a regional *lingua franca* – the language of commerce, employment, and education – for many of the states of the former Soviet Union, a range of new Russian consumer products, and a burgeoning popular culture spread through satellite TV, a growing film industry, rock music, Russian popular novels, and the revival of the crowning achievements of the Russian artistic tradition have all made Russia a more attractive state for regional populations than it was in the 1990s. Over the last several years, Russia has become a migration magnet for Eurasia. Millions of people have flooded into Moscow, St. Petersburg, and other Russian cities, from the South Caucasus and Central Asia in particular, in search of work and a better life.

At this juncture – in spite of the war in Chechnya, repeated confrontations with Georgia in the South Caucasus, and a recent show of force in a dispute over ownership of the Black Sea Kerch Strait with Ukraine – no regional state reasonably anticipates a Russian military invasion.[4] Instead of the Red Army, the penetrating

[4] Several recent incidents illustrate that Moscow is certainly not averse to displaying the heavy hand where it feels its security or key interests to be threatened directly by external developments. In summer 2004, after a brief thaw in relations between Tbilisi and Moscow – following the removal of Georgian President Eduard Shevardnadze in November 2003 and his replacement with Mikhael Saakashvili in January 2004 – Georgia and Russia clashed over the secessionist Georgian republic of South Ossetia, whose *de facto* independence is supported by Russia. The political disagreement over Tbilisi's attempts to restore control over South Ossetia's capital Tskhinvali assumed military dimensions in July 2004 when Georgia intercepted a shipment of weapons and ammunitions from Russia to South Ossetia, and when South Ossetian forces detained a contingent of Georgian peacekeepers just south of Tskhinvali. See, for example, 'Georgia: Moscow Talks on South Ossetia Continue amid Moderate Optimism', *RFE/RL Headlines*, July 15, 2004; and Igor Torbakov, 'South Ossetia: Tensions Subside But Uncertainty Lingers', *Jamestown Eurasia Daily Monitor*, Volume 1, Issue 51, July 14, 2004. A similar crisis was averted in the Georgian region of Adjara in May 2004, when negotiations between Tbilisi and Moscow ended a standoff between Georgian President Saakashvili and the region's leader Aslan Abashidze, who had run Adjara as his private fiefdom for more than a decade, refusing to recognize Tbilisi's authority. Abashidze left Georgia for exile in Moscow following the mediation of Russian Security Council Secretary Igor Ivanov. See, *Giorgi Sepashvili,* 'Adjara Celebrates Abashidze's Departure', *Civil Georgia,* May

forces of Russian power in Ukraine, the Caucasus, and Central Asia, are now Russian natural gas and the giant gas monopoly, Gazprom, Russian electricity and the huge energy company, UES, and Russian culture and consumer goods. Gazprom is the primary provider of gas to the Eurasian states and has regained its position in markets like Georgia where other companies had entered in the late 1990s. UES has similarly expanded its markets, especially in the Caucasus and Central Asia where early energy sector privatisations brought in foreign investors.[5] And private firms like Russia's Wimm-Bill-Dann Foods have begun to dominate regional markets for dairy products and fruit juices.[6] In 2002, Russia's accumulated investments in the countries of Belarus, Moldova, Armenia, Ukraine, and Kazakhstan reached about $1 billion.[7] While from January-September 2003, Russia's trade turnover with the

6, 2004 at www.civil.ge. The secessionist Black Sea republic of Abkhazia – a region that is now economically dependent on Russia, and where a large proportion of the predominantly non-ethnic Georgian population have assumed Russian citizenship – is also a contentious issue between Russia and Georgia. Tensions rose in relations between Georgia and Abkhazia in July-August 2004 in tandem with the evolving crisis in South Ossetia.

Similarly, in September-November 2003, Russia began to build a sea dam toward the Ukrainian Island of Tuzla across the narrow Kerch Strait that separates the Sea of Azov from the Black Sea. The dam was clearly designed to block access to the Strait. Russia and Ukraine have been in a dispute over the delimitation of the waters of the Kerch Strait since the collapse of the Soviet Union. The standoff resulted in a flurry of diplomacy and ended in a compromise agreement designating the Azov as an internal sea for Ukraine and Russia and thus off-limits to other shipping. See, for example, Askold Krushelnycky, 'Russia/Ukraine: Ire Over Kerch Strait Mellows', *RFE/RL*, Feature Articles, January 15, 2004.

[5] In summer 2003, for example, UES purchased 75 per cent of the electricity network in the Georgian capital, Tbilisi, as well as several electric generating facilities from an American investor, AES, securing effective control over Georgia's electric energy system. In the same period, UES took over Armenia's Sevano-Razdan hydroelectric power complex and the Razdan thermal power station, in exchange for nuclear fuel debts, later acquiring stock and management rights of Armenia's nuclear power plant, and a license to produce and distribute electricity in Armenia. For more general discussion of this issue see the Energy Information Agency at www.eia.doe.gov/emeu/cabs/caucasus.html.

[6] Wimm-Bill-Dann has formulated ambitious plans to acquire large dairy enterprises and build new plants in Ukraine, Belarus, Uzbekistan, Kazakhstan, Kyrgyzstan, Azerbaijan, and even in the Baltic states. For more information, see the company's website at www.wbd.ru.

[7] Institute for Complex Strategic Studies (Moscow), analytical report on foreign investment, in Russian at www.icss.ac.ru/publish/analysis/am066.html.

neighbouring countries of the Commonwealth of Independent states (CIS) increased by almost 30 per cent over the same period in 2002, with exports far exceeding imports.[8] As UES head Anatoly Chubais remarked in an interview in the Russian press at the end of 2003: 'Russian business is expanding across borders with confidence'.[9]

Russia may not be able to rival the United States in the nature and global extent of its 'soft power'. Harvard Professor Joseph Nye defines this in his new work on the changing nature of state power as emanating from three resources: '[a state's] culture (in places where it is attractive to others), its political values (where it lives up to them at home and abroad), and its foreign policies (where they are seen as legitimate and having moral authority)'.[10] But Russia is on its way to recovering the degree of soft power the USSR once enjoyed in its immediate sphere of influence.[11] This resurgence is becoming increasingly apparent to careful observers in Eurasia.[12]

If the influx of migrants continues, if Russian business investment grows in neighbouring states, if regional youth continue to watch Russian TV and films, purchase Russian software, CDs and DVDs,

[8] Russian Federation Ministry of Economic Development and Trade, State Statistics Committee of the Russian Federation, 'Ob itogakh Sotsial'no-Ekonomicheskogo Razvitiya Rossiyskoy Federatsii, v Yanvare-Oktyabre 2003g. i ob Otsenkakh do Kontsa Goda', (Moscow, November 2003), p.75, available at www.budgetrf.ru/Publications/2003/Pursuance/Federal/Monitoring/Minecon/econ200341100rept/econ200341100rept000.htm. The CIS countries comprise Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

[9] Interview with Anatoly Chubais, November 24, 2003, available on his personal website at www.chubais.ru/personal/first/show.cgi?241103prof.htm.

[10] Joseph Nye, *Soft Power: The Means to Success in World Politics* (New York: Public Affairs, 2004), p.11.

[11] Nye also notes in his introduction that 'the Soviet Union once had a good deal of soft power … Soviet soft power declined even as its hard economic and military resources continued to grow. Because of its brutal policies, the Soviet Union's hard power actually undercut its soft power' (p.9). Nye goes on to discuss the extent and decline of the USSR's soft power in Chapter 3 of his book, arguing that: 'A closed system, lack of an attractive popular culture, and heavy-handed foreign policies meant that the Soviet Union was never a serious competitor with the United States in soft power during the Cold War' (p.75).

[12] Author's interviews with officials and analysts in Kazakhstan and Kyrgyzstan in March 2004.

and other consumer products, and especially if the heavy-hand of Moscow is pulled back and the hand of commerce is extended instead in Russian foreign policy, Russia will achieve the economic and cultural predominance in Eurasia that the United States has in the Americas. However some skill is required to draw upon soft power resources in crafting policy – a fact demonstrated by the current failure of the US to capitalise on its own undisputed soft power and the growing global anti-Americanism.[13] And it is by no means assured that Russia's increasing soft power will be used to positive effect.

From the Heavy Hand of Moscow to the Hand of Commerce

Russia's ability to use soft power resources at all, however, stands in stark contrast with the situation a decade ago. In the 1990s, beset by the upheavals resulting from attempts to liberalise and reform its economy, Moscow lost the capacity to continue financial subsidies to the other states of the former Soviet Union and thus to maintain its economic attraction. Economic ties were further undermined by Russian decisions – motivated by the necessity of getting its own economy in order – to dismantle the ruble zone and to increase prices of oil and gas exports. This resulted in most regional states incurring huge hard-currency energy debts to Moscow. While it was cash-poor in the 1990s, Russia was still armaments-rich. Having inherited the bulk of the Soviet military arsenal – including bases, personnel and equipment – it retained a preponderance of hard power outside its territory in other former Soviet republics like Armenia, the Baltic States, Georgia, Moldova, and Tajikistan. This made the newly-independent, and weaker, states around it increasingly nervous as the economic benefits of association with Moscow faded.

Russia's cultural standing in the region also fell as the use of the Russian language became a political and highly-politicized issue.

[13] Joseph Nye, 'The Decline of America's Soft Power', *Foreign Affairs*, Volume 83, Issue 3, May/June 2004.

Concerns about the citizenship prospects of millions of ethnic Russians living in the newly independent states on Russia's borders – especially in the Baltic States of Estonia and Latvia, and in Ukraine and Kazakhstan – fed into a Russian nationalist backlash against the collapse of the Soviet Union. 'Russian-speakers' and 'co-ethnics' became a *cause célèbre* in political circles in the 1990s. In Moscow, a number of rising politicians – from its Mayor Yuri Luzhkov to Liberal Democratic Party leader Vladimir Zhirinovsky and parliamentarian Dmitry Rogozin – boosted their careers as well as honed their rhetorical skills by calling for government action in support of the interests of 'Russian-speakers in the near abroad'. In response, neighbouring governments rushed to push through new language laws and programs to expand the teaching and use of their indigenous state languages. Russian-speakers were increasingly viewed as a 'fifth column' for the reassertion of Moscow's influence over its neighbours' domestic and foreign policies.

Concerns over the prominence of the Russian language were particularly acute in the Baltic States. Politicians in Moscow deliberately tied the withdrawal of Russian troops from former Soviet military bases in Estonia and Latvia to the granting of special rights for Russian-speakers. In November 1993, for example, Russian Defence Minister Pavel Grachev stated unequivocally that: 'I, as Minister of Defence, want to link the pullout of troops to the protection of Russian-speakers'. And this policy was also extended to Central Asia, where new countries like Kazakhstan had sizeable Russian-speaking populations. In a lengthy interview with *Moscow News*, also in November 1993, Russian Minister for External Economic Relations Alexander Shokhin emphasised, like Grachev, that the issue and status of the Russian population of Central Asian states would be a central feature in their negotiations with Moscow on economic issues. 'We tie politics with economics', Shokhin declared, '… [and] whenever some benefits are requested of us, we are entitled to pose a question about the balance of interests'.[14]

[14] Both citations from Fiona Hill and Pamela Jewett, *Back in the USSR: Russia's Intervention in the Internal Affairs of the Former Soviet Republics and the Implications for United States Policy Toward Russia* (Cambridge, Massachusetts: Strengthening Democratic Institutions Project, January 1994), p.21.

Elsewhere in the region, in the South Caucasus states of Georgia, Armenia, and Azerbaijan, and in Moldova and Tajikistan, Russian politicians exploited state weakness and civil wars to retain Russia's presence on key military bases and borders. Moscow also employed military force to rein in countries trying to move beyond Russia's orbit, as well as to gain the upper-hand in the arbitration of relations between regional states. This included permitting 'volunteer forces' to cross Russian borders to assist opposing sides in conflicts, and deploying Russian military personnel and hardware in armed clashes – most notably in the conflict between Georgia and Abkhazia that led to the latter's secession from the Georgian republic in 1993.[15]

Russia also used threatening rhetoric, political ultimatums, and economic pressure to induce countries like Azerbaijan, Georgia, and Moldova that initially refused to join the CIS to become members of the Russian-led political and economic bloc. And these methods were used to try to discourage Central Asian states for pursuing closer economic and political relations with Turkey, China, and Iran. And, in the case of Ukraine, the Russian government repeatedly cut access to critical gas supplies during a series of disputes over the dismantling of Ukraine's nuclear arsenal, the division of the Soviet Black Sea fleet, and the future of Ukraine's ethnic Russian-dominated Crimean peninsula.[16]

Coercion involving the deployment of hard power resources to force former Soviet states to comply with Russian interests served to turn states away from, not toward Russia. Moscow was increasingly perceived as the bully on the block. Over the course of the 1990s, it lost its formerly dominant position in the region as well as the confidence of its neighbours. Only the most desperate countries like

[15] Georgia accused Russia of similar tactics in allowing 'volunteer forces' from Abkhazia, North Ossetia and other regions of the Russian Federation to travel across the Russian border to South Ossetia in July 2004 to support the Tskhinvali forces in their standoff with Tbilisi. See Zaal Anjaparidze, 'South Ossetia: Inside the Conflict Zone', Jamestown Foundation, *Eurasia Daily Monitor*, Volume 1, Issue 51, July 14, 2004.

[16] See Hill and Jewett, *Back in the USSR*, for a detailed discussion of these policies and events in the period from 1992-1994.

Armenia, Tajikistan, and Belarus (beleaguered by civil war, security concerns, and economic decline) clung to close relations with Russia. Countries like the Baltic States, Ukraine, Georgia, and Azerbaijan turned pointedly toward the West. And the Baltic States appealed directly to the United States, European countries, and international institutions for assistance in dealing with the issue of Russian troops on their soil and in mediating the growing conflict over their Russian-speaking populations. For example, international pressure on Moscow and US threats to withhold vital financial aid and technical assistance to Russia were instrumental in securing the withdrawal of Russian troops first from Lithuania in August 1993, and then from Estonia and Latvia in August 1994.[17]

Russian hard power exertion also drew unfavorable attention from Western analysts and policymakers in the 1990s. They saw a revival of Russian imperial ambitions and desires to reconstitute the USSR, albeit on the cheap.[18] This led to a series of policy responses to shore up the independence of the other former Soviet states and to offer them at least a modicum of security from Russian predation. These included the expansion of NATO and extending membership to the states of the former Soviet bloc in eastern Europe, including to the Baltic States; innovations like Partnership for Peace (PfP) as a NATO halfway house for other states of the former Soviet Union; and bilateral US initiatives emphasizing economic and technical assistance and closer political relationships with regional states, especially those perceived as most vulnerable to Russian pressure like Ukraine and Georgia. US and other international investors also moved into key commercial ventures in the increasingly attractive energy sector in the Caspian Basin. International investment in Caspian energy development was backed by the United States government, which spearheaded the creation of a new east-west corridor for the export of oil and gas to world markets from the Caspian across the Caucasus and Turkey, avoiding Russia as a

[17] See Carl Bildt, 'The Baltic Litmus Test', *Foreign Affairs*, September/October 1994, pp.72-85.

[18] See, for example, William Odom and Robert Dujarric, *Commonwealth or Empire: Russia, Central Asia, and the Transcaucasus* (Indianapolis, Indiana: Hudson Institute, 1995); and Uri Ra'anan and Kate Martin, *Russia: A Return to Imperialism* (New York: St. Martin's Press, 1995).

potential risk and bottleneck. Russia finally reached the nadir in August 1998 with the collapse of the Russian ruble and resulting financial crisis. The 1998 crash diminished Russia's regional economic standing even further.

The Rebound of the Russian Economy and Energy Sector

The turnaround came in 1999-2000 with the start of the post-crisis recovery of the Russian economy. The World Bank and other observers of the Russian economy typically cite a number of factors as key in stimulating Russian economic growth after the crash of 1998: relative price readjustments and the collapse in the real exchange rate, which resulted in import substitution and provided a stimulus to domestic producers of consumer and manufactured goods; a decline in real wages and underutilised productive capacity of labour and capital as a result of the decline of Russian industry in the 1990s; and a series of reforms encouraged by the government in the wake of the crisis that led to improvements in efficiency and industrial restructuring.[19] The most significant factor of all, however, was the rise of world crude oil prices from a low of around $10 a barrel in December 1998 (with an annual average of only $11.80 for 1998) to around $33 a barrel in September 2000.[20] This provided a major injection of cash into the domestic economy.

High oil prices were also the major factor in promoting the recovery of Russia's oil industry, which had been adversely affected by the collapse of the USSR and entered a prolonged period of decline in the 1990s. Beginning in 1993, the industry was gradually carved up and partially privatised.[21] A number of vertically integrated oil companies were established, each combining oil exploration,

[19] See The World Bank, *From Transition to Development*, p.i (Executive Summary), and p.7.
[20] Figures from the U.S. Energy Information Administration, 'OPEC Fact Sheet', January 8, 2002, http://www.eia.doe.gov/emeu/cabs/opec.html.
[21] For a detailed discussion of these developments see Fiona Hill and Florence Fee, 'Fueling the Future: The Prospects for Russian Oil and Gas', *Demokratizatsiya*, Volume 10, Number 4, Fall 2002, pp. 462-487.

production, refining, distribution, and retailing, with some companies organized on a regional basis, and some retaining a degree of state ownership.[22] The privatisation and division of the oil industry made it possible for new economic actors to enter the sector. The decade was marked by the emergence of new Russian oil barons or 'oligarchs,' like Mikhail Khodorkovsky of YUKOS, and Boris Berezovsky and Roman Abramovich of Sibneft. They had no prior experience in the Soviet oil industry but instead had access to financial capital from private banks, which they owned and controlled, and close political connections to the Russian government.

For most of the 1990s, Russia's new energy oligarchs structured their operations in ways that significantly reduced tax revenues to the state and moved large amounts of capital offshore as oil production in Russia was largely unprofitable.[23] Demand for oil declined by more than 40 per cent between 1990-1995, owing to the contraction of energy-intensive manufacturing industry and the huge military-related Soviet-era oil outlays. This caused a glut on the internal market. Oil exports were constrained by capacity limitations in the old Soviet pipeline system. The only real profits to be made were in refining. Between 1988 and 1998, Russian oil production dropped by approximately 50 per cent from over 11 million to around 6 million barrels per day (bpd) – in large part because of a sharp reduction in drilling, and little or no investment in new wells, or in technology to increase recovery from depleted wells.[24] There were simply few incentives to produce more and do better.

The sudden infusion of cash from soaring world oil prices into an essentially stagnant industry changed the underlying incentive structure. The oil price rise boosted company revenues even without increases in production, while the 1998 devaluation of the ruble had already significantly lowered ruble-denominated input costs

[22] 'Russian Energy Survey 2002', International Energy Agency, March 2002, pp. 66-70.
[23] For a discussion of the behaviour of Russia's energy oligarchs over the course of the 1990s, see Lee S. Wolosky, 'Putin's Plutocrat Problem', *Foreign Affairs,* March/April 2000, Vol. 79, No. 2, pp. 18-31.
[24] Statistics from 'BP Amoco Statistical Review of World Energy', June 1999.

(including labour) for Russian energy producers. After 1999, low input costs and high energy prices proved the winning combination. They gave Russian oil companies the internal capital to improve production efficiency without infusions of new outside investment. And they gave the new oil barons every reason to restructure and improve the management of their assets. Idle wells were brought back on line, new machinery was purchased, and new technology was introduced to enhance well recovery. By the end of 2001, Russian oil production had increased by around 1 million bpd to stand at just over 7 million bpd. New infrastructure, including the Baltic Pipeline System (BPS) and a new oil terminal at Primorsk on the Gulf of Finland, was built to increase export capacity by a projected 12 per cent. Plans for further export network expansion were underway.[25] By 2004, Russia's oil production had bounced back even further to reach 9 million bpd – with medium-term potential for still more increases, at least up to 11 million bpd (close to peak Soviet levels of production) – with exports reaching more than 4 million bpd of oil.[26]

Russia's export capacity was increased not just by new pipeline and port networks but also by the fact that its own oil demand remained low as a result of the continued decline of heavy industry. In contrast with Russian gas, where only about one third of production is exported, about half of Russian oil production is available for export. The bulk of Russian natural gas is used for power generation, home heating, and industry. While oil has predominantly brought cash flowing in from abroad, gas has kept the Russian economy afloat at home – as the main subsidiser of domestic industry and households. Unlike the oil industry, the gas sector was not carved up in the 1990s and is still controlled by the state-dominated monopoly, Gazprom, whose export revenues were also boosted after 1999 by high energy prices.

High oil prices and Russia's oil production rebound after 1999 were extremely good news for the Russian federal budget. Natural

[25] 'Russia to Profit from New Oil Line', *CNN.com*, December 27, 2001, at www.cnn.com/2001/WORLD/europe/12/27/russia.pipeline/index.html.
[26] 'Oil Exports Via Baltic Flood North Europe', *Moscow Times*, June 22, 2004.

resources constitute around 80 per cent of Russian exports, and oil and gas account for 55 per cent of all exports, making the budget particularly dependent on the energy sector. In fact, 37 per cent of budget revenues are provided by taxes on oil and gas.[27] Recent research by the World Bank and the IMF has shown that each dollar increase in the price of a barrel of oil (Ural crude) raises Russian federal budget revenues by as much as 0.35 per cent of GDP. And, indeed, the IMF's Resident Representative in Moscow, Goohoon Kwon, has argued that the oil sector accounted for as much as 80 per cent of total revenue gains at the general government level in the period from 1999-2001.[28] At the same time, changes in the world oil price accounted for 60-75 per cent of oil revenue gains between 1998-2001.[29]

In short, as a result of the sudden spurt in oil prices and the revival of the Russian energy industry, Russia's economic fortunes vastly improved. And with economic growth, Russia suddenly began to have something more to offer its neighbours than a brandished fist. It gradually became a more attractive country to do business with.

Fading Aspirations and Shifting Priorities in Eurasia

This is not, of course, the whole story. Many of the other countries of the former Soviet Union also suffered from similar financial crises in 1998-1999 owing to the knock-on effects of the Russian ruble devaluation on their own currencies. They underwent similar price adjustments and import substitutions, and boosted their own domestic production. Energy-rich countries like Kazakhstan also benefited from the same oil price windfall as Russia, and in similar ways. As economies in Eurasia started to recover and grow, Russia's neighbours began to look to it as a market for their exports. They sought to purchase new Russian consumer products that were

[27] The World Bank, *From Transition to Development*, p.8.
[28] Goohoon Kwon, 'The Budgetary Impact of Oil Prices in Russia', (Working Paper, August 1, 2003), p.7, at www.imf.org/external/country/rus/rr/2003/pdf/080103.pdf.
[29] Ibid., pp.2-3.

cheaper than imported goods from the West. Dependency on Russia for energy supplies also continued and debts to Russia grew with higher oil and gas prices.

At the same time, it became clear that aspirations in Ukraine, the Caucasus, and Central Asia for large-scale Western investment and the development of close economic and political connections with the US, Europe and other major economic powers would not be fulfilled in the foreseeable future. Beyond limited bilateral assistance and international financial institution loans and grants; membership in institutions like the OSCE, Council of Europe and PfP; and Western investment in large-scale energy projects in the Caspian Basin, such as the construction of the Baku-Tbilisi-Ceyhan oil export pipeline; economic powers apart from Russia had little to offer. The inescapable facts of distance and geography prevailed. So did political realities.

NATO enlargement and the subsequent expansion of the European Union (EU) to cover the countries of Eastern Europe seemed to roll back vestigial Russian attempts to reassert influence in Europe – including in the Balkans after a blip in June 1999, when Russian forces unexpectedly asserted control over Pristina airport in Kosovo during the NATO intervention. The emergence of new trans-national threats to US and Western interests, especially terrorism emanating from Afghanistan and the Middle East, shifted priorities. By 2000 (its nuclear arsenal notwithstanding), Russia had faded as a significant strategic threat to Europe. It was also evident that, with the notable exception of the three Baltic States, none of the other states of the former Soviet Union was likely to be a viable candidate for membership of either NATO or the EU in the near-term. Opportunities for further security, political, and economic interaction, including trade, with the US, and European countries were thus limited.

A Change of Regime and Goals in Moscow

In addition to the changes in the West's approach toward Eurasia, Russia's goals changed when Vladimir Putin came to power, first as Prime Minister in 1999 then as President in 2000. Putin assumed the Presidency with a pledge to bring stability and order to Russia, and to begin a process of restoring the country to 'greatness' by unifying society, stabilizing the economy, and strengthening the state.[30] His priority was on strengthening Russia internally and putting the economy in order, not on strengthening Russia's external position – at least not in the short-term.

The growth of the economy after 2000 made it possible for Putin to pay foreign debts on time and to free Moscow from the huge infusions of foreign financial assistance from the IMF, the United States and other major bilateral lenders that it had required throughout the 1990s.[31] A balanced federal budget passed into law at the end of 2000 for the first time in post-Soviet history. By the end of 2001, the Russian economy had experienced its best performance since the fall of the Soviet Union. In 2001, GDP grew by 5.5 per cent, industrial and agricultural production by 5-6 per cent. Exports reached a record $108 billion. The population's real incomes grew 6 per cent as wages soared by 20 per cent and pensions by 23 per cent. Official reserves of gold and hard currency also increased.[32] Three years after the financial crash of 1998, thanks to high world oil prices, the ruble was relatively stable.

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[30] For a more detailed discussion see Clifford Gaddy and Fiona Hill, *Putin's Agenda, America's Choice* (Brookings Institution, Policy Brief, No. 99, May 2002).
[31] In 2001, for the first time, Russia met its entire debt repayments schedule on time and even prepaid some of its IMF debt. See the World Bank's 1999-2004 report on Russia's creditworthiness, at www.worldbank.org.ru/ECA/Russia.nsf/0/E65EB715FA7A438BC3256C91004AE7A1.
[32] 'Russian Economy To End Year on a High Note, But Possible Downturn Looms', *RFE/RL Newsline*, December 18, 2001, at www.rferl.org/newsline/2001/12/1-rus/rus-181201.asp.

Investors operating in Russia were more positive about the prospects for the economy and for doing business in Russia.

Economic success contributed to extremely high popularity ratings for President Putin in his first years in office. Most importantly, from the perspective of the Russian population, thanks to a budget surplus (rather than a daunting deficit), Putin was able to pay salaries and pensions, and even provide modest increases. This was something his predecessor, Boris Yeltsin, had been unable to do in the 1990s. As a result, Putin maintained an approval rating of around 70 per cent, enabling him to push through reforms that the previously cash-starved and unpopular Yeltsin had planned but been unable to achieve. In 2001, for example, new legislation was passed on land reform, pension, and taxes – including the abolition and reduction of turnover taxes and the lowering of personal income tax to a flat rate of 13 per cent, which was among the lowest in the world. Land reform was considered a particular success. For the first time since the Bolsheviks seized all property for the state after the Russian Revolution, it became legal to buy and sell urban land.

With a combination of reforms, financial inducements, and strong-arm tactics against political opponents, Putin was also gradually able to restore the so-called 'vertical of power' – Moscow's central authority, and its political and fiscal control over the Russian regions. Seven new 'super regions' with presidential plenipotentiaries were created to oversee Russia's 89 territorial-administrative units which as a group were proving somewhat unwieldy in a federal system and some of which individually were being completely unruly. Regional governors' abilities to lobby their interests in Moscow were further reduced by the reform and essential emasculation of the upper house of the Russian parliament, their locus of power at the centre.

In his annual addresses on the state of Russia and his policy agenda, Putin consistently prioritized economic reforms (including administrative, budget, and tax reforms) and improving Russia's investment and business climate. Traditional security and foreign policy issues were relegated to secondary or tertiary issues. They were presented as areas where problems should be minimized, and where efforts should be focused on promoting the primary domestic

goal of economic reform and strengthening state structures. In Putin's most recent annual address on May 26, 2004, for example, economic goals were again paramount. In keeping with his early themes, the Russian President stated that the purpose of reform was to strengthen Russia's place in the world. But he stressed that this would be done primarily by bringing about 'a noticeable increase in [the Russian] people's prosperity'. Putin spent a great deal of time discussing issues related to housing, healthcare, education, taxation, natural resource development, and infrastructure improvements. He spent very little time on issues related to foreign policy.[33]

In the foreign policy arena, only relations with Russia's immediate neighbours in the CIS, were a focal point, with emphasis laid on 'deepening integration in the Commonwealth of Independent States … by removing barriers to mutual trade and information flows, business and social initiatives, and direct contact between people'. Further afield, beyond a reference to strengthening 'the anti-terrorist coalition,' Putin touched on the economic aspects of international affairs: fostering 'the integration of the Russian economy into the international economy,' and continuing to 'develop political and economic dialogue with the U.S. and with such major partners as China, India, and Japan'.[34]

In contrast again with the 1990s, Russia's relations with the United States also moved from centre stage after 2000. In part this was because Russia's sudden financial solvency eased its dependence on the United States and international financial institutions for loans, and also consequently removed their (albeit limited) leverage over Russian economic and political affairs. Putin also made a major decision in 2001 to avoid confrontations and improve the bilateral relationship with the U.S. specifically to secure a breathing space in foreign policy that would allow him to concentrate on domestic consolidation and reform.[35]

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[33] Vladimir Putin, 'Annual Address to the Federal Assembly of the Russian Federation', May 26, 2004, at www.kremlin.ru/eng/speeches/2004/05/26/1309_type70029_71650.shtml.
[34] Ibid.
[35] Gaddy and Hill, *Putin's Agenda, America's Choice*.

Putin got off to a rocky start with the Bush Administration owing to a series of spy scandals, and disputes over Washington's decision to withdraw from the Anti-Ballistic Missile (ABM) treaty and to pursue a national missile defence program. But a gradual improvement in relations was effected through personal contacts between the two presidents, and meetings of the respective foreign ministers. The September 11, 2001 terrorist attacks on the United States gave Putin's policy its greatest boost. They presented an opportunity for cooperation on tackling terrorism, an issue of common concern. President Putin was the first foreign leader to telephone President Bush after the attacks to offer the U.S. condolences and support for subsequent action. This support was extended to acquiescing in the establishment of U.S. bases in Central Asia to back-up the military campaign in Afghanistan, in spite of considerable opposition within the Russian armed forces. Putin has also been very careful to couch subsequent overtures and initiatives with the United States in the context of the war on terrorism – as the reference in his May 2004 annual address to strengthening 'the anti-terrorist coalition' suggests.

Presidential Foreign Policy and Geopolitical Aspirations

After 2001, in conjuncture with his carefully planned overtures to the United States, Putin put an end to the freewheeling and chaotic foreign policy of the Yeltsin period.[36] Yeltsin's dwindling public support, combined with his lack of personal prestige within his own inner circle, had led to considerable freelancing by a variety of groups and institutions in their spheres of responsibility or interest. This ranged from the Foreign Ministry itself; to different branches of the military; the nuclear power agency, Minatom; the fuel and energy ministry; the Russian parliament; regional leaders; and powerful private businessmen, the so-called Russian 'oligarchs'. As of 2004, freelancing had been eliminated to the extent that the President and the Presidential Administration could be said to be in charge of the foreign policy agenda.[37] In Moscow, foreign policymaking is now widely seen as 'off limits' for external participation, and even the policy functions of the Ministry of Foreign Affairs have been largely ceded to the Kremlin.

The Kremlin, however, remains a 'black box' for those outside. The motivations behind individual policy initiatives are still difficult to discern. By no means could it be said that Russia has become a unitary actor. Nevertheless, from the perspective of its neighbours, Moscow has been somewhat more predictable in its dealings over the last three years. And Russia has generally exercised regional power in a different way than it used to. Investing Russian capital, exporting Russian consumer products and popular culture, and offering access to Russian markets have become increasingly more important in securing Russian interests.[38]

Putin's annual addresses, other high-level policy statements, and the thrust of Russia's recent relations with its immediate neighbours would all seem to indicate that Moscow no longer embraces the

[36] The perceived failings of Russian foreign policy in this period are captured in a lengthy article in *Nezavisimaya Gazeta* in May 1995. See Nina Petrova, 'Russia's Foreign Policy Must Become Presidential. The Reasons for and the Consequences of the Defeats for Andrei Kozyrev's Diplomacy', *Nezavisimaya Gazeta,* May 17, 1995 (English edition). Petrova noted that a lack of professionalism and lack of a unified federal coordinating mechanism for foreign policy and foreign economic decisions in Russia was 'strengthening … the real threat of international isolation' rather than 'Russia's international prestige' and that 'the country's prestige is falling lower and lower … less and less notice is being taken of Russia both in bilateral relations and in international organizations … For the first time in history, Russia is threatened with international isolation both in Asia and in Europe, accompanied by very cool relations with members of the CIS'. To bring Russia out of its foreign policy crisis, Petrova advocated the creation of a 'Presidential foreign policy' and the strengthening of state institutions with the President at the centre to 'make sure that all – even the most authoritative – state organs have pursued a line in international affairs that is in strict accordance with the one the President is maintaining. Independent action and improvisation in foreign policy questions are impermissible'. This is the approach that President Putin adopted six years later.

[37] For a detailed discussion of the changes in foreign policymaking and its centralization in the Presidential Administration under President Putin, see Bobo Lo, *Vladimir Putin and the Evolution of Russian Foreign Policy* (London: Royal Institute of International Affairs, Chatham House Papers, 2003).

[38] Author's interviews with analysts and policymakers in the South Caucasus and Central Asia in Summer 2003 and March 2004.

grandiose imperial ambitions of the Soviet period.[39] However, Russia clearly still has geopolitical aspirations even if they are more modest. These aspirations are very much focused on the CIS – Russia's immediate neighbours and fellow former Soviet republics.

This fact was underscored in July 2004, when Putin addressed a plenary session of Russian Ambassadors who had been recalled to Moscow for a special meeting to review foreign policy priorities. Putin stressed that the priority tasks of Russian foreign policy and missions abroad were 'to protect national economic interests, raise the investment attractiveness of Russia, and resist discrimination in foreign markets,' and generally to 'serve the cause of the overall development and modernization of the country'. He also re-emphasized that 'our main priority remains the Commonwealth of Independent States (CIS)'. Most interestingly, Putin noted that Russia had not yet learned to use 'sufficiently well the historical credit of trust and friendship, the close ties that link the peoples of our countries' – in other words Russia's soft power resources. He stated that 'relations between CIS states and Russia should be made as attractive as possible not only for us, *but also for them*' [emphasis added].

Perhaps most significantly, Putin cautioned against calling for exclusive Russian 'leadership over the CIS expanses', acknowledging that Russia could no longer claim a monopoly over the affairs of the region. While still stressing the importance, as a decade earlier, of protecting 'the rights and interests of our co-citizens and our fellow-countrymen in CIS and Baltic countries,' Putin also suggested that this might be done by establishing 'large information and cultural centres for work with expatriates' – again by soft power, rather than hard power, means.[40] In the same week as the meeting of Ambassadors, President Putin appointed a new envoy to the CIS countries, Viktor Khristenko, the Russian Energy

[39] See Bobo Lo, *Vladimir Putin and the Evolution of Russian Foreign Policy*; and Igor S. Ivanov, *The New Russian Diplomacy* (Washington, DC: The Nixon Center and Brookings Institution Press, 2002), p.87.
[40] Vladimir Putin, 'Address at the Plenary Session of the Russian Federation Ambassadors and Permanent Representatives Meeting', Moscow, Foreign Ministry, July 12, 2004, available at www.kremlin.ru.

Minister and former Deputy Finance Minister, and an economist who favors the economic integration of the CIS region.[41]

Putin's emphasis on soft power and economic integration in his July 2004 speech suggests a real departure from Russia's more traditional heavy-handed and military force-oriented approach to its relations with the CIS. But, Russian hard power is still present and still deployable. Saber rattling tendencies persist, and the real danger remains that 'restorationists' in the military and security services, as well as in the Russian parliament will try to reassert themselves in foreign policy. The more hardline circles – the so-called *siloviki* – in Moscow make their opinions on the means of reconstituting Russia's authority in Eurasia quite clear in private discussions, as well as in public articles and presentations. They certainly favour the exclusive Russian leadership over the CIS expanses that Putin warned against and the use of coercive force to secure Russian interests. Their views are also shaped by the fact that the United States under the Bush Administration has been more assertive elsewhere in the world, including in areas of former superpower competition in Asia and the Middle East where it has launched military campaigns in both Afghanistan and Iraq. The feeling in these circles is very clearly that if Russia now has to leave the rest of the world to the U.S., then the U.S. should leave Eurasia and the CIS to Russia.[42]

[41] Jeremy Bransten, 'CIS: Putin Appoints New Envoy on Regional Affairs', *RFE/RL Headlines*, July 14, 2004.
[42] As one former senior Georgian official recalls from his many visits to Moscow during his period in office, he was repeatedly told by members of the Russian military and intelligence communities that Georgia needed to change its foreign policy stance in a dramatic manner and provide them with 'motivated inspiration' if Tbilisi wanted to 'resolve its [domestic] problems', including the secessions of Abkhazia, South Ossetia etc. This 'motivated inspiration' could be 'some news that, let's say, Georgia wants to rejoin the CIS Collective Security Treaty Organization, the Common Economic Treaty Organization or, let's say, declare that the [Russian] military bases [still in Georgia] can stay there forever'. He would then be told more bluntly 'just turn … [away from]… the West and Americans, forget about NATO and European integration, change your political vector'. Personal communication with the author, July 2004. For some additional illustrative thinking on foreign policy in 'hawkish' Moscow political circles, see also the 'Foreign Policy Views of Vladimir Zhirinovsky's Liberal Democratic Party' (LDPR) at www.ldpr.ru/Azbuka/azbuka_vneshpol.htm; and the book by Dmitry Rogozin of the Rodina (Motherland) Party, *My vernem sebe Rossiyu*, (We Will Get

Although freelancing has been discouraged, and Putin has repeatedly set forth a foreign policy agenda in his annual addresses and other statements, the fact that policymaking is now confined to the relatively narrow circles of the Kremlin and Presidential Administration means that Putin has very few elite cadres to rely on to implement a policy based on Russia's soft power resources. There are many more people sitting on hard power resources on Russia's borders and in bases in CIS states, sharing similar views to hardliners in Moscow, who may be tempted to deploy those resources on their own, or someone else's initiative, and who are very difficult to rein in – especially from behind the Kremlin walls many hundreds or even thousands of miles away.

To some degree, however, desires to deploy the real hard power military resources have been tempered by the debacle of the war in Chechnya. As the assassination of the pro-Moscow president, Akhmad Kadyrov in May 2004, and large-scale attacks by Chechen and other forces on Russian security installations in Ingushetia in June 2004, illustrate, the war is far from over. It will enter its second decade at the end of 2004. And it has the potential to spread conflict more broadly across Russia's North Caucasus region. With the high costs of the war – including tens of thousands of Russian military and civilian casualties; the total destruction of the city of Grozny, a key refining and training centre for Russia's oil industry; a massive humanitarian disaster; and increasing linkages with international terrorism – Chechnya offers a sobering, negative example of the use of force and Russian hard power. It underscores how quickly and easily the use of military force can become self-debilitating and counter-productive.[43]

Russia Back), available online at www.rodina-nps.ru/library. These all emphasize the importance of using hard power in pursuit of Russian interests.

[43] The war in Chechnya was launched in late 1994 during the period of acute Russian economic weakness, when diplomacy and political persuasion failed to rein the secessionist republic back in. See Fiona Hill, *Russia's Tinderbox: Conflict in the North Caucasus and its Implications for the Future of the Russian Federation* (Cambridge, Massachusetts: Strengthening Democratic Institutions Project, September 1995). Unfortunately for Russia, although financial resources are now available to promote Chechnya's physical and economic reconstruction, and its reintegration with the rest of the Russian Federation, Moscow has completely lost the confidence of the Chechen population after a decade of brutal conflict, and is bogged down in an intractable guerrilla war.

Energy Empire – Projecting Russian Influence Abroad

Other recent developments in Russia's neighbourhood demonstrate that Moscow can gain more traction in priority areas by deploying soft rather than hard power resources and, in the words of one leading Russian analyst, by 'turning Russian into an economic magnet for [the states of the CIS]'.[44] In June 2004, for example, Moscow saw a reversal of negative trends in two key relationships in Central Asia, with Tajikistan and Uzbekistan. In the case of Tajikistan, the government in Dushanbe sought the removal of Russian troops from Soviet-era bases in the republic, and Russian guards from its border with Afghanistan. Although there was still some arm twisting, the two sides reached a mutually acceptable agreement in a relatively speedy manner. Russia secured its troops and military installations – including ownership of a strategic space surveillance centre – in return for forgiveness of a portion of Tajikistan's debts to Russia and energy investments (which also give UES eventual ownership of a hydro-electric power facility). Most importantly for Tajikistan, it secured an agreement on the entry of its labour migrants into Russia.[45]

With Uzbekistan Russia signed a new strategic partnership agreement. This marked the end of a decade in which the Tashkent government had drawn further away from Moscow – in part because

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[44] Dmitri Trenin, 'Proyekt SNG – Novyy prioritet rossiyskoy vneshney politiki?' (Carnegie Moscow Center, Unpublished Working Paper, The CIS Project: A New Priority for Russian Foreign Policy?, February 2004).

[45] Remittances from Tajik labour migrants in Russia were estimated at around $1.2 billion in 2003, an amount far in excess of total state budget revenues, while the International Organization of Migration (IOM) suggests that more than 600,000 Tajik migrants (almost 10 per cent of Tajikistan's population) currently live in Russia. See Rashid Abdullo, 'Break-Through in Tajik-Russian Relations in Sochi', *Asia Plus*, June 10, 2004, at www.asiaplus.tajik.net/anal2004.htm; and *IRIN*, 'Central Asia: Special Report on Labor Migrants in Russia', March 17, 2004, at www.irinnews.org.

of poor personal relations between former Russian President Boris Yeltsin and Uzbekistan's President Islam Karimov – and had begun to pursue closer political, economic, and security relations with the United States. The new agreement emphasized not only military issues, including Moscow's provision of armaments and the training of Uzbek serviceman, but large-scale projects to bring Gazprom, the Russian oil company, LUKoil, and other Russian companies into the Uzbek energy sector. LUKoil, for example, undertook to invest $1 billion in a single gas project.[46] Tashkent's overtures toward Moscow in the weeks preceding the agreement were motivated in part by a souring of its relationship with the United States over Uzbekistan's failure to pursue economic liberalization and worsening human rights abuses. But the attraction of the huge investment capital potential of the Russian energy sector was evidently a major factor.

The June 2004 agreement with Tajikistan is particularly important as it highlights the increasing significance of migration and labour migrants both in the Russian economy and in Russia's relations with its neighbours. Russia is now a pole of attraction, rather than repulsion as it was in the 1990s, for regional populations. Russia's economic growth since 1999 has meant increasing numbers of customers to sell products to and new jobs in the service and other sectors for migrants, as well as for Russians. Over the last five years, millions of economic migrants, not just from Tajikistan, but from elsewhere in Central Asia and the CIS have poured into Russia in search of work.[47] Regional businessmen and traders have also

[46] For more detailed discussion of this agreement see Roger McDermott, 'Russia Signs Strategic Partnership with Uzbekistan', and Yuri Yegorov, 'Uzbekistan Looks Toward Russia', Jamestown Foundation, *Eurasia Daily Monitor*, Vol. 1, Issue 37, June 23, 2004.

[47] A recent study by the International Labor Organization (ILO) suggests that there may currently be upwards of 3.5 million illegal labour migrants in Russia (equivalent to about 5 per cent of the labour force), mainly from the CIS countries, while other analysts offer plausible estimates of up to 6 million. The lower figures would be similar to the figures for illegal immigrants in the United States. See Timothy Heleniak, 'Migration Dilemmas Haunt Post-Soviet Russia', *Migration Information Source*, (Migration Policy Institute, October 2002) at www.migrationinformation.org. In October 1993, the head of the Russian State Committee on Migration Policy, Vladimir Zorin, claimed that Russia was now ranked third in the world after the United States and Germany in terms of the number of migrants it attracted on an annual basis. 'V. Zorin: Rossiya vyshla na tret'e mesto v mire po ob'emam migratsii posle SSHA i Germanii', *RBK News*, October 8, 2003 at www.rbc.ru/rbcfreenews.shtml?/2031008121024.shtml.

started to bring their goods to Russian markets and stores. Russia is now ranked as the number one developing market for international retailers after its consumer market grew by almost one third between 1999-2003 to $280 billion.[48]

This is a two-way street. Growth in CIS states and increasing trade within the CIS benefit Russian manufacturing industries and further stimulate the Russian economy as export demand for Russian manufactured goods, fertilizers, and chemicals not produced by neighbouring countries grows.[49] And migrants from the CIS fill growing niches in the lower-paying sectors of the Russian service industry, agriculture, and the construction industry as Russia's continuing demographic decline produces long-term labour shortages.[50] Finally, as a result of the expanded economic interaction of the last five years, the Russian language has been restored as the regional *lingua franca* and as an asset for non-ethnic Russians in Eurasia, facilitating their work in Russia. The Russian language is no longer so readily perceived as the instrument of old imperial domination and political pressure that it was in the 1990s.[51]

All these developments would suggest that even traditionally fractious regional relationships with states like Georgia could change with the pull of the Russian market. Russia is already a major

[48] Denis Maternovsky, 'Russia Ranked No.1 Retail Target', *Moscow Times*, June 23, 2004.

[49] The World Bank, 'Russian Economic Report', No.8, June 2004, p.5, at www.worldbank.org.ru.

[50] More than 90 per cent of all immigrant workers in Russia are employed in low-skill or manual labour jobs and often in remote locations, not just in Russia's major cities. Almost one third work in Siberia and the Russian Far East on farms, construction sites, and in markets. Foreign workers often make up as much as 90 per cent of construction workers in Siberian regions. For more information see Ye. S. Krasinets, 'Vneshnyaya trudovaya migratsiya v Rossiyu', in *Migratsiya Naseleniya*, supplement to the journal *Trudovaya migratsiya v Rossii*, no. 2 (2001), pp.79-107.

[51] See, for example, the discussion of the persistence of the Russian language across the educational system in Central Asia in Bryon MacWilliams, 'A Delicate Balancing Act: Former Soviet Republics Try to Re-Establish Their Native Languages Without Discarding Russian', *Chronicle of Higher Education*, Volume 50, Issue 37, May 21, 2004.

destination for Georgian labour migrants. Remittances from these migrants play a key role in ensuring the subsistence of the Georgian population and may account for as much as 20 per cent of Georgian GDP, according to calculations by the International Organization for Migration (IOM).[52] Russia is also the primary market for Georgian consumer goods companies, such as its flagship Borjomi mineral water company – which is the premier consumer goods exporter in Georgia, one of the main employers in the country, and a primary source of Georgian U.S. dollar revenues.[53]

On June 1, 2004, in a somewhat improbable move, new Georgian President Mikhail Saakashvili appointed one of Russia's top businessmen Kakha Bendukidze – an ethnic Georgian, but long-time Russian resident – as his economics minister. Saakashvili charged Bendukidze with undertaking a program of radical economic reforms, and with attracting more Russian business investment to Georgia. The move not only recognized Russia's 'proximity' and 'economic might,' as leading Georgian political analyst Alexander Rondeli noted, but signalled that Georgia was prepared to do business with Russia and engage in closer cooperation, if commerce and mutual economic benefit were to be emphasized over security disputes in the bilateral relationship.[54]

In many respects, by virtue of its more limited foreign policy priority on the CIS, Russia is in a better position today than the Soviet Union in terms of being able to use its soft power resources to positive effect. Part of the attraction of association with the USSR for some of the far-flung members of the Soviet bloc in Cuba, Afghanistan, the Middle East, and Africa was its trade potential, infrastructure subsidies, technical assistance, and training and education programs in Soviet universities. But the possibility of large arms transfers and the sheer implacability of Soviet military power always tended to eclipse these benefits. The Soviet Union was also over-

[52] International Organization for Migration and Association for Economic Education, 'Labor Migration from Georgia 2003', (Tbilisi, Georgia: IOM, 2003), p.51.
[53] Personal author interview with Badri Japaridze, Vice Chairman of the TBC Group, and Vice President of the Georgian Glass and Mineral Water Co., December 4, 2003.
[54] See Simon Saradzhyan and Lyuba Pronina, 'Bendukidze Handed Georgia's Economy', *Moscow Times*, June 2, 2004.

taxed and over-stretched in its abilities to entice effectively. Today in the CIS, Russia can be more focused and draw to its benefit upon the cultural, linguistic, and other ties that persist in the region from the Soviet period.

But, ultimately, the possibility for Russia to change modalities in Eurasia comes directly back to energy. Russia's new ability to wield soft power resources and expand its economic and political influence comes from its oil power. The increasing windfall from high oil and gas prices since 1999 has spurred Russia's economic growth, enabled it to push through some important reforms, and afforded it the opportunity to become a 'new Russia' at home and abroad, including well beyond the boundaries of CIS. Oil and gas have made Russia something of an indispensable power on today's global stage.

The Indispensable Power – Russia in Global Energy Security

At this juncture, the Russian energy sector has come to represent Russian state interests globally. Russia's energy companies are expanding internationally with the assistance of the Russian government. Gazprom and oil companies like LUKoil have become particularly prominent in sensitive energy ventures and regions of strategic importance to the Russian state since 1999, including in the Middle East, neighbouring states of Eastern Europe, and the United States. LUKoil service stations have sprung up across the U.S. – approximately 2,000 nationwide, including in Washington, DC – a completely new experience for American consumers not used to Russian products.[55] Russia is a major energy supplier to Europe. In 2001, for example, Russian gas accounted for more than 20 per

[55] LUKoil acquired the U.S.-based Getty service station network and additional facilities from ConocoPhilips in a series of purchases in 2000 and 2003, see 'LUKoil plans to double its share of US market', *The Russia Journal*, January 28, 2004. In June 2004, LUKoil also opened a new oil terminal near St. Petersburg on the Baltic Sea to increase the oil shipments to its U.S. filling stations. See 'Oil Exports Via Baltic Flood North Europe', *Moscow Times*, June 22, 2004.

cent of the western European gas market, and Russian oil for some 16 per cent of European Union (EU) oil consumption, with Russia planning major increases in exports of both gas and oil to Europe.[56] And Russia has gained new prominence further east, in China and Japan, after almost entirely losing political and economic traction in the Asia-Pacific region in the 1990s. Insatiable Chinese energy demand is driving a new competition between China and Japan over access to regional energy supplies, and over export pipeline routes from Russian oil and gas fields in the eastern expanses of Siberia.

The bulk of current Russian oil and gas production comes from fields in West Siberia far from export routes to East Asia. But the opening of the rich oil and gas reserves of Russia's Sakhalin island close to the coasts of both China and Japan in the 1990s, and the prospect of potentially massive fields in East Siberia and the Russian Far East, have turned attention to this region and to Asian export outlets. China has negotiated with Russia for the construction of an export pipeline from Angarsk on the edge of Lake Baykal to its own oil refining complex in Daqing, which would bring future East Siberian oil into the industrial regions of northeast China. For its part, Japan, has proposed an alternative, longer, and more expensive pipeline from the Baykal region across Siberia and the Russian Far East to Nakhodka on Russia's Pacific Coast, for trans-shipment by tanker to Japanese ports. Both China and Japan have respectively indicated that they would be prepared to cover some of the financing and construction of these pipelines. Although a feasibility study for the Angarsk-Daqing pipeline has been completed, no decisions on an export pipeline route have been taken by the Russian government, in part because of uncertainty over how to optimize Russia's export position in East Asia. The Angarsk-Daqing pipeline route, although it could be modified with an additional (but costly) loop to Russia's Pacific Coast, would put China in the position of the virtual monopoly purchaser of East Siberian oil, which Moscow would like to avoid. While the Angarsk-Nakhodka route would enable Russia to export

[56] Anna Labuszewska (ed.), *The Resource Wealth Burden – Oil and Gas Sectors in the Former USSR*, (Warsaw, Poland: Center for Eastern European Studies, December 2003), pp.20-21; and 'EU/Russia Energy Dialogue: An Overview', June 1, 2001, at www. europa.eu.int/comm/energy_transport/library/russia_energy_Dial-over. ppt.

oil beyond Japan to other states in the broader Pacific region, the costs of the latter might be high politically, as well as financially, for both Russia and Japan. The two states are still locked in a territorial dispute over four islands in the Kurils chain, which has consistently prevented them from signing a formal peace treaty to mark the end of World War II.[57]

On the surface, given prevailing concerns about energy security and increasing demand in the rising economies of Asia on Russia's eastern borders, Russia's future prospects in energy seem extremely promising. Thanks to the increases in oil production since 1999, Russia is now the world's major non-OPEC, and non-Middle East and Persian Gulf, oil supplier. As Peter Davies, BP's chief economist, pointed out in his June 2004 presentation of BP's annual *Statistical Review of World Energy,* thanks to its fast growth in oil production, between 1998-2003, 'Russia alone supplied 46 per cent of *world* oil consumption growth … and exceeded Chinese consumption growth by 23 per cent … Russia has the resource base and the potential to increase oil and gas production and exports further – to supply a significant proportion of the world's rising demands ... Russia can – and will – supply an important part of the growing energy needs of Asia'.[58]

Conclusions such as these and Russia's willingness to challenge OPEC's decision to impose production and export cuts in late 2001 turned Russia in 2002-2003 into the new great hope of Western energy to diversify U.S. and global oil supplies away from the Middle East and Persian Gulf.[59] American policymakers and commentators declared Russia 'a separate nucleus of the energy equation,' and

[57] For a recent review of this issue see Peter Rutland, 'Pipeline Pirouette in Northeast Asia', Jamestown Foundation, *Eurasia Daily Monitor*, Vol. 1, Issue 53, July 16, 2004. See also, 'Japanese Investors Still Skittish Over Territorial Issue With Russia', *Interfax* (Moscow), June 25, 2004; and 'Russia, Japan Fail to Set Timetable for Peace Agreement', *AFP*, June 25, 2004.

[58] Peter Davies, Energy in Focus: 2004 BP Statistical Review of World Energy', presentation, Washington, DC, June 17, 2004.

[59] See Hill and Fee, 'Fueling the Future'.

'the next Houston – the global capital of energy'.[60] In a 2002 article in the pre-eminent American journal, *Foreign Affairs*, two energy analysts even suggested that Russia could soon displace Saudi Arabia and OPEC in oil markets in the U.S., Europe, and Asia.[61] And major international oil companies such as Shell, ExxonMobil, BP, and Chevron explored the expansion of existing investment in Russia's energy sector, as well as new ventures. In late May 2002, at a summit in Moscow, the U.S. and Russia announced a strategic energy dialogue that would focus on bringing more Russian oil to world markets as well as increasing commercial cooperation in the energy sector.[62] Russian oil majors like Yukos claimed that, with anticipated production increases, Russia could eventually supply as much as 1 million barrels per day to the United States—a significant proportion of the U.S. consumption of around 20 million barrels of oil per day.[63]

Unfortunately, hype tended to get ahead of reality in discussions about Russia's energy potential in this period. Even with projected production increases over time, Russia could not hope to displace OPEC or the Middle East in global oil supply calculations, or replace Saudi Arabia as the world's swing producer in oil.[64] Major changes in the Russian energy industry in 2003-2004 also provided pause for thought among international investors and potential partners in

[60] American Secretary of Energy Spencer Abraham, cited in Sabrina Tavernise, 'U.S. Sees Russia in Oil Catbird Seat', *New York Times,* November 29, 2001; and David Ignatius, 'Russia Wins the War', *Washington Post*, December 23, 2001.
[61] Edward L. Morse and James Richard, 'The Battle for Energy Dominance', *Foreign Affairs*, Volume 81, Number 2, March/April 2002, pp. 16-31.
[62] Charles Coe, 'Moscow Summit Brings U.S.-Russia Energy Dialogue', *Alexander's Gas and Oil Connections*, Volume 7, Issue #13, June 27, 2002, at www.gasandoil.com/goc/news/.
[63] Currently, the U.S. purchases very little oil from Russia – only around 1-2 per cent of total imports (depending on whether or not refined products are included in the total with crude). Crude oil imports to the U.S. from Russia are roughly the same as the share of American imports from Angola. The bulk of Russian crude oil exports, well over 80 per cent, go to Europe, including EU member countries and the central and eastern European countries of the former Soviet bloc. For additional information on U.S. imports see *2004 BP Statistical Review of World Energy*.
[64] See Shibley Telhami, Fiona Hill et al, 'Does Saudi Arabia Still Matter? Differing Perspectives on the Kingdom and its Oil', *Foreign Affairs*, Volume 81, Number 6, November/December 2002, Reviews and Responses to Morse and Richard, 'The Battle for Energy Dominance'.

Russian energy projects. These included the arrest, imprisonment, and trial of Yukos head Mikhail Khodorkovsky and some of his associates on tax evasion; the review of Yukos' licenses to operate in key oil fields and its potential break-up into smaller operating units as a consequence of the dispute over taxes; as well as legislative shifts away from Production Sharing Agreements (PSAs) for foreign oil companies operating in Russia; and the annulment in January 2004 of a key tender for ExxonMobil to develop one of the Sakhalin fields. This series of events indicates that the Russian state is bent on reasserting control over and dominating the oil industry and its revenue flows, and the state is in the process of reconsidering the role of the private sector, both domestic and foreign, in the future of Russian energy.[65]

Even with these problems, and the questionable future of the private sector in the energy industry, Russia with the state in charge seems much more reliable as an oil producer and supplier than the Middle East – given increasing instability, and fears of a major supply disruption in Saudi Arabia and the Persian Gulf from a catastrophic terrorist attack.[66] It thus seems inevitable that the U.S. and other major oil importers will seek ways of factoring Russia into their energy security calculations and of trying to ensure that more Russian oil reaches the world marketplace. Though Russia cannot compete with Saudi Arabia in terms of total oil reserves or production capacity, it has more to offer than oil in its energy equation.

[65] See Victor Somov, 'Don't Call Us, We'll Call You: ExxonMobil, ChevronTexaco and BP are 'Rewarded' for What They did in Russia', *The Russian Energy Weekly*, #4 (100), February 2, 2004; Gregory White, Jeanne Whalen, Susan Warren and Anita Raghavan, 'For West's Oil Giants, Vast Fields in Russia Prove Hard to Tap. ExxonMobil's Awkward Dance with Moscow Shows Perils', *Wall Street Journal*, April 27, 2004; Peter Baker, 'Putin's Kremlin Asserting More Control of Economy. Yukos Case Reflects Shift on Owning Assets, Notably in Energy', *Washington Post*, July 9, 2004.
[66] See Gal Luft, 'Iraq's Oil Sector One Year After Liberation', *Saban Center Middle East Memo #4*, June 17, 2004, at www.brookings.edu/fp/saban/luftmemo 20040617.htm.

A Future in Gas

Two decades from now, the real energy potential for Russia may be in gas rather than oil. Increased Asian energy demand, particularly in the static power generation sector is pushing natural gas demand up. China is especially eager to shift from coal to gas given the significant environmental toll on Chinese cities associated with burning coal.[67] China, Japan, and neighbouring South Korea would all like to meet more of their future energy demand through increased gas consumption to mitigate dependency on Middle East oil. Global gas markets are changing in response. Gas now accounts for over 20 per cent of world energy consumption, and is projected to account for almost 30 per cent of world energy consumption by 2020.[68] Domestic energy sectors in many countries still need major structural changes and large-scale infrastructure development to shift to greater gas use, but gas is rapidly becoming a globally traded rather than a local commodity. More than a quarter of gas consumed globally crosses international borders, either by pipeline or in the form of LNG.

LNG in particular and its transportability beyond regional borders suggests great long-term potential for Russia, including for exports to the United States. Russia eclipses Saudi Arabia and other energy-producing countries in gas. Its gas reserves, at just under one third of the world's total of proven reserves, far exceed those of any other country. And Gazprom, as a company, single-handedly holds 25 per cent of world gas reserves. Russia through Gazprom is already the dominant world gas exporter. If current trends in European gas consumption continue, Russia will certainly be the primary supplier in gas – if not overall in energy – to Europe in the next several decades. Russia is better poised for expansion into future markets in Asia in natural gas than in oil. LNG contracts have already been concluded for Sakhalin gas. And China and South

[67] See Jasper Becker, 'China's Growing Pains', *National Geographic Magazine*, March 2004.
[68] *2004 BP Statistical Review of World Energy*. See also on the growing importance of gas in world energy consumption Daniel Yergin and Michael Stoppard, 'The Next Prize', *Foreign Affairs*, Volume 82, Number 6, November/December 2003.

Korea are engaged in negotiations for the construction of a gas pipeline from Irkutsk on Lake Baykal with the Russian-British joint venture TNK-BP, which is developing the region's massive Kovytka gas field along with Gazprom.[69] As BP's Peter Davies noted in a June 2004 presentation: 'a new period of Russian gas is emerging'.

The Booms and Busts of Oil

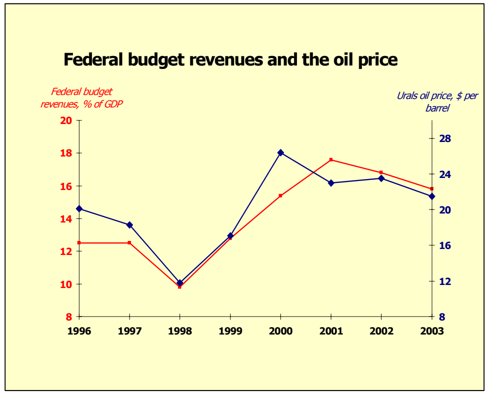
Although Russia's future energy potential remains great, the current oil price windfall masks pitfalls ahead. The Russian economy is not as robust as it might currently seem on the surface, and some of its weaknesses may eventually undermine Russia's ability to capitalize on its new soft power resources. While Russian energy companies have restructured, and improved their efficiency and performance sufficient to ride out oil bust cycles, the Russian state has in fact restructured in the opposite direction. It has become *more* dependent on the oil price than before. Looking carefully at Russia's economic growth since 1997, there is a clear correlation between growth and the rise in world oil prices.

This is particularly tricky as world oil prices are currently far above 'normal,' and oil is a commodity that goes through well-documented boom and bust cycles. For decades, the median world oil price has tended to be around $18 a barrel. Since 1999, Russia has become

[69] 'China Keen to Advance Kovytka Gas Pipeline Talks – TNK-BP', *Prime-TASS Energy Service* (Russia), April 23, 2004; and 'China Eyes Sakhalin, Shell Mulls Expansion', *Moscow Times*, June 15, 2004.

addicted to a price regime well above this. It could expect little GDP growth at the median price – and indeed no growth or even a collapse in growth rates at prices well below. In 1998, the drop in world oil prices to around $10 a barrel coincided with the worst of Russia's economic crises and the collapse of the ruble.[70]

As already noted, the Russian federal budget is in the same predicament. Budget revenues have risen and fallen in line with world oil prices. The Russian government may now have a very healthy budget surplus after a decade of crippling deficits, but the IMF's Goohoon Kwon has calculated that the Russian budget is five times more sensitive to oil prices than it was before 1998-1999.[71] It will be a major challenge for the Russian government to figure out how to buffer the economy as well as the budget against oil shocks – as key Russian economists acknowledge. Indeed, in March 2004, Putin's economics minister, German Gref, went so far as to warn the President that three quarters of Russian GDP growth was in his estimation due to the high level of world oil prices. He noted that prices would inevitably go down – bringing GDP growth down as well. Gref cautioned that Russia's time to take action to stimulate other sectors of the economy might be very short. Putin, however, disagreed with Gref's pessimism. He responded that oil prices were not likely to go down in the foreseeable future, and stressed that tax reform rather than major sectoral restructuring would suffice to stimulate the



[70] Chart courtesy of Clifford Gaddy, The Brookings Institution, 2004.
[71] Goohoon Kwon, 'The Budgetary Impact of Oil Prices in Russia'. Chart courtesy of Clifford Gaddy, The Brookings Institution, 2004.

development of industry and the growth of Russia's consumer market.[72]

Capturing the Oil Windfall for the State

In many respects, the mere fact that GDP growth and budget revenues are now tied to high world energy prices is a mark of considerable success for the Russian government. Vladimir Putin's greatest accomplishment since 2000 may be that he has ensured that as much as possible of the windfall from high oil prices has gone into government coffers rather than into the private hands of oligarchs. Prior to 2000, this was not the case. Oligarchs, like Mikhail Khodorkovsky of Yukos and Roman Abramovich of Sibneft, were able to retain the superprofits from the oil price windfall for themselves. They accumulated staggering personal fortunes as well as boosted the value of their companies by exploiting tax avoidance loopholes, engaging in transfer pricing (including creating a series of on and off-shore trading companies to purchase oil at low cost from production sites and then sell it back again through intermediaries), and other methods. Analysts calculate that Yukos and Khodorkovsky alone may have cost the Russian treasury $5 billion in potential revenues, and the Russian government is claiming $3.4 billion in back taxes from Yukos for the year 2000 alone.[73]

Khodorkovsky was also seen in the Kremlin as trying to enhance his financial position even further by 'buying' political influence in the Russian parliament through financial support for political parties with Duma deputies who play a role in energy-sector related legislation. He also dabbled in foreign policy and pursued private pipelines that would avoid the state-dominated export pipeline system, for gas as well as oil. Khodorkovsky and Yukos had openly pursued negotiations with the Chinese government for the construction of the pipeline from Angarsk to Daqing. And he had engaged in discussions with U.S. officials on the construction of a new pipeline

[72] Yekaterina Grigor'eva, 'Optimist Putin i Pessimist Gref', *Izvestiya*, March 20, 2004.
[73] Andrew Jack, 'A Victim of His Own Short-Term Ambition', *Financial Times*, November 19, 2003; 'The Last Days of Yukos', *The Economist*, July 29, 2004.

to the Russian deep-water port of Murmansk, which would facilitate increased exports of Yukos-produced oil to the United States. Yukos also publicly and loudly trumpeted a series of crude oil shipments to the Port of Houston in the United States in the summer of 2002, to showcase its potential to meet future U.S. energy needs. And, in 2003, Khodorkovsky signalled his willingness to sell a substantial portion of Yukos to the U.S. energy giant ExxonMobil, which greatly increased Yukos' stock price and his prospective personal fortune.[74]

Putin was eventually able to reverse this trend and to capture the oil windfall for the Russian state by imposing a tight fiscal policy, pushing Russia's energy oligarchs to place equipment orders with important domestic industries and to support key, but cash-starved, areas of Russian science; and ultimately by raiding oligarch holdings directly, as in the action against Khodorkovsky and Yukos. In the wake of Khodorkovsky's arrest in October 2003, the Russian government initiated a new round of reforms of tax on Russian business, especially in the energy sector. Russian oil taxes were raised and graduated in accordance with world oil prices in government proposals. Russia's Finance Minister, Alexei Kudrin, also suggested raising the dividend tax on oil revenues as part of the new package.[75]

Another major element in the Russian government's strategy to capture the oil price windfall has been the creation of a fiscal stabilization fund from all crude oil export duties and resources extraction tax revenues that accrue *above* a baseline oil price of $20 a barrel (for Urals crude).[76] The fund is intended to insure the federal budget against oil price volatility by creating a reserve to cover the Russian government's current expenditures for domestic and foreign

[74] For an excellent discussion of this issue and the Russian oil industry in general see Leslie Dienes, 'Observations on the Problematic Potential of Russian Oil and the Complexities of Siberia', (Manuscript, 2004), forthcoming in *Eurasian Geography and Economics*.

[75] Arkady Ostrovsky, 'Russia Pledges to Increase Export Duties for Oil Groups. Tax Strategy', *Financial Times*, March 23, 2004; Erin Arvelund, 'Russia Weighs Tax Shift Toward Oil Sector', *New York Times*, April 9, 2004.

[76] See the detailed discussion of this fund and its creation in the *OECD Economic Survey of the Russian Federation 2004,* 'The Challenge of Sustaining Growth', pp.4-5 (and Box 1.5), online at www.oecd.org.

debt and interest payments, and social commitments when oil prices fall below $20 a barrel. Russian leaders now claim they are bolstering the Russian budget and thus the economy against a future oil bust cycle by stashing away sufficient revenues to cover a two to three year period of low oil prices.[77] However, covering foreign debt obligations and social commitments in the event of an oil price decline will be only part of the picture for the Russian government in the future. The effect of the oil price on the rest of the economy is greatly under-estimated, both by Russian economists and many Western analysts.

The Oil Price Impact

Recent research findings from several sources (the World Bank, the IMF, Brookings Economist Clifford Gaddy, and Pekka Sutela of the Bank of Finland's Institute for Economies in Transition) indicate that growth across the manufacturing and service sectors in Russia can be directly traced to the oil price windfall. Rather than a trickle-down effect on the rest of the Russian economy from oil, there has been a huge flood, boosting the construction, manufacturing, and transportation sectors in particular. The growth in Russia's machine-building and manufacturing sector, for example, is attributable to a jump in the

A Case Study of the Oil Price "Trickle Down" Effect

From a Feb. 2004 report by the World Bank:

"[T]he reported increase in activities outside the natural resource sectors is a result of the secondary effects of high oil and gas prices multiplying themselves through the economy, rather than an independent revival of Russia's domestic industries. ....

[T]he overall jump in the growth rates of domestic manufacturing was driven by its largest sub-sector, namely machine building. Machine building accounts for almost 20 percent of total industrial production and for 35 percent of domestic manufacturing."

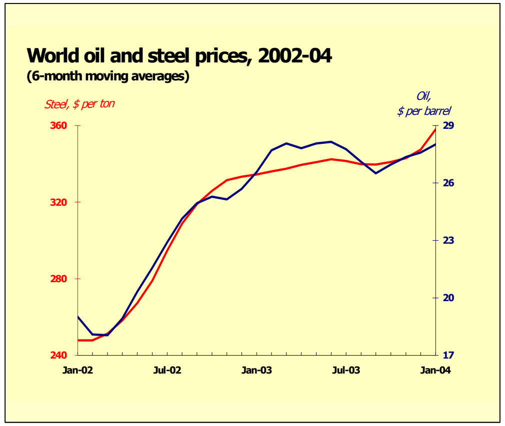
[Machine building growth accounted for more than half of total manufacturing growth.]

"Growth in machine building, however, was driven by the production of railway cars.... Railway car production, in turn, was triggered most of all by the need to provide additional capacity to transport oil out of Russia, to alleviate the bottlenecks of the state pipeline system. Railway car production went up a staggering 35.8 percent."

[77] 'In the Spotlight', *Official Web Portal of the President of Russia*, November 17, 2003, at www.kremlin.ru/eng; Elena Zagorodnyaya, Aleksei Tikhonov, 'Nesvoboda vybora. Chto prinesut i chto otnimut u Rossii vysokie tseny na neft'', *Izvestiya*, April 6, 2004; and Brunswick UBS, 'High Oil Prices, Taxes and the Market', *Russia Strategy*, May 14, 2004.

production of railway cars (for both Russia and neighbouring oil-rich Kazakhstan) to transport increased oil production to markets in Europe and Asia (including to China). Demand has not been met by construction of enough new export pipelines. The construction and defence industry sectors also show increased production to meet various demands from the oil and gas sectors.[78]

In some respects, it is even possible to argue that the entire Russian industrial economy has become dependent on oil prices. Some important industrial sectors that are not oil-related currently act as if they are also responding to the oil price. One of the factors driving this phenomenon is China and its rapid economic development. China is absorbing huge quantities of every major commodity –including oil, gas, coal, steel, scrap metal, and timber – and pushing up their prices. The world price of steel, for example, mirrors the rise of world oil prices. Russia is a major steel producer and exporter to China – as well as an exporter of scrap metal and timber – and Russia's economy has benefited significantly from the surges in China's commodities demand.[79]



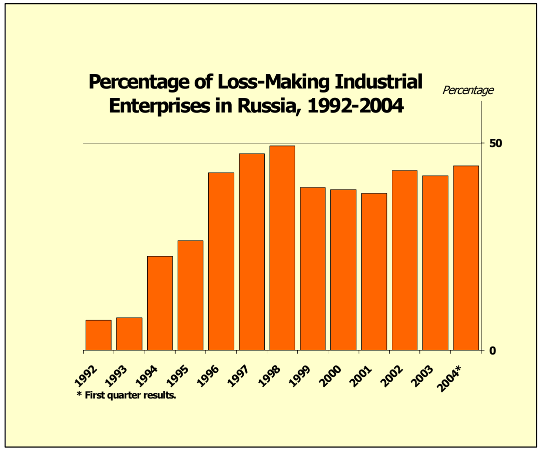
[78] Chart courtesy of Clifford Gaddy, The Brookings Institution, 2004. The OECD, however, suggests that these calculations on the influence of the oil price level on growth may be overstated, and that oil production growth has been more important, while significant increases in productivity in other sectors of the economy have also driven robust economic growth. See the OECD, *Economic Survey of the Russian Federation 2004,* 'The Sources of Russian Economic Growth', pp.7-8, online at www.oecd.org.

[79] Chart courtesy of Clifford Gaddy, The Brookings Institution, 2004.

Growing Discrepancies in the Russian Economy

Unfortunately, the benefits to Russia's economy have not been evenly distributed. The oil and commodities effect has instead reinforced a dual economy that has already existed in Russia for some time between domestic-oriented industry and export-oriented.[80] Export industries tend to be oligarch-dominated, resource-based, and high-revenue earning, but generate only a limited number of jobs. The oil sector, for example, according to the World Bank, only accounted for 1 per cent of total Russian employment in 2002.[81] The growing cleavage now is between those industries that can benefit from the flood down from oil prices and the energy sector, and those that can not. To some degree this is sectoral, but in many respects it is also regional.

Enterprises that have ties to the oil industry in energy-producing regions have benefited from proximity and high-level personal connections and contacts between enterprise directors and energy barons. And enterprises deemed to be strategically or socially important (either major defence industries or the largest employer in a major



[80] For a more detailed discussion of this see Pekka Sutela, 'Russia's Political Economy', in *The Russian Market Economy* (Helsinki, Finland: Kikimora Publications, 2003), pp.224-227.

[81] The World Bank, *From Transition to Development*, p.68.

city) have also received orders from the energy sector at the behest of the central government. Where there have been no special relationships or considerations, a significant proportion of the Russian manufacturing industry outside of commodities and machine building has not fared quite so well. A high percentage of enterprises – around 40 per cent in 2001-2003 – have been operating at a loss, while many factories still do business by barter.[82]

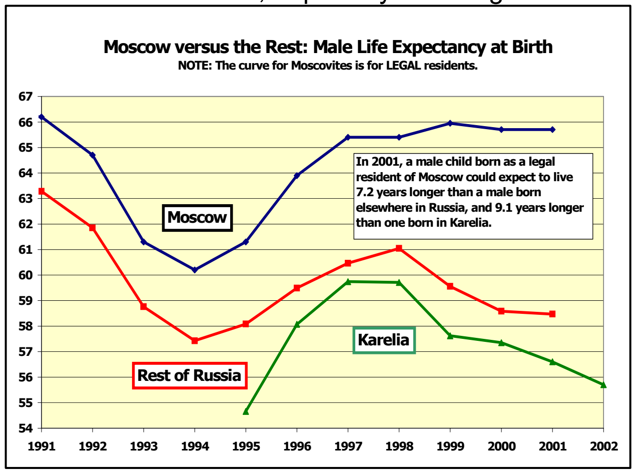
Beyond the commodities and heavy industrial sectors like machine-building/railway wagons, many analysts have pointed to consumer spending as a key indicator of the Russian economy's health, and as an important sign of more broad-based growth. Consumer spending has grown exponentially over the last four years, especially in relation to its earlier low levels.[83] But again, a good deal of this has been driven by the rise in world oil prices and the subsequent windfall to the Russian economy and budget. As Brookings Institution Economist Clifford Gaddy noted in a March 2004 presentation on the Russian economy, factors such as investment and consumption 'are not independent drivers of [Russia's] boom. They are merely the transmission belts or conveyor belts that transfer the oil price impetus more broadly throughout the economy'.[84]

Another issue to bear in mind when considering consumer spending in Russia is that, just as in countries the United States and United Kingdom, people have high spending and low savings rates. Especially as a large proportion of household expenditures are still

[82] Chart courtesy of Clifford Gaddy, The Brookings Institution, 2004. For a detailed discussion of the persistence of a barter economy in some industrial sectors see Clifford Gaddy and Barry Ickes, *Russia's Virtual Economy* (Washington, DC: Brookings Institution Press, 2002); and The World Bank, *Russian Economic Report*, No.8, June 2004, Table 10.
[83] For an illustration of this see Patricia Kranz and Jason Bush, 'Putin's Game. Westerners Think the Russian President is Turning Back the Clock. The Reality is Much More Complicated', *BusinessWeek*, June 7, 2004. The authors review increases in Russian spending on items like mobile phones, cinema tickets, laptops, and foreign cars, as well as discussing the expansion of international retailers, like the Swedish furniture manufacturer and outlet, Ikea, across the Russian Federation.
[84] Clifford Gaddy, 'It's All Oil', presentation at AEI Briefing on the Russian Presidential Election: 'Four More Years of Putin?' American Enterprise Institute, Washington DC, March 15, 2004.

covered by the Russian government, Russian consumers tend to spend all their disposable cash. The fact that the Russian government has more money in hand from oil revenues to pay state wages and pensions, to continue to subsidize housing, household utilities and services, and public transportation, encourages people to spend more than they might otherwise. Although the proposed reforms of many of these benefits may alter future spending patterns. The scale of Russia's consumer spending is not so high, when viewed from the perspective of a more advanced consumer economy where credit card usage and mortgages are widespread, but there is still great potential for more consumer and service sector growth if oil prices do not fall precipitously.

As in the case of the manufacturing industries in Russia, however, the consumer picture is not uniform. Not everyone is spending wildly across Russia, and recent polls show that a majority of Russians spend most of their income buying food.[85] Discrepancies in living standards in Russia have increased, especially on a regional basis. In less than a generation, Russian citizens have transitioned from a situation of general equality – with some at the top of the Communist Party totem pole more equal, of course, than others – to a situation of growing inequality. Although life has demonstrably improved across the Russian Federation, Moscow far



[85] 'As Poll Paints Not-So-Rosy Picture', *RFE/RL Newsline*, Vol.8, No.93, Part I, May 18, 2004.

outstrips everywhere else in terms of growth, living standards, educational and employment opportunities, new housing development, and even life expectancy (especially for men). Regions like Karelia bordering Finland, the Urals, the North Caucasus region of southern Russia, and large swathes of Siberia are particularly grim in this regard.[86]

Disparities in living standards and inequalities would certainly be exacerbated by the contraction of the Russian budget and thus of subsidies to those living in the weakest regions. Ten out of Russia's 89 administrative units account for more than half of Russia's economy.[87] The richest regions beyond Moscow in terms of per capita gross regional product are all oil or other key commodities-producing regions. As a recent Russian report on regional disparities notes: 'despite having less than 10 per cent of the population, the two wealthiest regions in Russia – oil-rich Tyumen in West Siberia and the city of Moscow – now account for nearly a third of GDP'.[88] There is great suspicion at the popular level in Russia that current plans to shift on January 1, 2005 from subsidized health, transportation, and other social benefits to lump-sum cash payments for the poorest and most vulnerable segments of the population – as part of the Russian government's social sector reforms – will not be sustainable if oil prices fall and if central government budget revenues fall along with them.[89] Fears over the fate of these benefits provoked a rash of public protests in June 2004 (a current rarity in Russia) and the first nationwide street demonstrations in many years.[90]

[86] Chart courtesy of Clifford Gaddy, The Brookings Institution, 2004.
[87] Michael Bradshaw, 'A New Russian Heartland?' presentation at the Ed. A Hewett Forum, The Brookings Institution, Washington, DC, March 15, 2004.
[88] Mikhail Balyasny, 'Study: Half of Economy in 6 Regions', *Moscow Times*, June 29, 2004.
[89] Jeremy Bransten, 'Russia: Many Can't See the Benefit in Controversial Social-Reform Bill', Feature Articles, *RFE/RL Headlines*, August 9, 2004.
[90] Jeremy Bransten, 'Russia: Widespread Protests Erupt Over Government's Economic Plans', *RFE/RL Headlines*, June 11, 2004.

Decline in Oil Prices and Long-Term Burdens

If we think about the possibility of a low oil price regime in the future (although it looks quite remote right now, with prices hovering in the vicinity of $40 a barrel, instability in the Middle East, and continued demand growth in China and Asia) the prospects could be quite sobering for the Russian economy. We also have a reference point for this potential future. For a brief period from October 2001 to March 2002, early in Putin's first term as President, oil prices dipped to around $15 a barrel. Reforms faltered in a number of regions. Economic and political tensions mounted in the Urals and Siberia, prompting Putin to make an emergency visit to Krasnoyarsk to meet with local leaders. Russian industrial companies that had been profitable the year before posted losses in 2002 as a consequence of cancelled orders from the oil and gas sectors. As Economist Clifford Gaddy noted in reviewing these developments, 'the effect of the 2002 experience on the Russian economy was dramatic. It confirmed that the entire economy was vulnerable to lower oil prices'.[91]

Fortunately, for Putin and the Russian economy, world oil prices rose again quite quickly after March 2002. Since then, the high oil prices and budget surplus have alleviated the pressure on the Russian government to restructure the economy and to tackle the hard reforms remaining from the agenda outlined by Putin's economics team in 2000 – natural monopoly reform (electricity, gas, pipelines, and railways in particular); housing and communal services; education and health; as well as the financial sector; civil service and public administration; and corporate and social taxes. Many of these reforms have been long in planning, with elaborate concepts drawn up but little sign of implementation. Some long-promised reforms, like a far-reaching military reform, seem to have been virtually abandoned. With a large budget surplus in hand, the government can still keep the failing areas of the economy and

[91] Gaddy, 'It's All Oil'.

Russian state institutions functioning. Putin's economic team, led by German Gref and Alexei Kudrin, fully recognize the imperative to try to advance some of the more costly and difficult issues – like the current social benefits reform – while the cash is available to soften the inevitable blows, as well as to seed and grow new initiatives and benefits delivery mechanisms.

There are several issues, however, that would seem to defy government resolution even with new funds to apply – issues that will continue to burden the Russian economy for the foreseeable future. One of these is Chechnya. The oil price windfall has enabled Russia to fight an otherwise ruinous war in Chechnya since 1999, to postpone hard decisions and fore-swear political compromises that Moscow might otherwise have had to make. Russian military commentators, like Pavel Felgengauer and Alexander Golts, estimated in 2000 that extra pay for soldiers in the war alone cost the Russian government around $110 million per month. Adding in other military costs, even conservative estimates put the annual total price for waging the war in 2000 at $2.2 billion. Others have estimated that the first two years of the war cost Russia as much as $10 billion – or a sum equivalent to almost one third of the country's official annual federal budget expenditures in the same period.[92]

Such high costs were particularly onerous for the Yeltsin government, which had no oil windfall to tap into. In the first round of the conflict from 1994-1997, the impoverished Russian state and its beggared military could not afford to keep the war going and were willing to make tradeoffs. Munitions were in short supply, as was even the most basic equipment, and there were public campaigns to raise funds to feed and clothe Russian conscripts sent to Chechnya,

[92] Pavel Felgengauer, 'Paying for the War in Chechnya', *Moscow Times*, April 26, 2001; Miriam Lanskoy, 'The Cost of the Chechen War', *Central Asia Caucasus Analyst*, Biweekly Briefing, November 7, 2001; Yuri Baulin, 'How Much a Day of the War Costs: Some Facts and Figures About the War in Chechnya', *Novaya Gazeta*, No.85, November 18, 2002. These figures, however, should be approached with some caution as they are subject to inflation and much of the money set aside by the federal government for Chechnya has been diverted by corrupt officials for other purposes.

especially in the winter months.[93] Again, this raises the question of what Moscow will do if the oil price drops, revenues fall, and decisions have to be made over what to prioritize and pay for.

Even greater than the problem of Chechnya in terms of duration and magnitude are the cost burdens inherited from the Soviet Union of Russia's spatial or territorial misallocation of population and industrial resources. Thanks to the Soviet-era industrialization and mass settlement of Siberia, Russia's population is now scattered across a vast land mass in cities and towns with few physical connections between them. One-third of the population has the added burden of living and working in particularly inhospitable climatic conditions. And about one-tenth live and work in almost impossibly cold and large cities in Siberia, which were heavily built up after World War II. Given their locations, these cities depend heavily on central government subsidies for fuel and food. They also rely on preferential transportation tariffs as inadequate road, rail, air, and other communication links hobble their efforts to promote interregional trade and to develop markets. Costs of living are as much as four times higher in these cities than elsewhere in the Russian Federation, while costs of industrial production are sometimes higher still. Many of Russia's loss-making enterprises are located in these cities.[94]

As a result of Soviet-era central planning, Russia is more burdened with problems and costs associated with its territorial size and the winter cold than any other large state or country in northern latitudes, like the United States, Canada, or the Scandinavian countries. As a result, on a more fundamental level, millions of people in Russia could simply not survive in the huge cities and harsh climate in which they live without access to an abundance of energy at low cost. Even as it has taken advantage of high energy

[93] See Anatol Lieven, *Chechnya: Tombstone of Russian Power* (New Haven, Connecticut: Yale University Press, 1998).
[94] For a detailed discussion of this issue see Fiona Hill and Clifford Gaddy, *The Siberian Curse: How Communist Planners Left Russia Out in the Cold*, (Washington, DC: Brookings Institution Press, 2003). The economic effects of this issue are also discussed in the World Bank's April 2004 report on Russia, *From Transition to Development.*

prices abroad, the Russian government has regulated prices for natural gas at home, keeping them artificially low. This has been a major sticking point, both with the European Union and China, over Russia's entry into the WTO, though the Russian government recently agreed to progressively raise domestic gas prices from around $27-28 per cubic meter to a range of $49-57 per cubic meter by 2010.[95] While awash with oil price wealth, the temptation for the Russian government, is to launch large-scale infrastructure projects to improve access to the far flung and frigid cities of Siberia and the Russian Far East, rather than to pursue alternative efforts to alleviate some of the budgetary burdens, such as long-term projects to encourage labor migration to other regions of Russia.[96]

Russian Energy: Curse, Blessing, or Neither?

The primary challenge that Russian policymakers face is how to use Russia's vast territory, its huge natural resource base, and particularly its world-class oil and gas reserves to its optimal advantage. Many analysts have assumed, in looking at the dependency of the Russian economy and the Russian federal budget on oil, gas, and other commodities revenues, that Russia faces a classic 'resource curse' – in the sense that these sectors have been emphasized to the detriment of others, that the focus on energy and commodities has retarded the development of other higher value manufacturing and export industries, and that long-term economic growth is not sustainable on this basis.[97] However, as recent research at Stanford University by Gavin Wright and Jesse Czelusta suggests, mining and energy sectors are the knowledge-rich and technology intensive areas of many countries' economies. As Wright and Czelusta write in their introduction 'investment in

[95] 'Rossiya uregulirovala vopros tarifov na gaz v ramkakh peregovorov po VTO', *Interfax* (Moscow), July 21, 2004.
[96] See Hill and Gaddy, *The Siberian Curse,* Chapter 10: 'Tearing Down Potemkin Russia', pp.196-213.
[97] See, for example, Jeffrey Sachs and Andrew Warner, 'The Curse of Natural Resources', *European Economic* Review, 45 (2001), pp. 827-838; Daniel Yergin and Thane Gustafson, *Russia 2010 And What it Means for the World*, (New York: Random House, 1993), p.246; and a more recent discussion by Robert Skidelsky, 'Can Russia Avoid the Resource Curse', *Wall Street Journal*, July 6, 2004.

minerals-related knowledge is a legitimate component of a forward-looking economic development program'.[98] Other countries have successfully pursued long-term economic growth and technological progress from a natural resource base at various junctures in their history – including the United Kingdom, the United States, Australia, and Norway. It is thus logical that Russia's energy industry would be emphasized in its economy and would be the mainstay of government revenues. This is where Russia's comparative advantage lies given the huge size of the oil and gas resources at its disposal, their intensive development in the Soviet period, and the scale of state investment to date in the sector.

Russia's current problem is not the development of its oil resources *per se*, but the risk of over-extending itself under the influence of the oil price windfall and of not adequately recognizing and addressing the weaknesses of the Russian economy. A corollary danger is the temptation to strip vital investment capital away from the energy sector to prop up and expand other areas of industry to the potential detriment of the overall health of the economy.[99] For example, there is currently considerable pressure on the Russian government from various quarters – including most prominently from former Russian Prime Minister and current president of Russia's Chamber of Trade and Industry, Evgeny Primakov – to use the super oil profits in the Russian state budget and stabilization fund to stimulate manufacturing and new hi-tech industries, as well as to launch large-scale construction and infrastructure projects.[100]

A government-directed strategy along these lines would potentially leave new – and newly-subsidized – industries in areas where Russia does not necessarily have a comparative advantage high and dry in the event of an oil price decline. As Wright and Czelusta

[98] Gavin Wright and Jesse Czelusta, 'Mineral Resources and Economic Development', (Stanford University Center for International Development Working Paper, October 2003), p.3.
[99] Wright and Czelusta describe the effects of diverting resources away from the energy sector in the case of Venezuela. See 'Mineral Resources and Economic Development', pp.16-18.
[100] Andrei Bondarenko, 'Khvatit sidet' na syr'evoy igle. V Samare Evgeniy Primakov govoril o vozrozhdenii promyshlennoy politiki gosudarstva', *Nezavisimaya Gazeta*, September 26, 2003.

underscore, 'as economists have long advised, it is imprudent for governments to make major spending commitments during periods of rapid revenue growth, as though this growth could be extrapolated into the indefinite future'.[101] They add that countries should be more aware of the ephemeral character of booms and plan accordingly, with the aim of making the best use of one-time gains.[102] And energy (oil and gas) is, in fact, Russia's real 'hi-tech' sector, and its industrial knowledge base. As will be discussed below, the energy sector needs considerably more investment capital to sustain and increase its current high productivity and efficiency levels in the decades ahead. The energy sector has also adapted well to the particular and peculiar difficulties of the Russian environment. Unlike other sectors of manufacturing, it is technology-intensive rather than labour-intensive. Its low employment figures, from the perspective of operating in some of Russia's harshest climates and most remote regions, are actually an asset.[103]

Political institutions and government policies are more of a long-term problem for the sustained growth of the Russian economy than the development of its natural resource base. As the Stanford researchers also point out in the course of their paper, good management is key to natural resource success: 'production and reserve levels have continued to grow in well-managed resource economies. Many other resource-based economies have performed poorly, not because they have over-emphasized minerals, but because they have failed to develop their mineral potential through appropriate policies'.[104] Beyond the pressure to strip investment from the energy sector, recent domestic political developments provide some basis for concern.

One of the more negative effects of the strengthening of the Russian state under Vladimir Putin has been a notable roll-back in some of the gains of civil society in the 1990s, and the removal of some of the checks and balances against executive power in the Russian

[101] Wright and Czelusta, p.17.
[102] Ibid., p.26.
[103] For a more detailed discussion of this see Hill and Gaddy, *The Siberian Curse*, 'A Leaner Approach to Siberian Development', pp.204-205.
[104] Wright and Czelusta, p.3.

system. Not all of these constraints on central authority were positive, of course, given the creation of regional fiefdoms, and the increasing political influence of a small number of oligarchs enriched in the early rough and tumble of privatization. But in the 1990s, when the state was cash-poor and weak under President Yeltsin, political parties, the independent media, and civil society in the form of NGOs flourished in Russia. Now, the flood of petrodollars into the Russian central budget seems to have enabled the Russian state to strengthen itself at their expense. In 1999, when the oligarchs loomed large in the Russian economy and in politics, Russia's liberal-leaning parties – The Union of Right Forces (SPS) and Yabloko – enjoyed a degree of success in parliamentary elections.

Today, one of the most prominent of the oligarchs, Mikhail Khodorkovsky, is in jail and on trial. And the liberal parties have lost their representation in the parliament, having found it hard to present credible alternatives to 'Putinism' — a strong Russia, with the image of the state rehabilitated at home and abroad; stability and predictability in the economy; and wages, pensions and debt obligations all paid on time. The independent media has suffered repeated setbacks, most recently with the removal from the air in June 2004 of one of the most popular television political talk shows, *Namedni*, and the role of NGOs and civil society groups in Russia's future development was openly questioned by Putin in his annual address to the Russian parliament in May 2004. In tandem with government efforts to tax and regain control over the revenues of the energy industry, these developments all seem to point in the direction of increasing state control over Russia's economic, political and civil life in the future. For many international observers, and for some in Russia, the new confidence of the state generated by the oil windfall has made it overbearing. Strengthening the state over the last five years has been perceived as strengthening authoritarianism.[105]

[105] For more discussion of this see Michael McFaul, 'The Grand Strategy of Vladimir Putin', *Weekly Standard*, November 17, 2003; the discussion of the crisis of Russian liberalism attributed to Mikhail Khodorkovsky, 'Kommentarii: Krizis liberalizma v Rossii', *Vedemosti*, March 29, 2004; Gordon Hahn, 'Putin's Stealth Authoritarianism', *RFE/RL Regional Analysis*, April 21, 2004; Strobe Talbott, 'Putin: Talk Like a Democrat, Walk Like an Autocrat', *YaleGlobal*, May 12, 2004; Mikhail Fedotov,

These developments may ultimately have a negative impact on economic growth if they increase the perception of Russia as an increasingly less open society, if they stifle independent initiative, and if they frighten off domestic, as well as foreign investors. The Khodorkovsky trial has raised fears in Russia and in the West of a wholesale revisiting – beyond the energy sector – of the results of the privatization of state assets in the 1990s. Other investors are being targeted at the regional, not just at the federal level, and the state is now seizing control of private property. In June 2004, an editorial in the *International Herald Tribune* went so far as to suggest that Russia itself was 'on trial' over its handling of the Khodorkovsky affair.[106] While many in Moscow see these fears about the broader impact of the fate of Khodorkovsky on the Russian economy and on future private investment decisions as entirely overplayed, it is clear that questions over Yukos' potential division and existing property rights could play out negatively for the Russian energy industry.[107] As the Stanford researchers, Wright and Czelusta, make clear in their article on mineral resources and economic development – security of property rights is one of the keys to success for both domestic and foreign investors, including for innovation purposes in the natural resource sector: 'Insecure ownership has adverse effects on production and exploration in minerals [including hydrocarbons] as it does in other industries'.[108] In addition, domestic changes and negative trends will inevitably spill over into foreign policy as they did in the 1990s. Observers in Russia's immediate neighbourhood, not

'Power and Media in Modern Russia: A Story of Love and Hate', presentation at conference on 'The Condition of Civil Society in Russia', The Brookings Institution, Washington, DC, June 1, 2004; Vladimir Ryzhkov, 'Putin's Mission Impossible', *Moscow Times*, June 2, 2004; Susan Glasser, 'Russian TV Host Dismissed: Firing Rekindles Charges of Censorship Under Putin', *Washington Post*, June 3, 2004; Mila Kuzina, 'Uvolen Parfenov', *Izvestiya*, June 3, 2004; Peter Baker, 'Putin's Kremlin Asserting More Control of Economy', *Washington Post*, July 9, 2004; and Oksana Yablokova, 'New Controls Planned for Funding of NGOs', *Moscow Times*, July 22, 2004.

[106] 'Russia on Trial', *International Herald Tribune*, June 15, 2004.

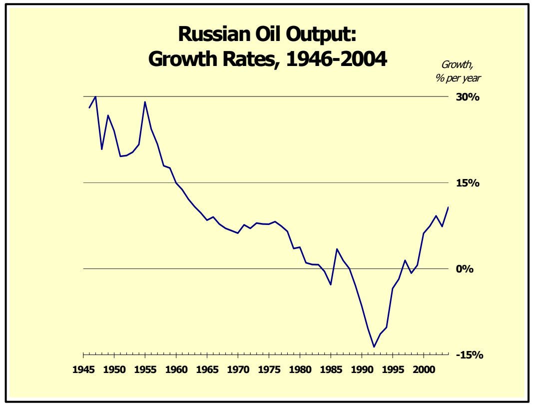
[107] 'Yukos Case Will Not Stop Private Investors', *Pravda.ru News From Russia*, July 21, 2004, at www.newsfromrussia.com/main/2004/07/21/55151.html.

[108] Wright and Czelusta, p.26.

just in Europe and the United States fear that a stronger and harder hand at home may soon be extended abroad.

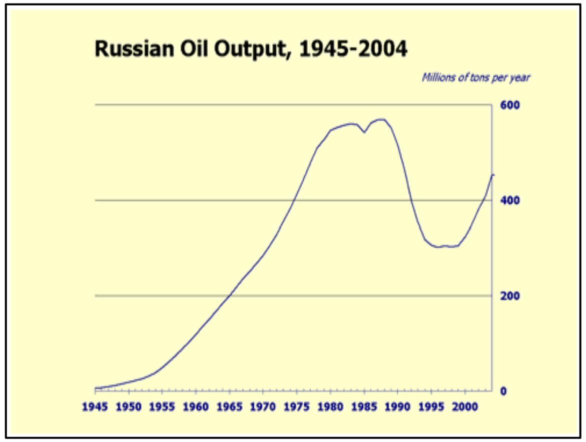
The State that Oil Built

In short, there are perils as well as great possibilities in the increasing role of oil and energy in Russia. The history of the USSR offers further illustration of this. Like Russia's economy, the late Soviet economy was built on and supported by oil**.** One of the prevailing theories behind the decline of the Soviet economy that ultimately led to the collapse of the USSR is that it was precipitated by an oil production decline, combined with both a dramatic drop in world oil prices after record highs in the wake of the 1970s OPEC oil embargo, and by the mismanagement and misuse of oil resources.[109] Soviet statistics show that a long period of continuing oil output expansion after World War II came to a fairly abrupt end in



[109] See, for example, Stephen Kotkin, *Armageddon Averted: The Soviet Collapse, 1970-2000*, (New York: Oxford University Press, 2001), pp.15-16. Kotkin writes that 'Without the discovery of Siberian oil, the Soviet Union might have collapsed decades earlier … Oil money … paid for a huge Soviet military build-up that, incredibly, enabled the country to reach rough parity with the U.S. And it helped defray the costs of the war in Afghanistan, launched in the late 1970s … Oil seemed to save the Soviet Union in the 1970s, but it merely delayed the inevitable … That was because Soviet factories consumed energy in horribly gluttonous quantities, as if it were free. Then in 1983, Siberian oil output began to decline … Making matters worse, in 1986 world oil prices plummeted … to one of their lowest levels in the post-war period ... the windfall oil and dollar profits the Soviets had been enjoying for years were wiped out'.

1976 just when the USSR began to enter its economic crisis.[110] There were many reasons for this contraction, including a prolonged neglect of Russian oil fields in the 1960s while other sectors of the energy industry (coal, gas and hydroelectric power) were developed before being deprioritized in the 1970s; increases in production and transportation costs from opening up and moving to more complex and distant fields in West Siberia; and technology deficiencies and equipment shortages.[111]



In this period, in fact, many factors collided at once with the downturn in Soviet oil output growth, putting increased strain on the economy. These included a huge industrial and infrastructure construction boom in Siberia, the Russian Far East, and the Russian North (the coldest and most remote regions of the Russian Federation); and the invasion of Afghanistan in 1979 and the subsequent war in the 1980s. In the 1970s and 1980s, massive long-term industrial projects were launched in Siberia, including the construction of the world's largest aluminum plant, massive dams and power plants, and the Baykal-Amur railway line, all in tandem with the increased exploitation of West Siberia's oil and natural gas fields. These projects were unprecedented in their scale and

[110] Charts courtesy of Clifford Gaddy, The Brookings Institution, 2004.
[111] See Robert Ebel, *Communist Trade in Oil and Gas: An Evaluation of the Future Export Capability of the Soviet Bloc*, (New York: Praeger, 1970), pp.82-87, 92-93, 104-107, 111-112; and Thane Gustafson, *The Soviet Gas Campaign: Politics and Policy in Soviet Decisionmaking*, (Santa Monica, CA: Rand, Project Air Force Report, June 1983), pp.5-7, 15, 36-37.

consumed huge amounts of Soviet investment capital. The climate in the regions the projects were carried out in, and the huge distances that had to be traversed to bring in construction materials, labour, and supplies, also meant that costs were more than 50 percent higher than elsewhere in the Soviet Union.[112] These projects consumed large quantities of energy as well as manpower and capital, and domestic demand for energy increased rapidly. The fact that domestic oil demand increased just as oil growth rates declined slowed the flow of oil exports to the West precisely at a time when there was an imperative to raise more hard currency revenues to finance the state-driven industrialization and construction boom. The Soviet Union thus found itself trapped in a proverbial vicious circle – the consequences of which became painfully apparent when world oil prices abruptly dropped in 1986 just as Soviet oil output peaked before beginning a ten-year decline.

Over-reliance on energy revenues is a theme of both the Soviet and post-Soviet periods. In spite of the fact that Russia has currently emphasized economic growth over Soviet-era military expansion, there is still a danger of repeating the Soviet experience. And not only is the Russian economy vulnerable to changes in world oil prices and a reduction in oil revenues, but by virtue of its new soft power resources the region around Russia is increasingly reliant on its economic growth. Thus the future of Eurasia in general may depend on high oil prices and the continued success of Russia's energy sector. A Russian economic slow-down with an oil price fall that decreases migration and trade flows to Russia would have broader negative consequences. Since the late 1990s, people in Eurasia have become accustomed to the idea that there is work in Russia, even if unemployment is high elsewhere. If migrants have to return to states in the South Caucasus and Central Asia, and new migrants cannot find work in Russia, the problem will not just be one of constrained remittances. More people will find themselves trapped in poverty with few prospects for economic or social upward mobility at home. Trade flows in goods and services to Russia will also be negatively affected retarding regional economic growth.

[112] See Hill and Gaddy, *The Siberian Curse*, pp.92-94.

In many respects, since 2000, Russia's greatest contribution to the security and stability of its vulnerable southern tier has not been through its military presence on bases, its troop deployments, or security pacts and arms sales, but through absorbing the surplus labour of these states, providing markets for their goods, and transferring funds in the form of remittances (rather than foreign aid). Central Asian states in particular are fearful of the social consequences of large numbers of labour migrants returning to the region from Russia. This migration has become a safety valve of sorts and has taken the edge off the kinds of social conflict and regional disparities that contributed to a ruinous civil war in Tajikistan in 1992-1997. Regional experts and officials have expressed genuine concern that if and when Russian oil production declines, and Russian economic growth ends, there could be a major spill-over effect.[113]

Oil Production – Possibilities and Constraints

But what is the real risk of a drop in Russian oil growth rates and production as in the late Soviet period? For now, energy analysts seem bullish on Russian production growth. President Putin is certainly gambling on this, and that the oil price windfall will continue and the state will remain flush with petrodollars for some time ahead. If there is no forward planning, however, Putin will be raiding the oil piggy bank now and short-changing Russia's future. All is not entirely well in Russia's energy sector. Considerable recent research shows that Russia has only a relatively small window of opportunity to tackle the challenges it faces, if it is to keep the oil (and gas) flowing.[114]

[113] Author's interviews with local and central government officials and analysts in Kazakhstan and Kyrgyzstan, March 2004.
[114] See, for example, Leslie Dienes 'Observations on the Problematic Potential of Russian Oil and the Complexities of Siberia', manuscript 2004, forthcoming in *Eurasian Geography and Economics*, Volume 45, Number 5, 2004, pp.236-262; and Valeriy Yazev, 'Vysokie tseny zastavlyayut rvat' mestorozhdeniya: Problemy zakonodatel'nogo obespecheniya neftyanoy promyshlennosti Rossii', *Zhurnal Neft' Rossii*, No.7, July 2004.

American geographer Leslie Dienes notes in a forthcoming paper, based on a long-term and extensive investigation of the Russian oil industry, that in spite of Russia's huge oil and gas resources, 'the present oil boom is temporary, since little of it represents *new* oil' [emphasis added]. Dienes stresses that 'the bulk of evidence indicates that the recent upsurge in oil extraction represents mostly oil not lifted during the chaotic years of economic decline, as well as oil left behind by the perverse extraction practices of the 1980s'.[115] New technology has enabled this oil to be tapped, but only a few Russian oil companies have undertaken major investment in new exploration, drilling, and new well completion since 1999, which means that Russia has fallen behind in developing its oil capacity for the future.

Yukos, for example, the flagship of Russian energy companies prior to the recent Russian government action against the company and its managers and owners, squeezed its existing oil wells to achieve the impressive production growth and profits that attracted the attention of Western investors. It tended to skim off the oil that was easiest to access and had the highest yields to reach short-term commercial targets. The company brought only 22 new wells on stream (less than 2 per cent of the national total of new wells) in 2000, despite being the second largest Russian oil company.[116] This is problematic as Russia's explored reserves actually decreased in the 1990s (in part because of the reclassification of previously poorly-evaluated reserves). A large proportion of current reserves in West Siberia – Russia's primary oil producing region – have already had 80 per cent of their producible oil lifted and are declining.[117] According to most forecasts, current West Siberian oil production will

[115] Dienes, p.237, p.238.
[116] Ibid., p.239.
[117] In April 2004, in part because of classification errors, and differences in the evaluation of reserves between Soviet and Russian assessments and those of Western industry, the Russian government decided to declare information on oil reserves a state secret—underscoring the basic uncertainty over how much of Russia's future oil resources will be recoverable in the next two decades. See 'Top Secret Oil: British Petroleum states that Russian oil reserves equal to 60 billion barrels', *Pravda.ru*, April 29, 2004.

reach its peak between 2005 and 2010, plateau, and then begin to taper off if no new fields are developed.[118]

While there are undoubtedly huge resources in East Siberia, these are more geologically complex, as well as more distant from both existing oil-producing centres and the primary energy markets. Bringing new reserves into production in East Siberia will require a great deal of lead time and investment, and there is no guarantee – especially under current circumstances – that this will be accomplished before production declines begin in West Siberia. The general story is similar in the gas sector, where production is already declining in West Siberian gas fields, and Gazprom is heavily engaged in exploration and new field development further east.

Over the last several years, the development of oil export infrastructure in Russia has also not kept pace with the expansion of oil production. Although alternative transportation routes (including rail and river barge) have been extensively developed, Russia still lacks the new pipelines for consumers in Asia like China and Japan. And transportation by rail over long distances to Asia may not be cost-effective at lower oil prices in the future. Russia will likely require external investment to break these bottlenecks – raising the difficult question of the role of, and guarantees for, the international energy industry in Russian oil at a time when the Russian state has made it clear that it intends to dominate and direct the development of the sector.[119]

Although Russia's energy resources are not likely to 'run out' anytime soon, without a major redirection of industry effort toward

[118] Dienes, p.243.; and Robert Ebel, 'Russia – King of the Oil Hill', Center for Strategic and International Studies presentation, July 21, 2004, p.4.

[119] According to EU estimates in 2000, the Russian oil and gas sector would require investments in the magnitude of $460-600 billion over the next twenty years to enable it to meet its long-term export obligations (including its obligations toward the EU). European analysts consider that, without financial support from foreign investors, Russia will certainly not be able to increase its export volumes, and may not even be able to maintain its current levels. See Labuszewska (ed.), *The Resource Wealth Burden,* p. 27.

exploration, new oil and gas field development, and the construction of new energy transportation infrastructure, Russia may soon face similar problems to the Soviet Union in the 1970s and 1980s. It is almost certain to encounter increasing costs of production and transportation, by moving to fields in East Siberia that are more difficult to exploit just as growth rates in West Siberia decline and, potentially, as oil prices also drop. And finally, as in the Soviet period, Russian domestic demand has to be factored into the picture. If Russian manufacturing industry grows further, if new transportation networks are constructed, and new large-scale infrastructure projects launched (thanks to heavy subsidization and investments from Russian government funds, fuelled by the oil price windfall), this will increase the domestic demand for oil. As in the Soviet period, increased domestic demand could depress Russia's export capacity unless high oil and gas production growth rates continue. The state will need more revenues from oil and gas exports and taxes if it is to complete and maintain these kinds of ambitious initiatives.

The bottom-line from all this is that the energy industry itself needs more investment and policy focus to fulfil its long-term, not just its short-term, potential to stimulate Russian economic growth. The Russian oil industry should not be raided at this time of seeming plenty to serve political or other economic interests.

Conclusion

Despite the necessary cautions about the perils of over-emphasizing the oil price windfall, energy will remain the base of Russia's power for the foreseeable future. It will underpin the Russian economy and domestic stability, enhance Russia's political and economic position in Eurasia, and restore Russia to a degree of its former superpower status – at least as an energy superpower, by making it a player in Asia as well as in Europe, and by increasing its attractiveness to the United States. Energy also has the potential to make Russia a different kind of power in the 21st Century than it was in the 20th Century (although, of course, this is in conjunction with the collapse of the USSR, the end of the nuclear and military confrontation with the U.S., and the contraction of Russia's geopolitical ambitions). Russia today is not the Soviet Union of the past. Russian oil no longer supports a massive military-industrial power and military machine.

This, in itself, could be one of the most significant developments of this decade – especially when one considers the trajectories of Germany and Japan after World War II. Fuelled by oil and gas, Russia may yet follow the same path after the end of the Cold War. It could become the dominant power in its immediate neighbourhood by virtue of its economic growth and new soft power resource potential – not by virtue of the old hard power that led it to invade, conquer, and colonize territory in the past. Russian dominance of Eurasia in this manner would be much more palatable, even for the traditional hawks in the U.S. and the West who eventually became comfortable with the economic dominance by Germany and Japan of their immediate neighbourhoods.

Russia is also not necessarily doomed to fall victim to the 'resource curse' by virtue of its massive energy endowment. Russia may have inherited considerable problems from the Soviet Union, but it has also inherited a knowledge and technology-intensive energy sector that can promote and sustain the country's long-term development. Russia's oil and gas resources are not a curse. Nor are they, however, necessarily a blessing in the sense of guaranteeing success. Russia's major dilemma is how to use its energy wealth economically and politically to its best advantage. The Russian economy still needs to be restructured and buffered against oil price shocks, and Russia has to avoid the trap of diverting itself away from investment in the development its energy sector to pursue the chimera of a 'more balanced' economy and by launching costly infrastructure and new industrial projects. The Russian government must also make difficult decisions about ownership of and foreign investment in the oil sector – as well as its regulation and taxation – to maximize the opportunities for its growth.

Politically, Russia's soft power potential will not be realized if hard power advocates win out and squander Russia's developing economic relations with the CIS by resorting to old strong-arm

tactics in pushing Moscow's interests. The tension between soft and hard power advocates remains acute. In addition, foreign policy and domestic policy are inter-twined. President Putin himself acknowledged this in his July 2004 address to Russia's Ambassadors, when he noted that 'in modern conditions, the line between the domestic and foreign policy is becoming thinner'. A harder, more authoritarian line in Russia's domestic policy could spill over into its foreign policy if the *siloviki* get the upper hand in Moscow.

This is a time for some optimism about Russia's economic future and its new role in its region and the world, but it is still not one for complacency. Russia's partners need to encourage Moscow to take steps to enhance and strengthen the energy sector and to use the revenues it generates appropriately. This is a critical issue not just for Russia, but for a much broader region in Eurasia, as well as for the primary consumers of Russian energy in Europe, Asia, and increasingly in the United States.

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