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Transition to Uncertainty

Fyodor Lukyanov, Editor-in-Chief

The global crisis is being discussed so much that there seems to be no aspect left that has not been analyzed in depth. The answer to the question "Who is to blame?" is well known. Everyone blames the greed of Wall Street and the irresponsibility of the state which refrained from controlling the markets. Another classic question – "What to do?" – does not have a generally accepted answer yet, and, to all appearances, will never have. Despite unanimous statements that countries should coordinate their efforts in order to overcome the recession, their practical actions reveal their willingness to try to survive single-handedly.

It still remains unclear what comes next, how the economic cataclysms will affect the alignment of forces in the world, who (if anyone at all) stands to gain from the crisis, and whether one should expect fundamental changes in the international system.

The Director of the Foreign Policy Planning Department at the Russian Foreign Ministry, **Alexander Kramarenko**, holds that the crisis is a natural result of post-Cold War attempts to impose one type of political and economic development on the world. He believes that the crisis is opening an opportunity to build a truly effective world order.

Olga Butorina says that globalization is acquiring an increasingly manifest regional dimension. Differences in economic development between various groups of countries make them react in different ways to the crisis, thus promoting regional coordination. The author views the crisis as a chance for a "decisive breakthrough in financial integration within the CIS framework." Recent months have shown that in the conditions of universal decline post-Soviet countries have no one to rely on except Moscow.

Vladimir Mau believes that the crisis has made the inseparable interdependence of the Chinese and U.S. economies still more evident. The development of this tendency will result in a geopolitical reconfiguration on the world arena. In particular, it issues a challenge to the other actors in international politics. This applies, first of all, to the European Union, which may lose its status of a privileged partner of the United States, and to Russia, which may find itself on the sidelines of major global processes.

Stefan Schepers offers his own scenario for a strategic rapprochement between

Russia and the EU, which would mark a markedly new stage in Europe's unification and turning into a powerful center of power. In his view, such integration would be in line with the general logic of European development over the last few centuries and, especially, over the last 60 years. A new pan-European project would be as ambitious as the idea put forward in Western Europe after World War II. **Georgy Velyaminov** shares this point of view. He believes that a pan-European alliance is an imperative, but it cannot be set up unless the issues of security and confidence are resolved. Both authors suppose that attempts to achieve close rapprochement between Russia and the EU would meet with displeasure or, more likely, opposition from the U.S., which views such developments as disadvantageous to itself.

Adrian Pabst suggests that the presidents of Russia and the U.S. should revise the security arrangements in the Euro-Atlantic and Eurasian space. He believes that the views of presidents Barack Obama and Dmitry Medvedev with regard to future threats are more adequate to reality than the views of their respective predecessors. General **Victor Yesin** proposes practical ways to overcome the deadlock in Russian-U.S. discussions about the deployment of elements of the U.S. missile defense system in Central Europe. This issue poisoned the atmosphere between the two countries under President George W. Bush.

The crisis serves as yet another reminder of how much the Russian economy depends on the situation on the hydrocarbon market. **Vladimir Feygin** analyzes why oil became a subject of unbridled speculation during the economic boom of the 2000s and how price leaps and falls could be avoided in the future.

Andrei Bely discusses the new conditions in which large Russian oil and gas companies have found themselves after the lending bubble collapsed, making the investment issue into an acute problem. Businessman **Vladimir Yevtushenkov** sees in the crisis a chance to overcome the "Dutch disease" and introduce a new, innovation philosophy based on a new type of state-business interaction.

Leokadia Drobizheva raises an issue that has now become particularly acute, namely national self-determination and nationalism. Last year was marked by the recognition of independence of new states (Kosovo, Abkhazia and South Ossetia), which caused mixed reactions in the world and was described by many as unlawful. The author discusses how the huge potential of national sentiments could be used for the good cause of development. **Mikhail Delyagin** proposes a plan for Moscow's actions vis-à-vis Abkhazia and South Ossetia – territories that are in a very difficult economic position.

Our next issue will continue analyzing the aftermath of the crisis, specifically its impact on global security.

Economic Reshuffle

– A future Rockefeller, huh?
– Hush. He IS Rockefeller.
A MAD cartoon, 1930

“In the West, national market systems matured in the conditions of more or less free trade, but closed financial markets. The states that embarked on the road of capitalism in the 1990s had no such margin of safety. With the possible exception of China, they quickly liberalized foreign trade, and found themselves de jure in equal, and de facto – in subordinate relations – to the main financial centers and currencies of the world.”

The Global Crisis As Seen from Russia

A Preliminary View of the Causes and Lessons of the Economic Crisis

Vladimir Mau

The global economic crisis is rapidly growing and it is difficult to say yet how long it will last. Forecasting the future of this crisis is as senseless as forecasting crude oil prices. When they were high, the only thing one could say confidently was that prices would eventually fall some day. In much the same way, one can be sure now that the crisis will end one day, although neither when that will happen, nor the amount of damage, nor the layout of the post-crisis economy are known yet.

The crisis Russia went through in 1998 had domestic roots – a weak government incapable of conducting a responsible macroeconomic (budgetary, in the first place) policy. The current situation is markedly different: for the first time ever, this country is coming to grips with a world crisis as part of the global economic and financial system. This signifies that Russia is gradually turning into a normal market economy.

One must take account of two important circumstances. First, the current crisis is bigger than just an ordinary cyclic one that occurs once every few years. Unfolding right in front of our eyes are deep-lying tectonic shifts in the financial –and possibly economic – architecture. Talk about the need for revamping the global financial model that took shape in the second half of the 20th century has been in the air for quite some time, yet this model continued to function and showed fairly good eco-

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Vladimir Mau, Doctor of Economics, professor, is Director of the Academy of National Economy under the Russian Government; a member of the Presidential Council for Science, Technologies and Education. The author offers acknowledgments to N. Sundstrom, S. Sinelnikov-Murylyov, S. Drobyshevsky, P. Ashrafyan, K. Rogov, and O. Kochetkova for precious advice concerning this article.

nomic results until recently, although everyone – politicians and experts alike – could see a growth of systemic risks. It is obvious now that the post-crisis landscape will change considerably, as some financial organizations and entire kinds of institutions will be gone.

Second, in spite of a fair macroeconomic situation (recall the two-fold budget revenue surplus), the Russian financial market has found itself in the hardest-hit category together with the Chinese. This may be a penalty for achievements as soaring indices attracted too much speculative capital. When the crisis broke out, this capital started to flow out as quickly as it had arrived.

The ongoing developments must be a subject of incessant analysis and discussion, as it is only in this way that an anti-crisis policy can be formulated. Special attention should be given to an in-depth analysis of the causes of this crisis, the mechanisms for interaction between its economic and financial aspects, priority measures for preventing an economic and financial collapse, the risks inherent in such measures, and the long-term consequences of a withdrawal from the crisis. Countries with emerging markets require special attention too, as their problems are vastly different from the problems faced by developed economies.

The nature and mechanisms of great economic upheavals are always enigmatic and hard to fully comprehend. Even many years later, economic historians are sometimes unable to understand them. The phenomenon of the Great Depression of the 1930s has still not been resolved: discussions continue on both its causes and the effectiveness of Franklin D. Roosevelt's countermeasures.

This clearly means that the reflections featured in this article are tentative and its conclusions cannot claim an all-time validity.

THE ROOT CAUSES OF THE CRISIS

As we analyze the unfolding crisis, it is worthwhile examining separately three groups of factors that predestined it: first, the specific problems of the U.S. economy; second, fundamental problems of today's economic development; and, third, the specific Russian circumstances. These factors may produce different results, and therefore counteraction to the crisis requires taking into account all the three groups.

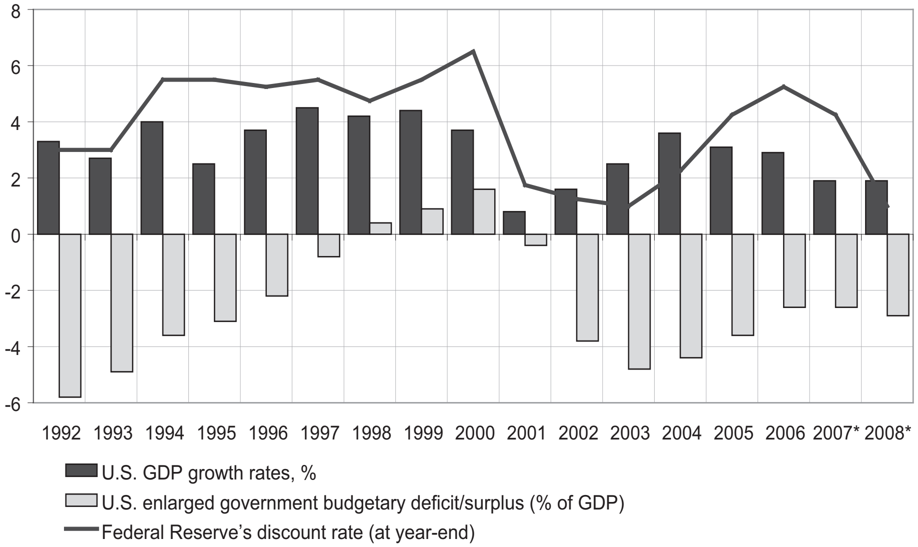
It has become customary while discussing the causes of the crisis to level criticism at the U.S. administration's inappropriate budget and monetary policies. In the first place, the critics point to the pro-cyclic policy pursued after the recession of 2001, when the country continued accumulating budget deficit amidst economic growth, instead of reverting to Clinton's strategy based on budget surpluses. This was manifest, above of all, in the policy of keeping low interest rates that remained unrevised for a long time in spite of the economic growth (see Graph 1). Naturally, one can hear complaints about the deficiencies of the system of supervision over financial markets and, consequently, its regulation, which did not make it possible to take appropriate measures on time. A proof of this can be found in Alan Greenspan's statement at the hearings in the Congress where he spoke about his superfluous confidence in the market's ability for self-regulation.

This policy, aimed to artificially whip up growth, has been quite fashionable in the first decade of the 21st century. As the leading international players watched China's double-digit growth, they did not want to lag behind the future superpower, and that is why the governments of many countries made steps to stimulate growth. Remarkably, the hard lessons of an overheated economy looked outdated – the Great Depression had long become a thing of the past and it seemed that we had overgrown it intellectually. The same logic was behind the task of doubling the GDP within a period of ten years that was set forth by the Russian government. It mostly concentrated on quantitative achievements and parameters of volume. However, while the Russian version of the whip-up policy relied on spare facilities that became available after the crisis of the 1990s and on a powerful inflow of cash from crude oil, the American economy had to develop in the conditions of two simultaneous wars – in Iraq and Afghanistan – which the U.S. administration could not finance without a budget deficit.

However, there are also deeper-rooted causes of the crisis. They are linked to the general characteristics of the world economy and do not boil down to erroneous economic policies.

First of all, one must point out the unprecedented rates of economic growth that permitted to increase the global GDP by one-fourth over the past five years. A rapid rise inevitably brings up systemic contradictions veiled by growing welfare. But the main thing is that, even if you realize these contradictions, it is difficult to interfere in the process and adjust anything in it. Why on earth should any restrictions and corrective measures be imposed when everything looks perfect? Each time anyone begins to voice warnings or doubt the correctness of a course amidst an economic boom, confident voices are heard: “This time it’s different.”

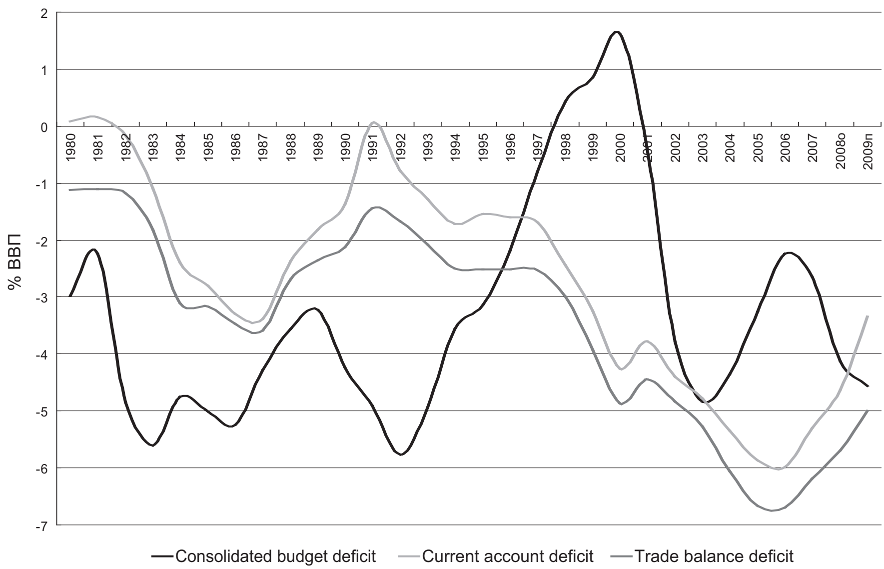
Graph 1. Indicators of Economic Growth and U.S. Budgetary System



This applies perfectly well to the U.S. economy’s triple deficit and current account (see Graph 2). It was clear to absolutely everyone that a triple deficit did not signal economic health and could bring detrimental results. But the hope that “this time it’s different” persisted.

Naturally, these hopes did not grow on a wasteland. They sprouted out of a rethinking of the new (innovative) approaches brought up by globalization. We have been speaking much in recent years about the importance of innovations and transition of the economy to an innovative pathway of development, and so the crisis that has burst out can be viewed as a truly innovative one. One can find at its basis a fast spread of financial innovations – new instruments of the financial market that, as some people would think then, would be able to create conditions for an endless growth and which, as it turns out now, the financial world pundits had a vague idea of. As a result, the volume of the CDS reached almost $60 trillion, or four times the size of America's GDP (see Graph 3). Thus, the crisis appears to be "a rebellion of financial innovations against their creators" – a thing that is unpleasant by not infrequent in history. As one can see now, the situation with the Barings Bank that went broke in 1995 through the solitary activity of Nick Leeson, a young trader from its Singapore branch, was just a harbinger of the crisis, a message to the financial word, which was never heeded.

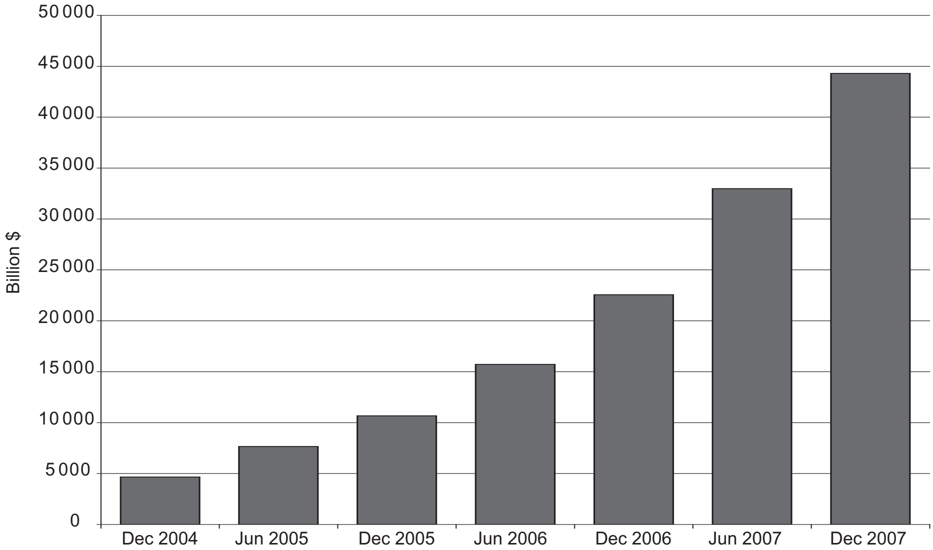
Graph 2. Imbalances in the U.S. Economy



Source: Bureau of Economic Analysis

Still, there exists another aspect of globalization that was also – besides new instruments – seen as a source of endless financial success and steady growth. Niall Ferguson called this phenomenon 'Chimerica,' meaning a combination of China plus America. The case in hand is the rise of a global imbalance that was for decades looked at as a source of well-balanced and steadfast economic growth. This resulted in a regime that stood in opposition to the model of globalization that existed at the turn of the 20th century: whereas a hundred years ago the monies would flow from the core countries (developed economies) to the periphery (to the then emerging markets), now the developing market economies have turned into centers of savings and the U.S. and other developed countries have mostly become consumers.

Graph 3. The Volume of World Market of CDS



Source: Bank for International Settlements

Here is what Ferguson wrote in his book The Ascent of Money: "Welcome to the wonderful world of 'Chimerica' – China plus America – which accounts for just over a tenth of the world's land surface, a quarter of its population, a third of its economic output and more than half of global economic growth in the past eight years. For a time it seemed like a marriage made in heaven. The East Chimericans did the saving. The West Chimericans did the spending. Chinese imports kept down U.S. inflation. Chinese savings kept down U.S. interest rates. Chinese labor kept down U.S. wage costs. As a result, it was remarkably cheap to borrow money and remarkably profitable to run a corporation. Thanks to Chimerica, global real interest rates – the cost of borrowing, after inflation – sank by more than a third below their average over the past fifteen years. Thanks to Chimerica, U.S. corporate profits in 2006 rose by about the same proportion above their average share of GDP. But there was a catch. The more China was willing to lend to the United States, the more Americans were willing to borrow. Chimerica, in other words, was the underlying cause of the surge in bank lending, bond issuance and new derivative contracts that Planet Finance witnessed after 2000. It was the underlying cause of the hedge fund population explosion. It was the underlying reason why private equity partnerships were able to borrow money left, right and center to finance leveraged buyouts. And Chimerica – or the Asian 'savings glut,' as Ben Bernanke called it – was the underlying reason why the U.S. mortgage market was so awash with cash in 2006 that you could get a 100 per cent mortgage with no income, no job or assets."

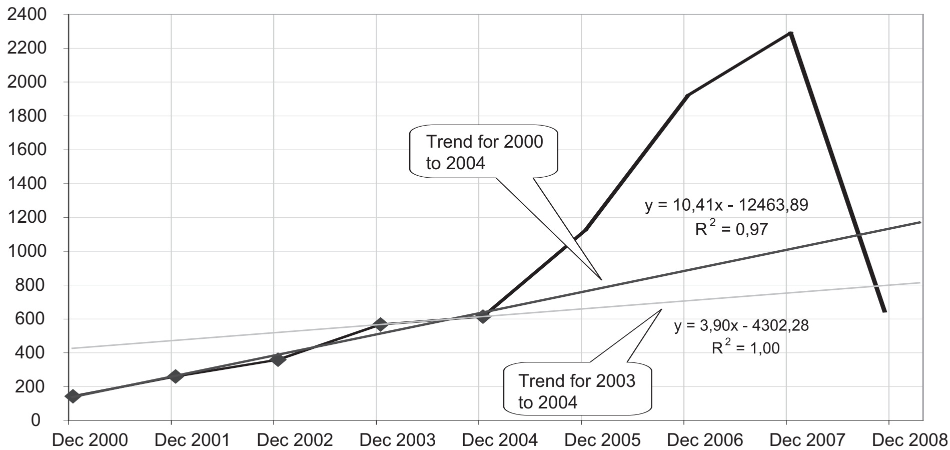
Finally, the unfolding crisis has one more fundamental prerequisite, and the most important one. I am referring to the target-oriented function of the development of business that has undergone a serious transformation over the past fifteen or so years. It has turned the growth of capitalization into a touchstone. This criterion drew the topmost attention of shareholders and is chosen as a benchmark for assessing the efficiency of management these days.

In the meantime, the craving for maximum capitalization develops a sharp contradiction with the fundamental aspect of social and economic progress – the growth of labor productivity. The increase of capitalization is linked to the growth of productivity, indeed, but only *in the final count*. Meanwhile, executives have to make reports to shareholders annually. Hence, to get a nice report and ensure a *current growth* of capitalization, one needs things that differ from the factors stimulating labor productivity. Nice reports require mergers and takeovers, since the volume of assets helps to build up capitalization. And of course one shouldn't shut down outdated production facilities, since their closure slashes current capitalization. As a result, many large corporations keep up old inefficient production facilities and technologies.

Apart from the general factors, there are specific reasons for the fast unfolding of the crisis in Russia. At first glance, the situation looks paradoxical: the crisis sweeps a country that has had an especially favorable macroeconomic situation and a double surplus (of the budget and of the balance of payments). Yet the reason is explicable: this is the reverse side of the favorable environment when double surplus attracts capital flows into the country and actively widens opportunities for borrowings. Naturally, this process took the opposite direction with the start of the crisis – an abrupt contraction of opportunities and the consequent fast shrinkage of the stock market.

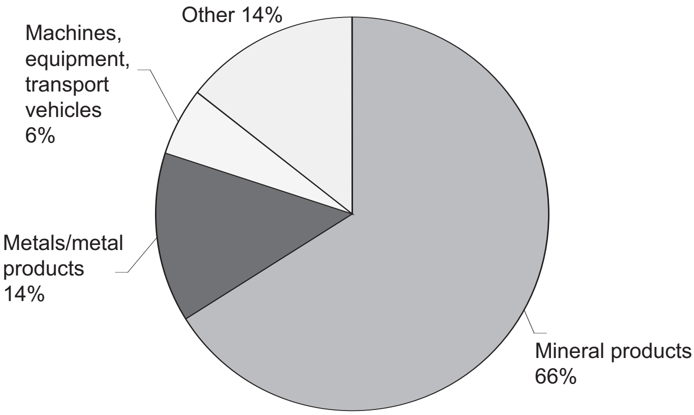
Simultaneously, it turned out that the Russian stock market was still in the phase of budding in spite of a huge growth from 2004 through 2007. Now it may deflate to the minimum parameters, which however have an internal logic. As shown in Graph 4, the stock market fall brought the indices to a point where they could have stayed if the 2005 hike had never occurred. The triangle-shaped figure shown in Graph 4 graphically reflects the financial market bubble that resulted from the disproportion-breeding boom.

Graph 4. RTS Index Dynamics (at closure)



The ineffectiveness of the current structure of the economy and exports also had a telling effect. In conditions of the domination of raw materials and investment commodities in exports, the country's balance of payments is more heavily dependent on cyclic fluctuations than in a diversified economy. A slowdown of growth and flagging activity of investors in importer countries can be a drag on the economy and trigger a hard landing scenario. This is a mirror-like effect of the phenomenon that Russia had to tackle after the crisis of 1998. As the world economy kept growing then, it generated a demand for Russian products and bred a boom when energy resource prices began to grow. Much was said about the importance of structural diversification, but no one would take up the issue seriously amid the boom (see Graph 5).

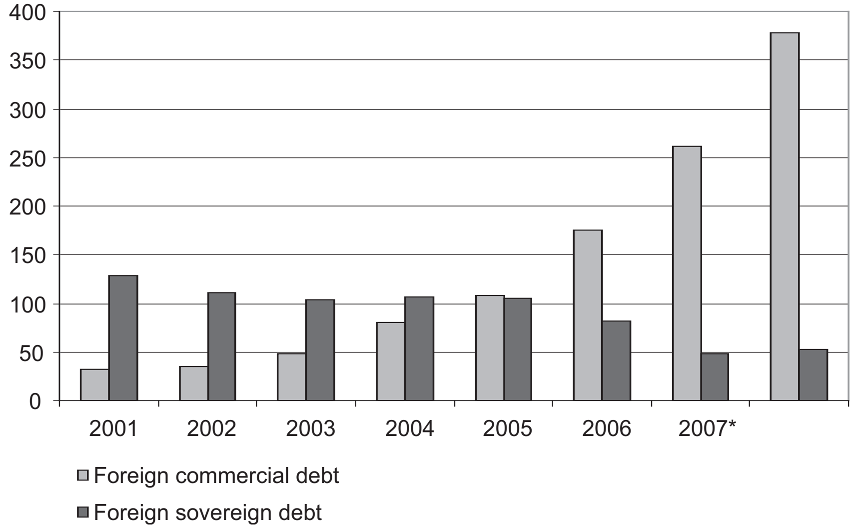
Graph 5. Structure of Russia's Exports in 2006



A growth of corporate borrowings abroad posed a most serious problem, especially due to the quasi-state nature of most of them. Many borrower companies have close connections with the government and act according to the principle of "privatizing the revenues and nationalizing the losses." This is how they are perceived in the financial market, too, where the agents understand that large Russian borrowers will always be able to lean against the federal budget. Thus the situation known as 'moral hazard' emerges, as was the case with the Asian economic crisis in 1997. It means that the borrowers borrow irresponsibly and the lenders lend rather groundlessly, while the government has to rescue the debtors in case of an economic crisis. One can speak here of a tendency towards cheabolization among the leading Russian companies if a reference is made to South Korean cheabols that are controlled by the state de facto and abide by the principle of "privatization of profits and nationalization of losses."

An important change of the tendency in the dynamics of foreign indebtedness took place in 2007 – the aggregate debt burden (sovereign and corporate) that had been decreasing began to grow. This heightened the dependence of Russia's economic position on fluctuations in the global financial market and pushed up a full-scale economic crisis (see Graph 6). One more mistake committed by Russian borrowers was that they easily subscribed to collateral schemes, although the successes of the Russian economy made it possible to do without collaterals in the recent years. The crisis activated the margin calls mechanism that sharply devalued their collaterals and put up sizable risks for their assets.

Graph 6. Volume of Russia's Foreign Debt ($ bln)



This situation affected the budgetary and exchange rate policy. On the one hand, the presence of a big number of influential players – including those having access to the budget – who often have strategically important assets, limited the opportunities for lowering the ruble's exchange rate, which would have sent the cost of servicing their debts up. On the other hand, a need arose to use state financial resources to help the borrowers cover or buy out their debts.

Last but not least, there was a lack of expertise among the political and business elite that had to – for the first time in its life – come to grips with a full-scale cyclic crisis (previous crises were transformational ones). Of course, the elite will get experience over time, but this will require many more years – and a variety of economic crises.

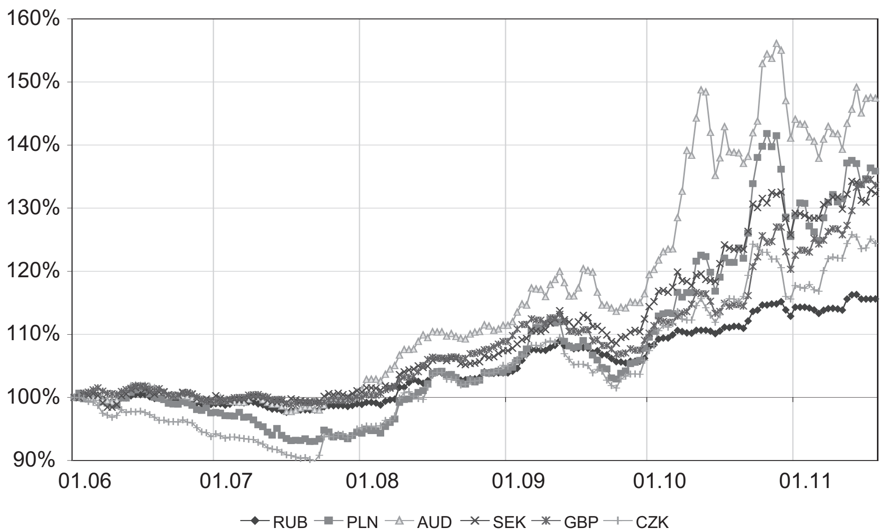
FIGHTING THE CRISIS

The crisis came as a shock to the economic and political elite worldwide. No one expected either such depth or speed. Economically developed countries, apprehensive of a collapse of the banking system and a deflation shock, took resolute steps to support the banks and stimulate production activity.

The list of crucial measures included provision of liquidity, broader guarantees for bank deposits of private individuals, buyout of certain banks by the state, aggressive lowering of discount rates, and adoption of 'stimulation plans' (budget injections for stimulating demand in the real sector). Simultaneously, the governments of many countries cut down the exchange rates of their national currencies against the U.S. dollar (see Graph 7). This measure was meant to help preserve international reserves and to serve as an additional factor for stimulating domestic production. An analysis of the logic and efficiency of these measures lies beyond the format of this article, yet it should be noted that the key problem is that these measures can provoke a major macroeconomic destabilization.

From the very start, steps were taken to avert a collapse of the lending system, and this was a natural consequence of the lessons learnt from the 1998 crisis. The banks received substantial financial resources for overcoming the liquidity crisis. On the one hand, these measures were aimed at supporting production activity, as the availability of lending resources, not the stock market, is a source of growth in the real sector in Russia. On the other hand, stability of the banking system is directly linked to the task of maintaining social and political stability in the country. The loss in bank deposits of private individuals will be much more painful and politically dangerous than any losses in the stock markets.

Graph 7.



Russian authorities have taken resolute enough measures to alleviate the impact of this crisis, partly copying the moves taken in the developed countries and yet acting differently in some points.

From the very start, steps were taken to avert a collapse of the lending system, and this was a natural consequence of the lessons learnt from the 1998 crisis. The banks received substantial financial resources for overcoming the liquidity crisis. On the one hand, these measures were aimed at supporting production activity, as the availability of lending resources, not the stock market, is a source of growth in the real sector in Russia. On the other hand, stability of the banking system is directly linked to the task of maintaining social and political stability in the country. The loss in bank deposits of private individuals will be much more painful and politically dangerous than any losses in the stock markets.

Dubious schemes, quite naturally, cropped up, too. The banks that received liquidity money from the government preferred to convert as much of it as possible into foreign currency so as to secure themselves against currency risks or to use it as an instrument of reducing their debts to foreign lenders. Such conduct was economically grounded yet ran counter to the intensions of the monetary authorities which issued the money. Also, there were situations where the redistribution of the money issued by the government was effectuated with the aid of bribes, which cannot but cause astonishment given the fact that a resource in short supply was distributed at a discounted price. (Unlike primary borrowers, second-tier borrowers were supposed to get the money at a price that would be slightly bigger than the interest at which the primary money was distributed.)

The government tried to prop up stock market indicators to a certain degree, but it had to give up the idea very soon. Although the dynamics of the stock market indicators is always impressive and stirs dramatic passions, it is not the sphere where the state should concentrate its resources. Supporting the stock market in this situation meant only one thing – helping fleeing investors withdraw money from this country by selling securities. True, devaluation of shares is unpleasant for shareholders and creates problems with margin calls, but the solution of this problem lies in a different plane.

The latter problem was especially painful, as the debts of Russian companies to foreign loaners posed a real threat of an outflow of Russian assets – into the hands of those who were crisis-stricken themselves.

The fast economic growth in the past few years was largely due to the availability of inexpensive money resources in the world market. Russian companies borrowed them eagerly. But the inexpensiveness of money does not make investing more efficient, especially when one looks at companies linked to the state. The understanding that the state will not let these companies die at a critical moment lubricates the issuance of loans to them.

The situation has changed, however. There are no easily accessible loans any more, while the securities collateralized against loans are devaluating. (This was another mistake made by Russian borrowers who easily agreed to collateral schemes, although the Russian economy's performance over the recent years made it possible to do without collaterals in many cases.) A total of $43 billion was to be paid off on these debts before the end of the year, and the state said it was ready to make available the funds of around $50 billion through Vneshekonombank (VEB) to get out of the situation. Still, a question is looming: Was the mechanism of utilization of the funds correct? Allocation of money to debtors for repayment of their debts is far from the most efficacious way of resolving the problem. It would have been much better if the VEB had bought up these debts. Steps of this kind would help these companies, above all, to increase their capitalization in the future and reduce the spreads on these debts.

The exchange-rate policy was dubious, too. The authorities did not venture – obviously for political reasons – to fully give up support for the ruble's exchange rate, which resulted in a sharp slimming of foreign exchange/gold reserves. The reasons for the cautiousness are quite clear: devaluation of the national currency – a third over the past twenty years – would not facilitate the growth of trust in the government. But the opposite situation, i.e. the exhaustion of resources, looks no less risky. I believe that prevention of considerable devaluation of reserves has a much greater importance for ensuring stability of the Russian economy than the steadiness of the national currency. More than that, gradual lowering of the ruble's rate would serve as a lifeline for domestic producers, defend the Russian market against imports, and create additional incentives for an inflow of foreign direct investment in the future.

And yet a policy like this naturally invites resistance of those who have sizable debts denominated in foreign currencies. A weakening of the ruble is synonymous with a hike of the price of their debts. These powerful forces have enough clout for lobbying their interests. The issuance of money for buying out their debts should have made them mitigate their stance. In a word, apart from being an important economic indicator, the dynamics of the exchange rate will also be a political indicator in the next few months, as it will create a real balance of forces between the main economic players.

Finally, the government offered a package of incentives, above all taxation ones, for supporting the development of the real sector. There are serious doubts as to the efficiency of this package, as the shortage of money is not the main problem in the manufacturing sector. The core problem is the faulty functioning of economic mechanisms and, as a result, the inefficiency of many producing industries. Although bountiful money injections can make the current social problems less intense, they will not resolve the problem of making production more efficient and renovating the structure of the economy. And without this the crisis will only get more dragged-out.

SLOGANS OF THE DAY: SOCIALISM AND POPULISM

An analysis of the current crisis in the context of long-term historical trends and in retrospect of the past 150 years vividly shows swelling manifestations of two critical trends in 20th-century economic history, namely, ***socialism and populism.*** Political demand for these trends is always heightened during economic crises and social cataclysms, and today's situation is no exception.

Both models were tested in the past century and both failed to live up to the great expectations that had been pinned on them. Socialism was mostly an experiment in Europe and Asia, while populism was tried in Latin America. The results are well known – both experiments flopped. Socialism solved the task of industrialization with enormous sacrifices, but it did not find internal resources for further development. Populism showed an enviable consistency in driving flourishing countries, beginning with Argentina under Juan Peron, into economic and social disaster.

"In the UK everyone is a social democrat now," read a headline in *The Financial Times* (October 7, 2008. p. 11). It shows graphically that the public at large buys into socialist ideas like hot cakes when the financial system is about to collapse and people are apprehensive about diminished incomes. A fiasco of market-oriented ideology and market values in the mentality of a big part of the elite and society is as clear as daylight. Apart from rare exceptions, both the rank-and-file and government appear to be ready to "buy" socialism immediately to maintain their quality of life, however imaginary. Everyone agreed that the proposed measures were "essential and the only possible ones."

It was the authorities, and not the market at all, that began to make decisions on who should be guillotined or pardoned. The situation surrounding Lehman Brothers, on the one hand, and with Bear Stearns and AIG, on the other, does not stand interpretation in market terms. The government simply decided to sort out relations with one corporation and to help the other, the way it happens in a centrally planned economy. And of course all of this was wrapped up in the appropriate rhetoric.

A much greater problem is posed by the policy ***of socialization (or nationalization) of risks.*** As the government saves debtors, replenishes banks with money (recapitalizes them) and sharply increases guarantees on private deposits, it assumes the risks inherent in the decisions of all major economic actors – bankers, investors and borrowers (all the more so that they are often the same people). This undermines the fundamental principle of capitalism – personal responsibility for decision-making. If one takes Russia, one can be sure that nationalization of the losses unavoidably leads to nationalization of the risks. This process begins in the banking sector and spreads to other corporations and sectors through bank guarantees.

Ownership relations, the inner sanctum of any social and economic system, undergo a deep transformation. Providing financial aid to distressed corporations opens the way towards their de facto nationalization. This is done through at least three channels – the buyout of debts from certain corporations, recapitalization in exchange for shares, and inflation of accrued liabilities. Governments are inclined to take on all the liabilities of financial institutions – through guarantees and through direct injections of money as well. Naturally, aid to financial institutions goes hand in hand with formal or factual washing out of packages belonging to private owners. The rights to private ownership – above all, of financial institutions (in the West) and corporations in the real sector – are being called into question. The latter process is quite visible in Russia, especially with regard to those whom the state rescues from margin calls.

Government decisions regarding the nature of activity of the de facto nationalized institutions will be the next, and quite logical, step. Harold Brown said he would continue to stimulate the banks that had come under his control in order to invest more money in small businesses. Support for small business is a sacred cause, no doubt about it, and all contemporary governments love doing this, but the aftermath of these kinds of decisions is easy to predict. When the authorities order where to invest, they will have to render assistance to the loyal banks whenever this politically motivated investment proves inefficacious. That is, state support and ineffective investment form an endless circle. The Europeans were the first to declare this set of measures in a statement on October 12, 2008 and the Americans joined them two days later.

Finally, it is worth remembering that huge capital inflow is due to stream into the market shortly and this will whip up inflation with a simultaneous drop in production. Russians are accustomed to living with high inflation, and, as we could learn from the experience of the 1990s, it is not only a matter of monetary policy. It also has a redistributive effect. Edmund Burke was the first to point to this, discerning the paper money of the French Revolution in 1790 as an ominous token of private property expropriation.

The risks of populist policies are looming large simultaneously with socialistic tendencies. The crisis is already spreading to the manufacturing sector. As growth rates slow down, problems with unemployment may surface. The most dangerous thing in this situation would be to try to stimulate growth with the help of budgetary injections. This will only add to the burden: countries overwhelmed by crisis will have to spend vast amounts of money to support liquidity in the economy and bring stability to the lending system.

Calls are being heard in the West and in Russia to assist manufacturers. Yet doling out cheap money to them would have dangerous consequences in this situation, even though it may bring about a short-lived increase in growth. It would not produce a steady result, while more rampant inflation would put up obstacles to investment. Meanwhile, one should remember that Russia is past the phase of recuperation growth, which requires demand and political stability to a greater degree than investment. The latter is turning into a source of economic growth now, and populist policies can undermine the conditions necessary for it. It would be unforgivable to fight the financial crisis with one hand and build barriers to economic growth with the other hand.

A turn towards socialism obviously reveals an attempt to gain more time for a respite and a reconsideration of values. It is too early to say yet how long it will last, but it will certainly not last forever. Any excessive state regulation goes against modern flexible production forces and the challenges of the post-industrial era. That is why one can hardly claim that the current etatist regulatory systems have arrived "to stand and deliver." Populism is a different story. Populism is ineradicable and its proliferation merely reflects the quality of the national elite.

RISKS OF ANTI-CRISIS STRUGGLES

A discussion of the problems of the current crisis revolves in one way or another around historical precedents and the genetic apprehensions born out of them. This refers first of all to the Great Depression, which was marked by protracted deflation and double-digit unemployment figures. It was only fully overcome thanks to World War II. References are also made to the crisis of the 1970s that gave birth to a new phenomenon – stagflation.

Measures taken by governments in developed countries today suggest that they mostly fear deflation, which may take a decade or more to cope with. In addition to the crises of the 1930s, the Japanese economic crisis in the 1990s furnishes an example, as well.

Deflation and stagflation are actually opposite ways in which a crisis may proceed and that is why they suggest radically different approaches.

Fighting deflation requires stimulating demand, i.e. an active budget policy and budgetary expansionism. This helps to lower taxes and discount rates, together with huge budgetary spending.

Dealing with stagflation requires a set of opposite measures, above all control over the money supply – that is, consolidating budget policy and increasing interest rates. Following the decade-long economic crisis of the 1970s, a way out of the situation was found only after the head of the U.S. Federal Reserve System, Paul Walker, dared to take unprecedented austere measures that drastically increased the discount rate. As a result, U.S. unemployment surged to over 10 percent and interest rates soared to over 20 percent. The country plunged into a deep recession, for which Jimmy Carter paid a dear price – he lost the presidency, but the country re-emerged with a revamped and dynamic economy.

Naturally, contrasting the two models is rather relative and the ongoing crisis will hardly replicate either form, but what matters for us is the understanding that the therapy depends on the nature of the illness and may require very different or even radically opposite remedies.

The experience of both crises may prove handy in the current situation. Strictly speaking, developed countries now resort to policies that they found inadmissible for emerging markets (including post-Communist countries) in the 1980s and 1990s.

The powerful financial injections by the U.S. and the European Union can now actually prevent the deterioration of the economy from going beyond the politically tolerable level, but one must use caution in applying these measures in developing economies. The problem is the U.S. fiscal authorities have two distinctive features. First, they control the printing press that churns out the world's reserve currency. And, although its status has been shaken somewhat, no one seriously calls this into question. Moreover, most countries keep their foreign exchange reserves in U.S. currency and are interested in maintaining its relative stability.

Second, due to this very special status of the U.S. dollar, corporations and households do not have alternative instruments for hedging monetary risks – it is most unlikely that they will rush to exchange their dollars for euros or yens even if they start doubting the correctness of the steps taken by the fiscal authorities. This explains why the speed of monetary movement in the U.S. is not increasing in contrast to other countries, despite the budgetary and financial expansionism in the past few months.

The reaction to financial expansion in the majority of emerging economies, including Russia, will be completely different. Weaker budgetary and monetary policies in countries where the national currency has not formed a durable credit history and, naturally, is in no way a reserve currency will most probably result in a flight from the national currency, as well as in an increase in the speed of money movement and inflation. In a global recession such developments will unavoidably mean stagflation.

Policies like these would be especially dangerous for countries where raw materials dominate exports. Those economies are extremely dependent on international markets since even a small weakening of demand there evokes a considerable slump in production in their export industries. And if business activity in developed countries remains low and demand for commodities from developing economies decreases, depression in the latter countries may go hand-in-hand with a flight from the national currency. Budgetary interventions cannot compensate for falling external demand, and this situation breeds inflation that is not accompanied by growth in production activity.

Thus the conditions of the current crisis depict a situation where deflation in one part of the world will combine with stagflation in another part, and the biggest risk for today's Russia comes exactly from stagflation.

This leads us to a fundamental conclusion about the unfolding crisis and the ways out of it. The world may actually face two simultaneously developing forms of the crisis, which, consequently, require completely different approaches. Fighting deflation in the West will push inflation beyond its borders, i.e. to developing economies, while the latter will quickly fall into the trap of stagflation as they copy Western anti-crisis measures.

This scenario primarily concerns countries with non-diversified exports pegged to mineral resources. If business activity and demand for exported goods remain low in importer countries, depression will go hand-in-hand with a flight from the national currency and this will be manifested, among other things, in inflation.

The de facto nationalization of many financial institutions and enterprises has big risks of its own too. Russia is actually reproducing the situation that emerged at the turn of the 1980s when the so-called "red directors" played an especially active role. This category of managers received broad powers to manage enterprises in the absence of owners to whom they would have had to report. The state could no longer exercise control over economic agents then, while private owners had not emerged yet. In other words, the "red directors" had de facto ownership rights without having owner motivations. History shows that businesses and the entire national economy had to pay a dire price for that.

Russia seems to be falling into the same trap today. As the state buys out debts, it actually establishes control over a sizable number of companies, which thus get management connected to the state. But due to the understandably different access to information, this manager will have obvious advantages over the officials, albeit very high-ranking ones, who put him in the post. This, in turn, pushes the moral hazard problem higher up the spiral, as the manager's personal interests start dominating over the interests of the company.

This reason alone makes it necessary to have a clear plan to re-privatize de facto nationalized companies. This kind of plan must be broadly known to the political and business elite and, above all, to the owners if they stay interested in the business.

Finally, it would be a grave mistake to consider the current crisis as a pretext for reassessing the correlation between the roles of the state and private enterprise. The crisis is often explained by the insufficient interference of the state and by its inability to exercise effective regulation when innovative financial instruments and technologies appear. Most people put all the blame on the free market and few dare defend the values of free entrepreneurship. Only a handful of individuals risk saying that "it wasn't deregulation that allowed this crisis. It was the mish-mash of regulations and regulators, each with too narrow a view of increasingly integrated national and global markets."

In the meantime, the post-industrial world – based on flexible technologies and quick renovation of all technological and economic aspects of life – will not disappear. This world resists centralized regulation and bureaucratic interference in the subtle tissues of its interests. Even if one acknowledges the importance of targeted state regulation of financial markets, it would be a great mistake to extrapolate the regulatory conclusions (and consequently the regulatory practices) to the manufacturing sector.

It has become popular in Russia to speak about the crash of the Western economic model and liberal capitalism today and this talk may make some sense from the political point of view. Yet it would be silly to fall victim to one's own propaganda. All of economic history shows that however harsh a crisis may be and whatever stage of capitalism's decomposition is attributed to it, market economies have always survived crises, and emerged from them stronger, tougher and more competitive. The crisis will end sooner or later, and then we will have to compete with economies that are not only stronger, but also hungrier and, as a consequence, more aggressive.

This will present a serious challenge to Russia and we must already start getting ready for it now. Not only does the crisis leave the need for economic, political, social, and military modernization unabated, it resolutely demands a course of modernization that should be laid out in the government's program documents, so that we can face our competitors with something bigger than state banks and state corporations when the crisis is over.

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A crisis is an unpleasant thing, no doubt, and you never know the price you will have to pay for surviving it, but it has an encouraging factor, as well – it may mark the beginning of rejuvenation, of a healthier growth, and of a cleansing from the sludge of pre-crisis agitation. The degree to which it proves to be beneficial depends on the efficiency and resoluteness of the government's actions and on the responsibility and unity of the national elite.

Last but not least, a great deal of attention must be paid on the part of the government and business community to measures for building mutual trust among market players. To this end they must make their actions clearly understandable to each other. It is important to provide information to the public about which financial institutions receive federal money, how much they receive and, moreover, how this money is being used. The crisis has shown once again that a market economy is built primarily on trust – a trust that is grounded in transparent information, not in the ability of one side to subjugate the other.

Dances with the Dragon

Lessons in Financial Choreography

Olga Butorina

The current crisis is often seen as a match to the Great Depression of the 1930s. Yet there is a hope that it would not evolve into a humanitarian disaster. The standard of living in the crisis-hit countries is much higher now than 80 years ago, and they are not facing the threat of all-out unemployment or poverty. The world's GDP is not going to fall by one quarter within the next few years, and hungry people will not be marching to Washington or other capitals, while inhuman dance marathons, such as the one in Sydney Pollack's movie is likely to forever remain a screenplay.

The two crises are similar in that they both began in the United States, with financial upheavals quickly engulfing the manufacturing sector and a majority of regions of the world. The key common characteristic is the breakdown of market mechanisms. In the 1930s, it was caused by the first wave of globalization. Production technologies changed dramatically at the turn of the 20th century: there was a breakthrough in the development of transport and communications, and transnational oil companies were established and gained a firm footing. As a result, certain national and colonial economies were drawn into the world economic system. The collapse of the New York Stock Exchange on October 24, 1929 put an end to an erratic market. It turned out that market forces could not run the world economy without an active participation by the state.

The current restructuring of the market relations was triggered by the completion of the global economy formation. In the past two decades,

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we witnessed processes that have changed the world. The rapid development of information technologies, the breakup of the bipolar political system, the spreading of capitalism to all regions of the world, the liberalization of capital flows and the fast growth of financial markets have lent a new quality to the world economy. The interdependence of certain countries, regions, markets and processes has increased dramatically. The imbalances in trade and financial flows have grown to global proportions.

At present, the state – as in the times of the Great Depression – has to re-define its relations with the market: figuratively speaking, it has to tame the dragon first, and then dance with it, keeping time with the situation on the world market. The task would be difficult, because each country, region and group of countries will have to learn and perform a dance of their own.

ROCK'N'ROLL, STEP, AND BREAKDANCE

The events that have led to the ongoing crisis are surprisingly reminiscent of the situation in the 1920s. In 1925-1929, stock prices on the New York Exchange grew almost three-fold. Millions of Americans speculated on the exchange to gain more profit. In the first years of the 21st century, not only stock prices grew rapidly, but also real estate's. The record-low interest rates stepped up competition among banks. To attract clients, the banks eased the requirements to borrowers. They took little interest in the borrowers' real incomes in the hope that the prices of houses they had as collateral would keep growing and that loans would easily be redeemed with higher prices. In other words, banks and their clients were playing a big financial pyramid. As in 1929, there came a moment when it collapsed.

It is opportune to describe the present crisis as over-consumption, rather than overproduction. Excessive consumption, not justified by the real economic situation, became the last resort for the markets of the United States and a number of European countries to delay an impending system transformation. Mass consumption involved everybody: the population, companies, banks and the state. The average state debt of the U.S. and the 27 EU countries stood at around 60 percent of the GDP in the recent years. In 2006, the debt of U.S. and British families reached 150 percent of their real income, while in Germany and many other EU countries it made up 80 to 100 percent. Clearly, no family can live without buying food and medicines and paying for electricity for 18 months in a row. At present, U.S. families deduct 18 percent from their net income for debt payments, on the average. Thus, the 150-percent liability can be redeemed in eight or ten years. Until very recently, ordinary members of the consumer society would never think of tightening their belts for such a long period.

Many came to believe that the global economy was able to produce virtual money to buy real goods and services. Stock indices grew by leaps and bounds in the past few years. The rising stocks were a welcome security for credits. But this implied that one kind of obligation – shares and bonds – made the groundwork for other obligations, i.e. bank loans. The emission of virtual money by private companies and banks turned into a separate economic activity, quite profitable and practically unaccountable to anybody. New financial instruments played the key role in that process; the consequences of their use were not clear to the state and consumers, and even its originators were unable to fully realize the implications.

The long worldwide increase in the prices of real estate, gold, stocks and exchange commodities was, in fact, a warped form of world inflation. The bloated U.S. balance of payments deficit and the constant decrease in the dollar rate from 2002 against major currencies made investors turn to alternative assets. With the statistically low inflation in developed countries (2 to 3 percent a year), inflationary pressures began to affect the spheres which monetary authorities were unable to control – the commodity and stock floors. As a result, the hidden inflation, together with money supply, made a classic crisis tandem.

Information flows are another reason behind the malfunctions of market mechanisms, or, rather, their changed role in the production of material values. In the past 10 to 15 years, information has become as important a factor of production as labor, land and capital. But whereas labor, land and monetary relations are regulated by extensive legislation shaped over centuries, relations in the sphere of information are still at the puberty stage of wild capitalism. Newspapers and magazines, along with advertising and rating agencies, directly influence the demand, supply and prices of products on the market – from simple commodities to complex financial instruments. Yet none of them bears responsibility commensurate to the deviations of money flows they create.

Many have an impression that the era of monetarism, associated with the names of Ronald Reagan and Margaret Thatcher, is fading into the past, to be replaced by a modified version of Keynesian economics. Indeed, speeches by world leaders and declarations by international economic organizations are infused with Keynesian rhetoric.

The nationalization of debts, massive injections into the banking sector, increased controlling functions by the state – these are all Keynesian tools. At the same time, it would be incorrect to assert that Keynesian objectives – full employment and stimulation of domestic demand – have been made the cornerstone.

The new economic policy (regardless of the name it will be given in the future) ***should be able to resolve two key tasks: restore the normal functioning of market mechanisms and return to the state the niche it has lost in the economic system.*** At first glance, this mission has inherent contradictions, as it appears to be neo-classical and Keynesian at the same time. Yet it is based on common sense and the current situation.

That market mechanisms are imbalanced can be seen with the naked eye. Dramatic fluctuations in the prices of stocks, real estate, fuel and food show that the market has ceased to be the key measure to gauge the socially justified cost of this or that product. If that is so, the allocating function of the market (dealing with rational distribution of resources) is faulty as well: capital is invested in speculative transactions rather than in the manufacturing sector. This hampers the realization of yet another objective of the market – facilitating technological process and increasing labor productivity.

The breakdown of adequate supply-demand interaction is particularly noticeable on the money market, or the market of inter-bank loans. When U.S. banks cut the volume of current credits to European partner banks in September 2008, due to non-payments at home, a liquidity crisis hit Europe. There was an acute shortage of dollars for daily trade and conversion transactions. In this situation, each commercial bank decided to hold back its cash and stopped extending loans to other partner banks even at high interest rates. To save the market from collapsing and solvent banks from bankruptcy, European governments and the European Central Bank took unprecedented bailout measures.

The panic in the banking sector subsided, but the money market has not been re-launched since. Large commercial banks with sufficient supply of cash only give loans to privileged clients. An overwhelming majority of other European banks can only borrow from national central banks, which makes such transactions less convenient and more expensive. The most popular instrument – unsecured one-day loans – has been withdrawn from the market. Basic reference rates (LIBOR, EURIBOR, EONIA), a starting point in calculating the cost of credits, have become, in effect, a theory. Their use has decreased due to the drastic decrease in the volume of transactions.

The deformation of market mechanisms is fraught with yet another danger. If operators stop relaying signals to each other – and therefore do not contribute to market pricing, the state monetary-credit policy stops working. For example, in order to pull the economy from recession, central banks normally lower the refinancing rate. It is assumed that intermediaries, i.e. commercial banks, will also decrease their rates, at which they extend loans to each other and their clients. But in a situation where the market of inter-bank credits is idling (which is happening in Europe at present), cheaper credits may be unavailable for businesses and the population. For example, the European Central Bank (ECB) lowered the refinancing rate by 1 percent in October and November, but the cost of credits for the population and companies practically remained unchanged by December.

The peculiarity of the current crisis is that it started amidst low inflation and low interest rates. In the 4th quarter of 2008, the inflation rate slowed down considerably, with decreasing oil and food prices among the contributing factors, yet the demand for investments did not budge. According to prognoses, developed countries will post zero growth in 2009 at best, or a 1- or 2-percent fall at worst. This implies that the Western world risks getting into a trap of deflation (economic decline under low inflation) similar to the one the Japanese economy has been trying to overcome for more than a decade.

The evil of deflation is that it limits domestic investments and is conducive to capital flight. Monetary authorities lose the main lever that could be used to speed up economic growth – the opportunity to lower interest rates. Deflation is first and foremost dangerous to the euro zone. European business has become accustomed to an evolutionary and moderate monetary policy; the ECB rarely changes its rates, and the range of their fluctuations is quite narrow. Conversely, U.S. entrepreneurs have long got used to the aggressive and jerky interest rate policy by the Federal Reserve System, so the U.S. will be able to pull out of deflation. According to the January forecast by the European Commission, inflation in the euro zone will make up 1 percent in 2009, a two-fold decrease from the normal level. In Great Britain, the consumer price index is expected to fall to 0.1 percent.

SALSA, CZARDAS, AND HOPAK

In 2009, countries with developing markets will account for 100 percent of the growth of the world's GDP, which is unlikely to exceed 2 percent. According to forecasts, their economies will grow 4 to 5 percent, whereas the GDP of developed countries will fall 1.5 to 2 percent. In 2004-2008, the average GDP growth rates in developing states reached 6 to 8 percent a year, exceeding the economic growth in developed states (pacing at 2 to 3 percent a year) by more than three times.

The crisis is quite painful for young market economies, despite positive dynamics there. In recent months, the IMF approved bailout loans for Hungary, Kyrgyzstan, Ukraine, Iceland, Belarus, Latvia and Serbia, worth a total of 40 billion dollars. IMF missions reported alarming conclusions after visiting Uzbekistan, Vietnam and Kazakhstan. ***The crisis is setting an almost impossible task before countries with developing markets – that of modernizing market mechanisms and strengthening the state's position in the economy, although their economic system is deformed a priori, while international practices and standards ignore the fact of this deformation.***

Whereas Western countries have to tame just one dragon – the markets, developing states have to deal with two "monsters" at once – the markets that got out of control and the inherent defects of a transitional economy. Some of these defects stem from the "catching-up" type of development – a relatively low standard of living of the population and high GDP growth rates. Consequently, almost all macroeconomic indicators fluctuate within a broader range, compared with countries with developed economies. Market situation changes, for example, in Mexico and

Hungary, are much more pronounced than in the U.S. or Germany. This "roll" is a natural consequence of fast economic growth and insufficient stability of the economic system in general. As a result, any unfavorable changes on world markets (or external shocks) are more painful for developing markets than developed ones.

The fuel and food price hikes in the world pushed the inflation rate in Asian states with developing markets from 4 percent in 2007 to 8 percent in 2008. Compare: the average annual consumer price index in the euro zone increased to 3.3 percent from 2.1 percent. The reason behind the difference is high energy consumption of the GDP, and a large share of foodstuffs in family budgets of developing states. On the whole, inflation is a sore subject for these countries. It is generated by high economic growth rates and frequent pay rises, a characteristic and necessary measure (from the social point of view) for the "catching-up" type of development. In addition, budget deficit can push up the inflation, following huge spending by the state on modernizing production, technological development and welfare programs.

Low interest rates are not possible under high inflation, which itself creates inflationary expectations. A vicious circle is thus formed, which is hard to break.

According to a forecast published by The Economist, inflation in Russia, Turkey, Ukraine, Kazakhstan, Uzbekistan, Vietnam, Argentina and Bolivia will reach 10 to 15 percent in 2009. In Venezuela, it may increase from the current 30 percent to 40 percent. In Brazil, Mexico, India, Indonesia, Lithuania, Latvia, Estonia and Bulgaria, prices are expected to grow 6 to 7 percent.

The second part of the problem stems from the fact that globalization influences developing countries not in the way it influences the developed world. However, the global rules of the game are determined by the interests and practices of developed countries. Importantly, national market systems in the West matured in the conditions of more or less free trade and closed financial markets. States that embarked on the road of capitalism in the 1990s had no such margin of safety. With the possible exception of China, they quickly liberalized foreign trade, and found themselves de jure in equal, and de facto in subordinate relations to the main financial centers and currencies of the world.

Not surprisingly, many of their crucial economic inter-relations acquired quite a different shape compared with those of their Western partners. During the past decade, a majority of countries with developing markets had large inflows of foreign capital, especially short-term ones. This is understandable: high rates of growth transformed into high yields of stocks, which attracted investors from Western countries with slower development rates. Since the financial markets of young economies are not large, the increased external demand for their securities was vigorously pushing the rates of their currencies upwards. According to the Bank for International Settlements (BIS), the Russian ruble appreciated against the majority of currencies in the world by 90 percent in the period from 2000 to the middle of 2008 in real terms (which takes into account an adjustment for inflation); the Czech koruna appreciated by 70 percent; and the Hungarian forint by 60 percent. During the designated period, the currencies of Brazil, India and Poland appreciated by 40 percent each, on the average.

But since last autumn, when markets experienced shortages of liquidity, investors rushed to convert their funds from "exotic" currencies into dollars. The increasing inflation and the general worsening of the economic situation in countries with developing markets only speeded up the outflow of short money. As a result, the Brazilian real fell by 26 percent, the Mexican peso, the Indonesian rupiah, the South Korean won and the Polish zloty fell by 15 to 20 percent, and the Hungarian forint and the Czech koruna by 12 percent each over the last few months of 2008.

The currencies of the three Baltic States, pegged to the euro, are still within the designated corridor. But the margin of their strength is diminishing before our very eyes, as are the reserves of their central banks. The situation is particularly difficult in Latvia: the inflation rate in this country has reached 15 percent, and forecasts for 2009 show a 7-percent decrease in the GDP. If IMF and EU loans received by the country fail to save the Latvian lats from devaluation, the currencies of Estonia and Lithuania will come under pressure.

Another peculiarity of transitional economies is that the authorities have to fight for the stability of prices and stability of the exchange rate at the same time – the tasks the developed states never combine because they are mutually exclusive. For example, the European Central Bank has always underlined that its key and only objective is to keep prices stable, and that it does not handle the euro rate.

Things are different in countries with developing markets. The population there can easily slip away from the national currency to euros or dollars, so normal economic development is impossible without a stable exchange rate. A falling exchange rate provokes a rapid derangement of the national monetary system, and more stable foreign currencies begin to edge out the national currency from circulation, which pushes up inflation even more, cuts investments and devalues the local currency. Today, the world's expert community does not deal with this issue in earnest, while international organizations do not issue recommendations to developing countries. Each of them resolves the problem at its own risk, as a rule in a "manual control" mode.

There is a tremendous difference between developed and developing states in terms of monetary and credit policy. The above loaning pattern (the central bank gives money to commercial banks and the latter extend loans to companies and the population) exists only theoretically in transitional economies. Indeed, the central bank fixes the refinancing rate, which is the reference point for rates on the inter-bank market and the final rates for clients. But commercial banks do not borrow from the central bank, so the borrowing pattern does not materialize. The reason is simple: interest rates in developing countries are always higher (due to inflation and fast growth) than in developed ones. In the conditions of globalization, there is no need for local commercial banks to borrow from the central bank at 10 percent interest per annum, if they can borrow from foreign banks at a half-price rate. That is, the disproportion in interest rates in developed and developing countries, paralyzes the refinancing mechanism in the latter. As a result, the state loses a crucial instrument of economic regulation.

Therefore, developing countries, often accused of excessive state regulation, have far less freedom in macroeconomic policy compared with developed states of the West. Using a truncated toolbox, they encounter tasks that their stronger partners have never faced, and that have no adequate solutions in modern economic practice.

TRAINING IN INTERNATIONAL CHOREOGRAPHY

Many think that the on-going crisis will stimulate unconventional, bold solutions and help overhaul the existing rules. According to Deutsche Bank CEO Joseph Ackermann, 2009 will go down in history as a year of complete reconfiguration of the world financial system. Director of the IMF European Department Marek Belka adds that "the crisis could generate political momentum in favor of deeper reforms that seem impossible in normal times."

The crisis has showed that neither national nor international bodies failed to correctly assess the risks that had emerged on the financial markets in recent time.

The crisis was not predicted, so no measures were taken in time to ease its intensity and scale. Several oversights became obvious in methods for monitoring financial markets. At present, banking supervision systems operate on the national scale, whereas financial markets have become global. The share of foreign capital in the aggregate volume of funds attracted by banks keeps growing, as does the scope of their international operations.

It is easy now for investors to choose which securities are more attractive: national or foreign. The same applies to loans. Consequently, the interest rates on government bonds and stock markets of various countries become increasingly dependent on each other. Whereas economic slowdowns in the U.S. earlier triggered corresponding slowdowns in Europe only several months later, there was no time lag this time. The high dependence of developing countries on exports to the U.S. and other Western states, as well as on world fuel prices and the international movement of capital, did not let them protect themselves from the crisis.

Now the international community's efforts are directed towards working out international rules that would help prevent the recurrence of such a crisis in the future. To this end, the leaders of the world's 20 largest countries met in Washington on November 15, 2008. Their final declaration began with the phrase about the readiness to "work together to restore global growth and achieve needed reforms in the world's financial system."

The document noted the necessity of major improvement of the international regulation of financial markets, enhancing their transparency, strengthening the international regulation of trans-border flows of capital, and carrying out reforms at international financial institutions, while attracting to this task countries with developing markets, too.

Prior to the meeting, the IMF and the Financial Stability Forum (FSF), a body created after regional crises of 1997-1998), published a joint statement on the division of their spheres of responsibility. It was confirmed that the objective of the IMF was to monitor the international financial system as a whole, while the FSF should work out international standards of financial supervision and regulation. Together, these two institutions will be setting up early warning mechanisms. The IMF will assess macro-financial risks and systemic vulnerabilities, while the FSF will assess financial system vulnerabilities.

The crisis showed an obvious lack of knowledge about important economic processes and interaction. For example, complex methods to test banking systems have been developed in recent years, with the use of state-of-the-art econometric instruments. Stress-tests were run in 2005-2007 in a majority of EU countries. They all showed a high stability of banking systems – which the world crisis quickly disproved. It turned out that the tests did not take into account psychological factors and the system behavior of financial institutions. Furthermore, it has become obvious by now that market operators around the world were acting pro-cyclically before the crisis. During the boom stage, banks and investment companies were only pursuing maximum profit and did nothing to limit their future losses. In other words, they were making things worse.

The fact that the acute shortage of liquidity on financial markets occurred after years of intensive increase in money supply indicates little knowledge of the mechanism of monetary circulation in the conditions of globalization. Top officials of the Central European Bank acknowledge that both inflation and deflation processes at low interest rates have not been sufficiently analyzed. This has even more significance for the specifics of economic processes in countries with developing markets. There are all reasons to assume that the crisis will give a powerful impulse to the development of economic science and boost international cooperation in this field.

The development of regional financial cooperation is another measure. The EU has already publicly acknowledged the necessity to step up interaction between supervising bodies of various countries, and work out general principles of control over financial markets. Monetary authorities of a number of countries, especially, small and open ones, have insistently called for creating uniform supervision bodies for the EU. The crisis has made it clear that the European Union has to improve its legislation regulating trans-border banking.

For example, in Finland, where two of the main three banking networks belong to Swedes, apprehensions have been voiced starting late last year that anti-crisis programs, approved at headquarters, would be aimed at preserving parent businesses. Meanwhile, affiliated banks in Finland are of strategic significance, and their shutdown would deliver a blow to the whole national economy.

The crisis has seriously complicated the situation in small and open European economies which are not part of the euro zone. In Switzerland and Denmark, analysts say that if these countries were part of the monetary union, their financial markets and national currencies would not have come under such heavy external pressure. The difficult situation, in which the Baltic States' economies have found themselves due to problems in the banking sector, has only strengthened their resolve to enter the euro zone as soon as possible.

The necessity to boost regional integration is broadly discussed in Asia. From 1990 to 2007, the share of regional trade in the whole foreign trade of 15 countries in East Asia – ASEAN plus Three (China, Japan, and South Korea) – increased from 43 to 54 percent.

ASEAN states created free trade zones with China, Japan, Korea, India, Australia and New Zealand. In response to the financial crisis of 1997, the region set up a network of credit lines to fight speculative attacks on the currencies of the participating countries. In late November 2008, Bangkok hosted an international conference "The Future of Economic Integration in Asia." Governor of the Bank of Thailand Dr Tarisa Watanagase noted that "while we see significant adverse impacts of global integration, Asian economic integration, in fact, has a crucial role in helping a number of our regional economies withstand this enormous external destabilizing shock."

On the agenda now are such issues as the liberalization of the market of financial services and the harmonization of the standards of financial activity, including accountability. But the main objective is to set up a deep, liquid and stable financial market in the region.

RUSSIAN DIVERTIMENTO

Russia needs to make the best use of opportunities, emerging during the acute phase of the crisis (presumably until the second half of 2009), to convert its international cooperation in the financial sphere into a new substantive quality.

First: It should raise, together with several CIS (Commonwealth of Independent States) and/or SCO (the Shanghai Cooperation Organization) partners, within the framework of a G-20 summit, scheduled for April, an issue of setting up an international center to study macroeconomic processes and policies in countries with developing markets. The functioning of such a center under the aegis a leading international financial institution will help to:

1) attract the attention of the international economic community to problems of transitional economies;

2) raise the level of knowledge about the patterns and principles of their economic processes;

3) work out better methods for carrying out monetary, currency and economic policies in this group of countries;

4) take into account the specifics of the fledging markets in working out international financial control standards. On the whole, the measure will contribute to the movement towards a multi-polar world within the scope of a global economic dialogue and G-20 meetings.

Second: It is expedient to put issues of anti-crisis settlement and crisis prevention in relations with the European Union on the agenda of the next Russia-EU summit in mid-2009. This subject is politically neutral and has an important practical content, which everybody acknowledges. The fact that a number of EU countries, including former Socialist states, have found themselves in a difficult economic situation, will contribute to the development of productive dialogue between Russia and the EU in this field. It should be taken into account that Sweden will take over the rotating EU presidency from July. This country has one of the world's best economic schools with strong positions in issues of monetary circulation, finance and exchange rates.

Third: The crisis should be used as the starting point for a decisive breakthrough in financial integration within the CIS framework. Until now, there have been no tangible results in this sphere of cooperation, although the 1998 crisis in Russia quickly spread to other CIS states and now these countries are experiencing serious economic difficulties. Meanwhile, the region has all opportunities for active use of the ASEAN and EU experience in the stabilization of national currencies, integration of their national stock markets, harmonization of financial standards, and the development and unification of trans-border payment systems.

Resisting the crisis and developing international cooperation in this field should be made central issues on the agenda of the coming meetings of CIS governing bodies. They should adopt clear programs of actions that would meet the best international practices. In order to accomplish this, Russia (on its own, or together with active partners, such as Kazakhstan) should coordinate the issues of technical support for future projects with international groups of experts, for example, from the Central European Bank, which carries out such activities in some third countries.

The End of the "Paper Oil" Era

Ways to increase predictability and reduce the risks of the energy market

Vladimir Feygin

The world community has entered a period that will determine the future development of the economy and, possibly, the entire arrangement of the global system. Manifestations of the crisis are wide-reaching and multifaceted, while the unstable situation makes forecasting barely possible. Dynamical systems theory experts link such phenomena to the "points of bifurcation," at which the smooth trajectory of development ends and the system's behavior undergoes a restructuring, the results of which are hard to predict.

Some weighty disproportions, underestimated interconnections and risks that were not embraced by an in-depth analysis or were simply hushed up have come to the surface. The crisis makes it easier to rethink the situation, as the dominant paradigm, which could scarcely be called into question in conditions of economic growth, is getting weaker.

The structure of economic ties that took shape in the past decades has serious inherent inconsistencies. The widespread conviction that the expanding global economy is stable by virtue of its scale and diversification of the participants' interests is creaking at the seams. The towering imbalances of world trade and U.S. deficits aggravate the general situation, but market participants cannot assess the situation adequately or counteract to it using the available instruments (hence the abrupt fluctuations of exchange rates). As a result, market participants often act relying on feelings (sometimes strange even for professional market analysts) that easily grow into panic.

This uncertainty has objective reasons, as various sectors of today's

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financial and economic system are interconnected and, more often than not, the same players drift from one sector to another – together with their capital. Many macroeconomic indicators have become unpredictable, aggravating the risks of projects with long payoff periods. The entire situation forces even long-term investors to shift the focus onto short-term positions in a bid to compensate for their losses (real or anticipated).

It is only now that market players are becoming aware of the scale of the risks, as until very recently risks could be hedged by a variety of inexpensive tools. Offers of such tools came not only from private investors but also from the government, as one saw in the case of real estate market mechanisms. The crisis as such was largely a result of underrated risks.

Thus, any investor who moves to the short-term market and becomes a purely financial speculative player there (even including pension funds) expects to get short-term profits. A market of this kind generates many financial instruments, but the abundance of financial instruments does not guarantee large profits anymore, as the number of players and the resources drawn have grown several-fold in recent years.

Shares are the simplest of all instruments, and the inflow of money to that market began to be felt about ten years ago, as a result of which the stock market started moving in a steady upward trend. However, its integral growth at rates considerably higher than those of economic growth could not continue forever. Slow growth irritated professional market traders, who had become accustomed to windfall profits.

Naturally, points of growth do exist, but a search for them entails the difficult task of looking for objects of capital investment and serious risks. The desire to make life easier first brought about an influx of investment in hi-tech companies, however that sector later crashed. Then the sizable growth of the Chinese and Indian economies bolstered by unbalanced exports of their products – to the U.S. in the first place – raised the efficiency of many companies and pushed their stock prices up, but this growth had petered out by 2006 and 2007 as well, and the oil market turned out to be a good sector for investment.

Objective uncertainty stemming from insufficient data on proven reserves in major oil-producing countries – especially in Saudi Arabia –

and a sharp overall decrease in exploring for new deposits amid a steady demand for oil fueled fears that a shortage of oil was already possible in the foreseeable future. This facilitated the rise of a long-term tendency for growth in oil prices and a steep increase in the activity of financial investors in the oil exchange instruments sector.

Thus a new bubble – an oil-related one this time – formed. In the less than two years that preceded the peak of oil prices in the summer of 2008, the presence of financial investors on the oil market had grown severalfold and they accounted for 80 percent of all transactions. These investors did not need oil as a commodity and did not have it themselves. They carried out transactions with what is known as "paper oil" – with the aid of exchange instruments linked to the oil market. Remarkably, claims were made that the considerable dominance of paper deals over real transactions with oil was a sign of a mature market and that it provided the necessary liquidity and an objective price for this commodity.

However, life does not support these theses. In reality, the market is volatile and this fully conforms to the interests of the vast majority of players. Moreover, market participants are interested in keeping this volatility at a high level. (It should be noted, though, that volatility per se does not guarantee a victory. A more favorable situation is when the market is moving in a direction that can be predicted by the market participant.) The modern information society has mechanisms that allow it to push masses of players towards supporting a certain trend. The list includes well-targeted rumors, ignoring some information ("the market has swallowed it already") and over-emphasizing other information, as well as proliferation (usually under the aegis of respectable institutions – more often than not, financial ones) of ostensible forecasts, which, in fact, are indicators of the predominant vector in market development.

If this vector is clear to a majority of players, then the market is ready to move in this direction and investors are ready to get revenues from it, even though the movement may overstep the boundaries of long-term assessments and fundamental indicators. This is how bubbles are formed.

Assessments of a financial agent's success are based entirely on short-term indicators, so the agents assess the items for their investments against short-term indicators as well. Since the problem of uncertainty persists, investors have to assume higher risks camouflaged as market instruments.

The crisis has pushed the risks still higher. Previously there was an obvious global tendency ("the main line") suggesting that as markets grew, consumption also increased. This was bolstered by the relevant instruments of growth, such as large-scale inexpensive loans and equally inexpensive insurance schemes.

Yet commercial forecasting becomes impossible when the number of risks rises above a crucial point. This triggers a sharp decline in activity and prolongs the crisis. Imagine that acute and conspicuous elements of the crisis have been eliminated. What is to be done with the vagueness surrounding the price of credit resources, exchange rates and, last but not least, the market demand for commodities? The latter has begun to influence even traditional mass commodities like oil and gas.

How does one subdue entropy? In the first place, we must analyze specific markets, mechanisms and interests of the participants, and if the analysis reveals that a given market does not correspond to the tasks it is expected to resolve, then we must modernize that market.

The main criterion of market analysis is the availability of stabilization mechanisms. If the tasks are long-term, then we must have mechanisms capable of overcoming the propensity for short-term deals and short-lived benefits, gregariousness, timidity, and other deficiencies of existing markets.

Let us look at some concrete examples.

THE CRUDE OIL MARKET

The history of the crude oil market is reviewed in detail in an array of publications (see, for instance, "Putting a Price on Energy." International Pricing Mechanisms for Oil and Gas, 2007). Market instability and the phenomena pertaining to it have also been a topic of discussion (Alexander Arbatov, Maria Belova, Vladimir Feygin. "Russian Hydrocarbons and World Markets." *Russia in Global Affairs,* No. 1, January/March 2006; Vladimir Feygin. "The Price Swingboard." *Global Energy*, October 2008 – Russ. Ed.).

As the oil market began to develop along the liberal model and saw a sharp inflow of financial players, price establishment turned into a separate business for the relevant “professionals.” This business only requires a monetary resource. The commodity is separate from the business and the people involved can guess the correlations between supply and demand only through tentative signs – rumors, expectations, statements – and sometimes by individual parameters, such as changes in the reserves of oil and petroleum products in the U.S. The participants are inclined to overstate the significance of some factors, partially due to scarce information and partially because they have a material interest in rocking the market. For the very same reason, they are interested in coordinating their behavior to a large enough degree and are not interested in unlimited competition. If the market is rocked by only one or a few participants, it requires sizable financial costs and is risky.

The direct involvement of commercial players in this process is insignificant (at any rate they are almost never present on the market under their own names). Their efforts were much more noticeable earlier when the market was smaller. It is well known, for instance, that British Petroleum was fined for attempts to manipulate the market.

In the current crisis, the involvement of financial investors on the oil market is diminishing, but those who have stayed behave in the same way, or delicately coordinate their efforts. The forms of coordination may differ, but the essence remains unchanged, since financial players make profits on it.

Oil is a special commodity. Many other commodities are also susceptible to price leaps and falls, but oil prices draw much greater attention and this issue is far more politicized. When prices were high quite recently, producers of oil and other vital energy resources would say that their commodities would continue to become ever more expensive and that it would even be possible to buy up the economies of developed countries with dollars gained from oil, gas, steel, etc. They would even claim that world markets should work according to the rules established by producer countries.

There are a number of opinions out there today claiming that an oil price of $30 to $40 per barrel is acceptable during the crisis period and producer countries should not act selfishly, keep their appetites in check and make sacrifices so that the world economy get out of this crisis. Yet such prices mean a mortal blow to the economies of many oil-dependent countries, like Nigeria or Venezuela. So would it be justifiable to get out of the crisis at their expense? One of the compromise solutions suggests that countries should renounce defending extreme positions: claiming that justice is being established on the international market, and, adversely, interpreting the essence and results of the existing balance too broadly. As we have said earlier, modern markets do not resolve long-term issues. Attempts to create long-term instruments for oil and gas markets were made in the past when long futures were considered in this capacity. But neither their reliability – in essence they prolonged the tendencies that took shape in the sphere of short-term futures – nor the volumes traded could turn them into instruments of investment. Another example was the efforts made in Britain to use futures for the market entry price at terminals in order to justify investment decisions: in the final run, the Transco company acknowledged this practice as faulty.

So how is it possible to make up for the shortcomings of the market that stem from player shortsightedness and interest in coordinated moves, including those that go beyond the limits of reasonable price corridors? Using the language offered above, what are the stabilizers of the market? The answer for today is clear: as regards the crude oil market, it is OPEC (or possibly OPEC in cooperation with other producers) that is making efforts – albeit tough ones – towards harmonizing supply and demand.

Further prospects for normalization involve modification of the mechanisms of crude oil trading. It is important to return to the fundamental principle of price formation as a balance of supply and demand, rather than a balance of market derivatives. This is possible if more trading floors are opened and producers bring the amounts of crude subject to sale (for instance, 10 to 15 percent of their sales over a coordinated period of time). Trading will be done as a price auction for the real amounts of supplies.

The impossibility of selling the stated quantity of products at the prices that would satisfy the suppliers will mean the excessiveness of the amounts offered or of the prices quoted. As in other places, the sellers and consumers of commodity batches will have an opportunity to change their offers, tap mutually acceptable terms of transactions or reject them. Technical issues – and they are many – can be resolved as well. This practice may lead to a sharp growth in market transparency and information awareness by the participants. Naturally it will influence the behavior of petroleum exchanges that will adjust their role to the new conditions on their own.

Of course, if producers (with the involvement of consumers and the minimum possible brokering) assume this approach as a guideline, problems of a different kind may appear. It is good when a traded commodity has wide accessibility and is homogeneous, and market participants abound on both sides. As for oil, its homogeneity is quite relative (it has several basic brands). But what about its abundance?

It is obvious that natural factors and the principle of state sovereignty over natural resources also play a significant role. When oil prices "went off scale" and OPEC claimed that there was an abundance of oil on the market, developed countries apportioned all blame to "resource nationalism." Their claims suggested that state-run companies in producer countries are inefficient, reluctant (or unable) to run a sufficient number of projects, and thus they create a shortage in oil supply. The producers, on the contrary, made assurances that they were doing their best to develop production capacity, including reserves, yet they could not catch up with growing demand. Remarkably, OPEC again said quite recently that it is implementing new projects in this crisis amid rapidly falling oil prices, and that it had set for itself a task of restoring the required level of reserve capacities.

A few simple questions arise. Do multinational corporations, which are not run by the state, create sufficient reserve production capacities? Which factors (except market ones, like the influence of consumer countries) can stimulate them to expand these capacities? Why has all the talk about a malicious OPEC died down now that demand has begun to shrink?

There is another question: Do producers have a duty to fill up the market with their resources amid such conditions? It appears that, generally, the answer is no.

And how will the liquidity of the markets be guaranteed? The answer is in a natural way – that is, by providing sufficient amounts of the commodity and a sufficient number of trading participants, along with due observance of the principles of openness (for commercial participants interested in transactions of the type that will be effectuated on these floors).

If this is the case, a chance will appear that the volatility of prices will diminish sharply and stabilize within a fundamental corridor (the upper limit of which marks the possibility of a changeover to other energy resources). This will require that market players understand that they should moderate their behavior to a certain extent. It will also require their mutual responsibility for the market's long-term stability (particularly in creating reserves and modest expectations of state support for alternative energy projects – see below for a discussion of this new sector).

Synchronized steps may be needed to interact in investment processes, as the shortcomings of the oil market have the largest noticeable impact on investment decisions – they are likewise a basis for durable stability in the oil and gas industry.

Governments acting in a reasonable union with private businesses and using market instruments have a significant role in the process. This does not imply "socialization," which has become a scarecrow thanks to some analysts. Yet if the purely financial market has failed to create reliable instruments for long-term projects like nuclear and hydropower plants, it is impossible to shun the role of the state. That this should not be confined to government investment only is another story. For instance, it would be reasonable to issue long-term maturity bonds for private investors in such projects that would have reliable guarantees, including the profitability of these projects exceeding that of secure deposits.

THE NATURAL GAS MARKET

Let us now look at the specificity of the gas market – first of all in Europe – from the point of view of the problems discussed above.

The gas industry needs long-term stability to an even greater extent than the oil industry. Gas projects, including the construction of appropriate infrastructures, require more capital investment and have longer payoff periods. It is well known that these factors contributed to the rise of a system of long-term agreements on the European market with a sizable (70 to 80 percent) share of take-or-pay obligations.

Why do the parties to them – suppliers and customers alike – hold on to them? These agreements provide for the sharing of risks, although they do not get rid of risks. Each party assumes the risks it finds easier to assume considering the market situation, experience, etc. The general principle is that the customer bears the risks for supply volumes and the seller, for prices.

The customer under a wholesale contract is not the end consumer of gas – he is an intermediary trader in fact, simultaneously offering various services. He bears the risks for selling the amount of gas stated in the contract and at prices specified in it.

These risks are limited when the market is developing and consumption is growing. Gas then offers its natural advantages (obvious for the consumer) and barriers obstruct access to the market of the given customer (wholesale purchaser) for competitors. The existing risks take the form of irrational taxation, inadequate price formation in contracts or the rise of alternative technologies and energy resources, as a result of which competitiveness of supplies under an agreement (sometimes signed for a period of more than twenty years) may change.

The risks get much higher, however, in the course of market liberalization. These are regulation risks linked with the easing up of unlimited competition on the purchaser's traditional market after it is opened. European gas market reform ideologists suffer from a double consciousness. Initially, they hoped to get rid of long-term contracts altogether (because that is how they understood the goal of market reform – as a liberal competitive market), but then they had to put up with these contracts and even recognize their importance.

A need emerged at a new stage of reform (declared in early 2007 but still awaiting final endorsement) to decide on what mechanisms would provide for the development of infrastructure in a situation where the transportation and supplies of gas become separated from each other. This problem still remains.

The proposals being drafted in Europe have been given the nickname "a gas Gosplan," an allusion to Soviet-era central planning. These proposals have actually moved the decision-making on investments (and this is the most painful problem for the gas sector due to its high input-intensive nature) to the level of a bureaucratic structure while leaving the obligations on investment (and the relevant responsibility) to commercial companies (operators of the gas distribution system). Meanwhile, long-term agreements per se can serve as a basis for appropriate decisions (for more details, see: Vladimir Feygin.

"Towards a Global Gosplan." *Mirovaya Energetika*, No. 8 (44), 2007 – Russ. Ed).

Thus we again face the dilemma of choosing between ideal notions about the market (which in practice result in monsters like the "gas Gosplan") or pragmatic decisions in the form of long-term agreements allowing a successful sharing of risks by the parties and laying the market groundwork for long-term development.

Do the long-term contracts have shortcomings? Yes, they do. For instance, they do not take account of the seasonal nature of production activity in the gas sector and the way prices are formed. This shortcoming manifests itself especially vividly during sharp oil price fluctuations, like what happened in the second half of 2008 when gas became less competitive due to the delayed factoring of the changes in oil product prices into the price calculation formula. However, these and other weaknesses are easy to analyze and correct, and contracts can be more flexible and diversified as well.

Does the presence of long-term contracts mean that other forms of contract relations on the natural gas market are not necessary? It does not, of course. But can Europe do without long-term contracts in a situation where gas is pumped over thousands of kilometers and the risks of implementing projects are very high? While previously theoreticians would try and convince everyone that this was possible, the new situation on the financial markets makes a negative answer all too obvious. So would it be more reasonable to recognize reality instead of harboring a dislike for long-term contracts and disassembling the structure of this market by introducing mechanisms that restrict the participation of suppliers, or promulgating the idea of a "New Energy Policy" (which we will discuss below)?

NEW RISKS

Events related to the complex of problems concerning environmental protection, energy savings and alternative sources of energy have posed a serious challenge to the stability and predictability of the energy sector.

Proponents of radical measures drafted demands to developed countries to reduce greenhouse gas emissions by the middle of this century. After that, the "horizon" of planning was brought forward to more practical deadlines. Completion of the tasks was pegged to 2030 and, according to new scenarios, including those drafted by the International Energy Agency (IEA), the volumes of emissions must return to the current levels after a certain period of further growth – resulting, in the first place, from the growth of economies in developing countries.

These scenarios suggest a giant leap in the field of energy efficiency; a steep growth in the use of renewable sources of energy; an increased share of atomic energy; and the broad use of CCS (pre-combustion carbon capture and storage) technologies, which the industrial sector still uses on a narrow scale. This means that by 2030, global consumption of basic hydrocarbon resources – crude oil, natural gas, and coal – must return to current levels.

When oil prices were high, developed countries were constantly worried about insufficient investment in the energy sector. It is appropriate to ask IEA experts now what reaction they expect to hear from the producers of energy resources or investors if the forecasts show that the solution to global climate problems can make the results of investment totally unnecessary already in the short-term.

The European Commission issued in mid-November 2008 a voluminous package of documents on the so-called New Energy Policy (NEP). It aims to promote practical steps under the previously stated 20-20-20 targets – that is, a 20-percent reduction in greenhouse emissions, a 20-percent increase in energy efficiency and an equal simultaneous increase in the share of renewable sources of energy by 2020. From the very start these elegant objectives were not propped up by well-calculated measures, which means they remained political statements of intentions.

The new package of documents on the NEP incorporates – along with various proposed measures – the results of research on various scenarios for energy consumption in EU countries, conducted at the European Commission's request. Apart from the basic scenario (which does not bring in the 20-20-20 goals), it also includes an alternative scenario (that of the NEP) that reaches two out of the three goals (but predicts an increase in energy efficiency by 13 to 14 percent against the proposed 20 percent). Along with this, total consumption of energy in the EU is expected to decrease by 2020, while gas imports will either grow slightly or go down a little (the calculation is made against 2005).

Europeans aired assurances during the first discussion of the document held at the EU's initiative in Moscow last November that this is not a forecast-type document. This apparently should sound like a call to stay away from taking its provisions too seriously. No wonder. Even a superficial analysis of the scenario shows that the quantities of imported gas featured in it are smaller than the total amounts of gas put in the agreements with major supplier countries. This either means that the contracts signed earlier will not be implemented under certain scenarios or the authors of the forecast simply did not bother with such "trifles." The second option looks more likely.

One way or other, this is the first time ever that a package of official EU documents has planted a bomb under the basis of cooperation with energy resource suppliers – first of all with Russia. Such "scenarios" – to say nothing of possible practical policies on them – push risks in the energy sector to a markedly new level.

U.S. President Barack Obama has also said that the development of alternative energy and new energy technologies are among the priorities for his administration. One can expect more active steps by the U.S. in designing collective actions for the post-Kyoto period. The U.S. Congress is already discussing bills on tougher measures against greenhouse emissions. But as U.S. energy sector experts analyze realistic ways to resolve these tasks, they themselves draw the conclusions that natural gas is destined to play the main role as an ecologically safe and efficient energy resource.

It appears that an analysis will eventually be needed of why the conclusions drawn by U.S. and EU experts differ so vastly.

Another dimension of the problem relates to the possibility of amassed governmental investment in developed countries in alternative sources of energy, as well as in the energy and energy-saving technologies in general. The progress of these technologies, equipment and methods is interesting and important for all countries. Otherwise, the human race will inevitably run into a shortage of energy resources or the cost will become unaffordable. But if the efforts made in order to rapidly break away from dependence on hydrocarbons entail massive state subsidizing, producers will have the right to ask questions about whether this approach frustrates the balance of interests of the sides and the principles of energy security. An analogy with fair trade principles, which are coordinated between countries in the format of the World Trade Organization, naturally comes to mind here.

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Financial markets will no longer operate as they did before and it is obvious that a change in the regulatory model is needed. This will influence the mode of functioning of commodity markets as well.

If one imagines that the objective reasons behind the current crisis have been eliminated, the critical mass of risks standing in the way of a reversion to the trajectory of rapid development remains the same. There is a need for mechanisms to increase predictability and reduce the risks that take the form of an irresponsible inflating of volatility and overblown short-term interests. They naturally include interstate instruments, the build-up of public awareness and non-confrontational interaction among the parties to the process. Stabilization mechanisms can vary, but the mutual understanding of their acceptability is highly advisable.

It is important that state interference be restricted, especially during the period that follows an acute crisis phase, and not only in producer countries.

A rejection of coordinated steps is fraught with confrontational and catastrophic scenarios, such as mass refusals by producers to supply sufficient volumes of resources to the market when prices are very low or attempts to prevent such or similar development scenarios by unconventional methods (such as the use of force) – unless the elimination of problems and unilateral approaches become a universal goal.

A Global Answer to a Global Challenge

Crisis Lessons for the Future of the Russian Economy

Vladimir Yevtushenkov

It is difficult to agree emotionally with the analysts and publicists who point out positive aspects of the on-going global economic crisis, yet there is undoubtedly one positive factor in it. The crisis has not only caused people to mobilize material and intellectual resources, but has forced one to consider how the economy may change in general and what has to be adjusted to secure its further development.

It is quite possible that anti-crisis measures, as hostages of inertia thinking, are far off the mark, and other solutions will be needed based on another paradigm for analyzing the economic matter. Regardless of speculations about the causes of the crisis, we all understand that the post-crisis economy will be different. What kind of economy will it be?

The very real possibility of a dangerous divergence between reality and expectations requires active efforts to develop the future economic model not only on the part of academic scientists, but also by those who are deeply involved in the economy and influence the functioning of the economy to a certain extent, i.e. business people. It is due to this involvement that the impact of the crisis becomes much more painful, while the need for its positive comprehension is felt more acutely. I will venture to suggest that the suddenness of the crisis was the price for our unwillingness to see and objectively assess quantita-

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tive changes that were building up, shifts in the economic setup, and fundamental changes in the qualitative characteristics of the entire socio-political system.

NEW PARADIGM NEEDED

This is not the first time humanity is facing such a systemic challenge that emerged as a result of evolution and the incorporation of forced or desired innovations into economic activities. A popular journal recently counted a dozen and a half "famous" crises, beginning with the construction of the Panama Canal. But if we analyze global crises, we would see that the transformation from a natural economy to a market economy was as dramatic and "unexpected," although the situation was not viewed as a catastrophe due to the scale of the world economy. Nevertheless, crises are caused, as a rule, by a mismatch between established ideas and actual economic relations.

The present crisis also suggests a transfer to an entirely new paradigm of the idea of economic processes, which, in turn, automatically requires fundamentally new mechanisms for their regulation. The main feature of such a paradigm could be linked with the concept of global internationalization – that is, a merger between globalization as a general trend for active expansion of economic systems beyond national economies, and internationalization as a process of including agents of economic activity in transnational co-operation. Before our eyes this process, which is mainly effected through mergers and takeovers, has acquired a huge dimension. Over the past decade such transactions have made up at least 40 percent per year on the average.

The globalization of the modern economy did not begin recently and its structure is rather complex. Its core is the mega-economy that began to take shape in the last quarter of the 20th century. The interrelation between national economies has become so strong that they all act as a single whole – albeit internally differentiated – constantly changing and ridden with conflicts. The prerequisite to this was the emergence of new information technologies, a considerable increase in the volumes of cross-border movement of capital, technologies, knowledge and people, as well as a large-scale expansion of commodity and financial markets.

THEORY AND MODELS

There is no need to build new models to justify in theory the global internationalization of the economy. Rather, we should look at the existing and well-known models, for example, the "Kondratiev waves" model which proved the regularity of economic crises. Yet this obvious conclusion is followed by a more significant premise: in order to predict the behavior of an economic system, it must be considered as a global hypersystem. Mathematicians proposed much later the so-called fractal theory, which enables a formal analysis of such systems.

The current article does not consider the extent to which this theory might be applied to economic analysis, but it is important to underline that the approach to the economy as an ordered set of economic agents and institutions that provide for their functioning is a special case. The fractal hypothesis assumes that an economy has different levels, and that despite changes, the value of its heterogeneity remains constant during an extended period of time.

Arguably, the faster internationalization processes run, the faster the emerging turbulence subsides. Crises therefore do not just determine the accruing contradictions in the internationalization of economic agents; they act as moderators in their settlement.

From this point of view, the current crisis will contribute to the establishment of such fractals of the modern economy as regional common markets: in Europe, the United States and the Middle East. Aside from the free movement of goods, they will guarantee the free movement of the workforce, funds, common rules for buying/renting real estate and purchasing stocks, as well as equal terms for using the benefits of insurance, education, healthcare and employment.

It follows from this theory that fractals create additional incentives and opportunities to internationalize not only economic, but also managerial activity. Recent proposals to set up supranational bodies to regulate the market, even if they materialize in different forms, are unlikely to yield the desired effect. We should rather rely on integration ties between regional regulators of socio-economic relations: only the emerging trend towards deepening and expanding these ties can help avoid a scenario of global development where conflicts between and inside countries prevail and where protectionism governs economic policy. As a result, sovereign defaults would no longer appear as something extraordinary.

THE GEOPOLITICAL DIMENSION OF THE CRISIS

The first effect of the global internationalization theory, which suggests what a post-crisis economy might look like, is its geopolitical dimension. The geopolitical factor has always played a fundamental role in strategic plans for developing socio-political systems. But in the new conditions that are emerging as a result of the implementation of anti-crisis measures, the national borders of economies will lose their significance, as the world market is becoming universal.

It would be trivial just to say, for example, that the BRIC countries (Brazil, Russia, India and China) will move, in the foreseeable future, from a group of developing states to developed ones. But this fact will change considerably the geopolitical picture of the world. In a certain sense, the positive side of the crisis is that the intrigue regarding further development is gone.

Perhaps it is a coincidence, but Paul Krugman received the Nobel Prize in Economics in 2008 for his work explaining the specialization of various countries in international trade amid conditions of partial competition. Modern technologies (computers + Internet + mobile communications + information systems) have completely changed the general picture of economic exchange, by joining space and time at every point in the world market. Plainly speaking, transactions, as a realization of economic interests, are no longer associated with a particular place of the production of goods or services, while sellers (although certainly not all of them) have become vendors peddling not so much a product, as a brand to help consumers zero in on certain products so that they do not get lost in the variety of alternative products.

Competitiveness is becoming the only reason for the right to be present on the market. Even before the crisis, it had become apparent that the points of growth of competitiveness could be found in technological clusters. They are through technologies: thanks to their universality, they have a high multiplying effect that influences the entire production process – from design and development to production and sale to consumers. By assigning the leading role in economic development to technologies, the new U.S. administration even plans to establish the post of director for technologies.

A characteristic feature of technological clusters is that the technologies they are based upon are applied in various fields, thus enhancing the level of national competitiveness. It is no wonder the economy has begun to be viewed abroad through the prism of clusters, rather than through traditional groups of companies, industries or sectors. Clusters fit better into the very nature of competition and the sources of attaining competitive advantages. The majority of cluster participants are not direct rivals because they service different industries. State and private investments, aimed at improving the functioning of a cluster, benefit a variety of businesses. Incidentally, it is the clusters that have been the least affected by the crisis – the crisis has paved the way for them to win the market as such, regardless of regional or national borders.

Therefore, although "decoupling" the global economy from the U.S. economic cycle has not taken place yet, global internationalization is leading national economies along this path strictly and steadily, just as any objective law would. The crisis has only sped up this process. A practical conclusion from this seemingly theoretical premise is that the BRIC countries – and Southeast Asia in general – will cease to be just a location for mass production, but will become equal and, most importantly, equal-ranking participants in production, innovative development and the sale of competitive products.

The East-West confrontation will lose its economic significance – albeit not as fast as one would wish – while geopolitical motives in addressing the development problems of national economies will give way to signals from macro-regional common markets that secure coordinated development. The world is likely to realize that GDP growth is not as important to the state as its balanced position on the world market. So, apocalyptical forecasts (like a possible collapse of U.S., European, Russian, etc. economies) simply stem from traditional thinking.

Internationalization is based on the mobility of capital, technologies and labor. From this point of view, the Russian economy lags far behind developed countries, as it is very passive in conducting its own policy of internationalization. This is explained by a weak financial base and a low level of innovation in production (machine-building companies have been producing 70 percent of their products without the benefit of innovations for 15 consecutive years). At the same time, there are apprehensions about and obstacles to Russian companies in other countries.

Unlike many countries whose participation in internationalization is associated with their producers entering world markets, Russia opened its market in the course of this process. That has played an adverse role to date – since we have our own market, there is no need to seek a world niche, which weakens competition and contributes to a sort of "colonialism." This is perhaps why the present crisis has hit Russia particularly hard.

At the same time, the participation of the Russian economy in internationalization is inevitable. Two Eurasian transport corridors – Transsib and North-South, as well as Pan-European transport corridors II and IX – run through Russia. There is also a ramified network of existing pipelines and pipelines under construction. Russia's participation in resolving European energy problems plays a role, as well. The strategy to develop power generation within the next decade, approved by the Russian government, envisions a considerable increase in electricity generation based on modern technologies and boosting electricity exports. Simultaneously, the program envisions sweeping measures to launch energy conservation technologies; the energy intensiveness of production in Russia is three times higher than in developed countries. This opens a niche for a mutually advantageous "barter" – energy in exchange for energy conservation technologies.

THE GOVERNMENT AND BUSINESS AMID THE CRISIS

It may seem tempting to try to overcome the crisis by defying or even resisting the emerged trends. But this tactic is doomed to failure. It would be much more productive to use it for a major revision of one's approach to the analysis of socio-economic processes.

Changing one's views of the role and place of the government in the economy appears to be crucial. The concepts of the state as a "night watchman," a source of "general welfare," etc. are fading into history; they are being replaced by such notions as "state-partner," meaning business partner in the first place.

Admittedly, the history of relations between the government and business is not simple, especially in Russia. There was a period when the

Russian government considered free enterprise as a criminal activity. Later, the government shared its property with everyone who was ready to start a business, thus becoming the main source of establishing business. Russian business covered an entire era within a mere decade. We can still recall the caricatures of "new Russians," financial pyramids, bankrupt banks and the notorious 1998 government default. The state, with respect to business, played different roles during this period – from benefactor to sinister malefactor.

We are now on the verge of changes, and not just in Russia. Look, for example, at the close-knit bloc forged between U.S. business and the government in fighting terrorism or overcoming the current recession. Not surprisingly, in calculating various indicators that characterize a country's economy, for example, the competitiveness indicator – which the IMD business school in Lausanne, Switzerland, publishes every year – spending on the conduct of business and the effectiveness of government are taken equally into account. For Russia, the first indicator by far exceeds the second – for now at least.

If we turn to theory, we will find a large variety of models there as well, which determine the position of business in the economic system. Many concepts have been proposed since the time of Adam Smith, who was the first to challenge the infinite wisdom of statesmen in managing available resources. The classic liberal doctrine assigns to the state the role of a "night watchman": it sets rules of conduct for the market and monitors strict compliance with them. Of course, the rules are set not at the wish or whim of the authorities. They are adapted to market behavior, i.e. to how transactions are conducted, how incomes are distributed, how much money is invested in production, how much is consumed, etc.

But even in a well-established pure market economy, the state and business regularly revise their mutual relationships. The scales, on which contributions to the economy by state management and entrepreneurial diligence are weighed, periodically tilt towards one side or the other. The Soviet economy, where the role of the state was made absolute, showed convincingly that such a path has no future.

Yet the crisis has again made many people speak of increased government interference in the economy, of building of the so-called power vertical, and of the equidistance of businesses from the government decision-making center. The enthusiasm these slogans evoke in officials – who have always wielded tremendous power in Russia – is understandable. But it is unclear on what premise the new model of relations between the state and the business community will be built. The crisis has actually reconciled the advocates of state-controlled economy with liberals, because both have realized that the opposition between the state and businesses has long become obsolete and should give way to partnership.

However strange it might seem, it is easier to put such an approach into practice in the Russian economy, which is still routinely referred to as transitional. Despite considerable efforts to liberalize the economic system and laws regulating relations between the authorities and economic agents, the nation still pins great hopes on the government as almost the only institution that can ensure that public interests are duly observed. These ideas should not be fought against, no matter how illusory they may seem, but guided into a productive vein. The conditions are quite suitable for this now.

The strategic goal is to build a dynamically developing and socially-oriented economy that fits well into the international division of the production, capital and labor markets. The main objective is stable development. This would consolidate the transfer from the mobilization economy of "besieged fortress" to the economy of partnership and co-operation, and underscore the requirement for the inclusion of Russia into the global economic system.

Contrary to widespread belief, the state and business now have an increasing number of common, mutual interests. For example, both business and the state seek consolidation as a major management task since it is easier to manage a large economic entity. Accomplishing this task is crucial for further development.

One should make a reservation here: the path of co-operation between business and the state is not straightforward. The main difficulty is launching institutional mechanisms for the participation of the dependent party (business) in establishing the rules for their conduct. There might be a temptation to expand the boundaries of one's discretion, ease the burden of one's participation in resolving issues that have little to do with business interests, evade sanctions for violations, etc. The crisis may play the role of a catalyst here.

The crisis was mainly caused by the problem of regulating the global and national markets. That is why no restructuring – not even on a global scale – of capital, investments, loans, funds, rights, demands, obligations, collateral, debts, assets, shareholders' stakes, transactions, etc. will yield a long-term effect in full measure, if no fundamental changes are made to the approaches and mechanisms of state interference in the economy. Only the restructuring of institutions, especially development institutions, can pull the economy out of the crisis.

The state is a regulator in the traditional paradigm. But even in this role it does not prescribe the rules of behavior to market participants, but increasingly often sets the so-called behavioral conditions.

In the new paradigm, the state is an active participant in market relations, and an economic agent. It is the implementation of this pattern that resulted – accidentally or intentionally – in the establishment of state corporations. The special position of these organizations is proven by the high degree of independence of their activities, which are beyond state management or control. But in any case, state corporations have become subjects of market relations, having brought the state and business considerably closer to each other.

It must be admitted that this new kind of enterprise has caused apprehensions that the state may take over private corporations, not through nationalization, but through state corporatism. To overcome or prevent this threat, business can adopt the tactic of incorporating assets, or some of them, in a state corporation, on the condition that state investments are swapped for profit-sharing. In this form, it would not be direct budget funding of the private sector, but private-state partnership, a mechanism which has become very popular in recent years.

INDUSTRIAL POLICY AND CRISIS

The crisis does not only change our ideas of a mega-economy, but also requires that we revise the principles of the functioning of economic mechanisms at macro- and micro levels. Due to its global nature, the crisis is changing the main guidelines for the use and development of the research, technological and industrial potential of a country, which is usually called "industrial policy." In a post-crisis Russia, this would be noted for a sharp contrast between the quantity of industrial companies and the quality of their contribution to the national economy.

Since the general objective of Russia's economic policy in the short-term is to help its producers join the world economy, the industrial policy must remove the contradiction between production and consumption: goods must be produced not because Russia has many production capacities, but because there are many people wishing to buy these goods.

Of course, products produced by some Russian enterprises not only rival their competitors, but also excel them, although a product per se is not yet a commodity in demand. The market environment is a competition not only between the consumer qualities of this or that product, but also between expenses included in the production cost, labor costs, the level of innovation and many other things. The state industrial policy creates the groundwork – first of all in legislation – to enhance the comparable level of Russia's commodity production.

The national economic policy specifies the common guidelines for a country's socio-economic development in organizational, legal, and production mechanisms for the operation of economic agents. Taking into account the tasks the Russian economy is facing in the short-term and the condition of its industrial potential, the industrial policy could develop along the concept of crystallization of variously-scaled production systems.

Admittedly, for a transitional economy, as the Russian economy has been called in the past decade, many solutions that seem well-known elsewhere have to be rediscovered. It is much easier to design economic policy from scratch than modify an established system of social relations.

But when entering a new era it would be hypocritical to discard everything accomplished by previous generations, thinking of this heritage as a burden that prevents us from attaining new heights. Clearly no politician aspiring to be a national leader would risk taking such a haughty stance with respect to the past.

We lean on everything accomplished by citizens of the vast country in order to use it for further development – not contrary to, but in accordance with the general laws of economic growth and together with competitors/partners.

It is another matter that each national economy is described by too many parameters to fit them into a single algorithm for all. The selection of such an algorithm is up to the national industrial policy which stems from the general national economic policy.

Shaping this policy is the state's prerogative. The crisis, as it was earlier said, has changed the position of the state with respect to business, making them partners. Now these partner relations should be extended to the process of drawing up an industrial development policy. As business has a better knowledge of and sensitivity to the essence of the market economy, it should play the leading role in this process, since there is a real danger that officials will set their own priorities and select mechanisms for their implementation in such a way that the end result will be quite different from what they expected.

So the crucial thing is to decide which objectives should be set before the industrial complex, how the system of priorities should be set, how they should be implemented, what mechanisms must be used, and, lastly, how to distribute the roles between economic agents in this process. Such issues must be settled jointly by business and the state.

THE FINANCIAL MARKET, BANKS AND INSTRUMENTS IN LIGHT OF CRISIS

One of the main instruments of globalization is the advanced growth of the world financial market. This has made it possible to speak of a financial globalization and its leading role in all global processes. Its influence on the manufacturing sector of the economy has been mostly felt in the rapid internationalization of financial instruments, which has generated the term "turbo-capitalism."

Conceivably, the world banking system has become the main victim of the crisis. Gone are global investment banks – a whole institution that has been part of economic development in the past decades. The 1929 economic disaster in the U.S. economy is called the Great Depression – a dramatic description, yet it is no more than a depression, whereas today the crisis has been pulling the whole world system into the "shrinking" vortex of recession.

The avalanche of publications in the scientific and business press has described in detail practically all aspects of the forced restructuring of the banking system, intended to enable financial institutions to not only survive, but also acquire new qualities to meet the requirements of the modern global market. From this point of view, we have to remember that banks are a special mechanism that effects direct relations in the entire chain of economic relations – which means they cannot but be involved in the internationalization of economic processes that determine the development of any socio-political system.

Bank internationalization in post-crisis conditions is likely to increase dramatically. Its major feature is determined by the fact that raising financial resources and concentrating them in one or another area will largely depend on cooperative ties in the international division of labor forces.

Only a successful solution to this difficult task will help secure and expand the position of the national bank segment on the domestic market, and also provide for an active expansion of domestic producers beyond their country. Banks will actually acquire not only financial, but also production functions, because they will become an instrument for re-orienting production towards the manufacture of competitive goods. This, in turn, will require the development of innovation projects, the launch and speedy transfers of high performance equipment, high technology, and stringent standards.

Banks will thus turn into infrastructure (investment-financial) clusters, differentiated by industries: investment-industrial, agrarian, service, trade, etc. The general bank architecture will acquire a network-like character. The value of a network product is not so much in its physical or functional qualities, as in consumers' attitudes towards it. It is the consumers who assign internal value to such a product, which is reflected in its market value. Thanks to the use of modern information technologies, the entire economy is gradually becoming a network product.

The establishment of such clusters will be accompanied by a considerable enlargement of banks through takeovers and mergers, and also due to natural growth. The number of captive accounting centers – which at present act in the guise of banks – will decrease in reverse proportion to the number of large transnational agents operating on the market. At the same time, the emergence of financial-investment clusters will resolve the old problem of orientation towards universal or specialized services in banking, by combining both, because such a division within a cluster makes little sense. Perhaps the existence of the trend in fighting the crisis explains why it is equally significant for the Russian banking system, which is universally acknowledged to still be poorly developed, and for the largest Western banks with a long and positive credit history.

The bank's leading role as infrastructure clusters in the global economy is to optimize the distribution of risks in implementing investment projects aimed at developing any socio-economic system and all its sub-systems. Strategic management, to be implemented within the framework of such industrial-financial clusters, will provide for market segmentation, rather than just diversification of production.

In raising development resources, IPOs will be replaced by private equity funds (PEF), as more transparent and controllable forms that combine design and investment approaches. The establishment of transnational PEFs will help unify world financial markets more effectively, which is regarded as a way to overcome the crisis.

The structure of the financial market will become polycentric: an increasing number of national currencies will be part of transactions as long as trade increases, so financial centers will lose their special – and privileged – significance. Investment will become instable to such an extent that the volume of investment in the economy will lose its index value, and the global openness of the market will become a major indicator of development.

However strange this might seem, this change will reduce the chances for blowing financial bubbles, which emerge in individual markets, that – for the time being – are viewed as isolated from the world market. The number and scope of projects will increase at an exponential rate, above all due to the innovation factor. The industrial development of nanotechnology alone, for example, will require tremendous funds. It is enough to calculate how much investment was needed to develop mobile communications – the best known example of the use of nanotechnology.

THE RESOURCE ECONOMY AS A RESOURCE CIRCULATION ECONOMY

In talking about the consequences of the crisis, it should be noted that the crisis has stripped the economy of illusions, reminding it of its original purpose – the circulation of material resources. The hypertrophied development of the financial sector made it seem as a self-sufficient institution of economic development. The crisis has dispelled this delusion and reminded everyone that material resources are a fundamental factor of the stable functioning and development of any economy. For Russia, this realization is particularly important because its economy continues to develop extensively, despite repeated statements from the government that the Russian economy will stop being pegged to natural resources.

Meanwhile, economic foresight suggests that extensive economic development eventually leads to a blind alley. An exponential increase in expenses for the mining and transportation of raw materials forces one to seek new ways to optimize the resource economy. There is only one way out – to launch innovation mechanisms to seek and apply new technologies, including high technologies, for processing raw materials, and to apply new approaches to the use of resources that would ensure an exponential increase in the depth and completeness of processing. Finally, it is necessary to replace personnel with trained and re-trained workers, engineers and managers, ready for and capable of working in the new conditions.

The innovative ideology must bring about radical changes in established conservative thinking and help conserve resources by using them completely and recycling waste. Suffice it to cite one example: the so-called "tailing dumps" of mining companies contain more raw materials than they produce.

The heavy dependence of the Russian economy on the production of raw materials means not just that the budget is totally dependent on global oil and gas prices, but there is also a disregard for opportunities offered by the circulation of raw materials, from their production to use by consumers, and by the recovery of the raw-materials base. The industrial policy is therefore mostly focused on energy resources. Meanwhile, each barrel of refined oil boosts its added value two-fold or more.

The Dutch disease has an inhibiting effect on the Russian economy also because of the weakness of the resource circulation system. Moreover, Russian legislation makes no mention of such a system at all, although it mentions the circulation of pharmaceuticals, for example. At the same time, the National Security Strategy, approved by Russia's Security Council, has described the rational use of natural resources and the environment as a top priority of the domestic economic policy.

Changing raw-material sectors over to new technologies would accomplish yet another, one might even say a global, task – to preserve the environment and provide for compliance with environmental regulations in economic activity. It is not by accident that the raw materials factor has been made the cornerstone of the concept of stable economic development, put forth by renowned scientists and supported by the governments of a majority of developed states, including Russia.

Also, the concept of the social responsibility of business, which has received broad public support, should provide for an economical attitude towards natural resources – especially as such an attitude determines the effectiveness of the whole economic system.

Finally, the solution to the problem of rational development of the resource economy is closely linked with Russia's position on the world market. Until now, the country's position on the European market has been determined exclusively as a supplier of fuels, mostly oil and gas. Meanwhile, the Reuters/Jefferies CRB index includes 19 kinds of raw materials.

Decades ago the Soviet Union did a great service to Germany by removing all of its obsolete equipment as war reparations, and thus forcing the country to renovate all its production facilities. Now the crisis will act as such an innovation "executor," although one can hardly expect a new Marshall Plan, for example, from the G20.

Economics would be a simple science if there were no politics in it. Thus, the depth and clarity of the horizon in developing a post-crisis economy depends on whether politics complies with economic laws or goes against them.

World Architecture: Time to Create

Boris Yeltsin reanimating the Russian economy.
The Guardian, 1992

❝ *As regards structural overhaul of the economy, the U.S. seems to have missed the chance offered by the end of the Cold War much like the Soviet Union missed the opportunity to launch broad social and economic reforms in the mid-1970s. For decades, the U.S. transformational potential rested on benevolence, which stemmed from the opportunity to resolve its problems thanks to its privileged position in the global financial system.* ❞

The End of the Cold War and the Acquisition of Meaning

A Glimpse at the International System Transformation

Alexander Kramarenko

The end of the Cold War caught many people by surprise on both sides of the infamous Iron Curtain. It bred a euphoria that was not a substitute for sober analysis, which simply seemed to be uncalled for at the time. The awareness came much later that the world had entered an unprecedented transitional period in its development that would obviously result in an intellectual challenge. These moods were summarized in a call to formulate a shared vision of the new historical era. The crisis of U.S. foreign policy, boldly manifested in "war of choice" in Iraq, sent a signal of alarm. It seemed that a country that had emerged victorious from the Cold War should not undergo this crisis. Yet we are now seeing a global financial and economic crisis rooted in the ideologies and practices of how the U.S. financial sector functioned over the past two decades. It shows convincingly that one-sided solutions and actions cannot bring any of the so-called public goods to the international community. On the contrary, solutions are not being found to existing problems and new ones are springing up.

Presumably, the riddle of the current stage of global development cannot be solved unless one gleans the meaning of what happened at the end of the 1980s and the beginning of the 1990s. It would not be an overstatement to claim in this connection that the problem of what the future has in store for the U.S. – which has become the façade of the historical West – will be of key significance.

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AMERICA... WHAT KIND OF AMERICA?

The results of the 2008 U.S. presidential election expressly show that Americans have acknowledged the need for change. The question is what kind of change and how fast it will materialize. There are grounds to believe that the WASP (White Anglo-Saxon Protestant) factor in the U.S. has reached a critical juncture in its onward evolution that lasted four centuries. Like Russia, the U.S. can only change on its own, but, quite obviously, also by interacting with the rest of the world. All the international partners of the U.S. will have to recognize this reality and display an understanding of the complexity and painfulness of transformations in that great country.

Opinions differ widely over what kind of America the world really needs. For instance, Dominique Moisi, a senior advisor at the French Institute for International Relations (IFRI), claims that the world needs the Old America that has been lost. Boston University professor Andrew Bacevich sounds more convincing when he recommends proceeding from the postulation that "transforming the United States was likely to prove an easier task than transforming the world" (*Foreign Affairs*, July/August, 2008). In other words, the case in hand is to integrate oneself – along with all the others – into a markedly new phase of global development heralded in by the Cold War and its conclusion.

Since the Cold War was not followed by any meaningful international debate that could have helped understand the importance of the changes that had taken place, the U.S. political class came to mistaken conclusions about international affairs and, above all, the economy and finance. The latter sector also witnessed the prevalence of inertia and a willingness for generalization on a global scale. This could be seen, for instance, in an attempt to force the Europeans to pursue a tougher U.S.-style social and economic model through the Lisbon agenda for the EU. It appears that the line of socialization of Western Europe's economic development during the Cold War had been a tactical stratagem dictated exclusively by geopolitical considerations, above all, the necessity to respond to "the Soviet Union's challenge." Moreover, U.S. political leaders embarked on dismantling the balance between the market forces and state regulation of the economy that had taken shape at the end of President Franklin D. Roosevelt's New Deal. The policy of deregulation was launched during the presidency of George H.W. Bush and it unavoidably spilled over to other Western countries. The degree to which the barriers in the way of the free market were eliminated actually largely foretold to what extent one or another country was afflicted with the crisis.

As regards structural overhaul of the economy, the U.S. seems to have missed the chance offered by the end of the Cold War much like the Soviet Union missed the opportunity to launch broad social and economic reforms in the mid-1970s. For decades, the U.S. transformational potential rested on benevolence, which stemmed from the opportunity to resolve its problems thanks to its privileged position in the global financial system. This allowed the Americans to live beyond their means – the combined federal budget deficit and the current accounts balance amounted to 8 percent of GDP, or $1 trillion, in recent years. This course ran counter to the foundations of U.S. morals that had emerged from Puritan ethics.

That is why the election of Barack Obama as president could not be something accidental; much like the arrival of the George W. Bush administration to the White House, which accelerated the complex process of America's self-destruction, had not been accidental. The shock from the distresses that embraced the finance sector – the most vulnerable for the American consciousness – has set the scene for launching a radical transformation of the country. Everything will depend on how big the revolutionary potential of the new administration really is. The main thing is not to regard these painful shocks as the U.S. having lost the fight. They should be seen as the results of an obsolete system and a hawkish ideology that have outlived themselves and that failed to meet modern requirements. An approach of this kind helped Russia overcome its national disaster after the disintegration of the Soviet Union, recognize the causes of what had happened, draw conclusions, and rise to its feet again.

It is important to remember that the Soviet Union and the U.S. had much in common during the Cold War: their foreign policies were equally ideologized; they both put emphasis on official propaganda, conformism and patriotism; and they both abided by the same categories of political rationality. I trust the correctness of claims that history eliminates – one after another – the extremes of social development represented by various products of Western liberal thought. One such extreme was Soviet ideology, manifested in the rejection of private ownership, the socialization of property and command management of the economy. The U.S. represented the opposite extreme – the boundless freedom of private enterprise. This means that the current crisis in the U.S falls into the same category as the breakup of the Soviet Union.

The U.S. will probably emerge from its deep transformation as a basically new country, one that it has never been seen before, with the exception of the ingenuous glimpses of people like Franklin D. Roosevelt, Dwight Eisenhower or John F. Kennedy. They all recognized a multipolar world as something inescapable and realized the danger stored in the militarization of foreign policy and the economy, and this understanding put them closer to the Europeans, whose outlook had been shaped by the end of the Cold War.

It would be the least desirable to see "the Americans' instinctive wish to be left alone" (Zbigniew Brzezinski, Brent Scowcroft. America and the World. Basics Books, New York, 2008, p. 35). prevail in this situation. Zbigniew Brzezinski's vision of the U.S. leading role as a catalyst of collective action that the international community is ready to undertake appears to hold water. This role will require a considerable renovation of U.S. society towards "greater enlightenment." This prompts the conclusion that tangible changes in U.S. policies can only result from America's own genuine transformation.

RUSSIA AND THE WEST

The pivotal point in global development inevitably makes one turn to the philosophy of history; otherwise the essence of current events will be impossible to understand. A superficial analysis leads to mistaken strategies. This is graphically illustrated by the calls for the West's civilizational solidarity for "the defense of Western values and lifestyle," although one can clearly see that the global financial crisis is, first and foremost, a crisis of the Western lifestyle no longer supported by intellectual or other resources.

"The 500-year global domination by the Atlantic powers is coming to an end," Zbigniew Brzezinski believes (*International Herald Tribune*, December 17, 2008). It is here that the fundamental issue of Russia and the West comes into the spotlight. In essence, we shared all the tragedies that swept Europe in the 20th century – the continent's "twilight period" when the Western part of the continent set the tune for the development of all European civilization. An opportunity has arisen with the end of the Cold War for genuine collective decision-making in the Euro-Atlantic region, but this is inconceivable without Russia's equal participation.

Back in 1918, Oswald Spengler spoke about "the decline of the West," implying the final stage of existence of the West-European/American culture. He linked this stage of the transformation of culture into civilization to imperialism and presumed it would follow the Roman-Puritan-Prussian line.

Yet history has proven the essential bankruptcy of the claims of Greater Prussia – which Germany turned into through Bismarck's will – for imperial leadership. In reality, a united Germany became a tool for the destruction of Old Europe and this was convincingly shown by the outcome of both World Wars. In actual life and in the conditions of democracy, German heroism (as opposed to English mercantilism) combined with the Prussian spirit eventually bred Nazism – which Spengler could witness himself.

In fact, Nietzscheanism, which advanced the cult of the Жbermensch (Superman, or Overman), and declared the "death of God," could not produce anything else. The Russian writers Fyodor Tyutchev and Fyodor Dostoyevsky foresaw the stalemate of Western anthropocentrism. Remarkably, they did so even before Spengler, whose analysis was torn off – and not by accident – from the Christian roots of European civilization. As for the fruit born of European civilization, it has become obvious that the entire range of current global problems is a product of the five centuries of Western dominance in politics, the economy and finance.

Incidentally, Spengler's skepticism caused an allergic reaction among Russia's Bolshevist leaders as well. They had their own ideas of what concerned breathing new life into European civilization and making it more universal – along the lines of a "world revolution." Here lies the deep-rooted commonality of Bolshevism and the idea of "the historical West," which permits a view of the Cold War as a method of Europe's global domination.

The problem of the historical West is especially acute on the other side of the Atlantic because the burdens of politics grounded in the instincts and prejudices of the past have proven to be the heaviest there. It is hard to escape the conclusion that we have been witnessing the Spenglerian “internal destruction” of the failed Western global empire. Even though the unipolar world existed at the level of mythology, it had an influence on international relations. Many countries were spellbound by the image of the only hyperpower, believing that it actually existed, and that is why the empire did exist, albeit in a sketch drawing.

Spengler’s theory is still relevant merely for the fact that it helps to understand a lot in European and world history. Without intending to make accounts to the West, one nevertheless has to admit the huge costs of the Western freedom from moral imperatives – Nazism, two World Wars, the Cold War, and the current global financial crisis. Joseph Stiglitz, the Nobel Prize winning economist, said that this crisis has been bred by “the toxic mix of special interests, misguided economics and right-wing ideologies,” as well as the faith that investment banks and ratings agencies had in the “financial alchemy” (*The Guardian*, September 30, 2008), which differed little from the one practiced by financial pyramids in England and Holland in the early 18th century. In other words, liberal capitalism has gone full circle. That is why it is really difficult to believe in the possibility of a return to the state of affairs “as before,” or as if nothing has happened. At any rate, the uniqueness of the first crisis in the era of globalization calls for greater caution in forecasts.

The international community has been idly watching the frustration of balances in the global system for too long. Crises and instability will continue to plague the world while the general rules of the game are absent. A smooth landing is only possible if all the players that have the considerable potential and resources necessary for implementing coordinated decisions become engaged in the game. The legitimacy of any system of global governance will be determined by its efficiency – in counteraction to the new challenges and threats common for all countries.

If this is the case, all of European civilization will be rejuvenated, not decline, on a truly collective basis. Anyone can see plainly that the tragic experience of the 20th century has transformed Western Europe into something compatible with other cultures and civilizations. This shows through in the integration processes within Europe; its apparent reluctance to wage wars outside its borders (this is proven by Washington’s endless complaints against its NATO allies); and the desire to consolidate international legitimacy. This mild non-aggressive worldview unites Russia with the vast majority of European countries and one may expect that the U.S. will choose this path as well, after it draws conclusions from its political experience of the past few years. Interesting enough, even a politician as pro-Atlantic as former British prime minister Tony Blair has developed an understanding of the need for "peaceful coexistence of the global society in which we live" on the basis of a broad spectrum of values that would include, apart from democracy and the market, "the common good, compassion, and justice" (*International Herald Tribune*, December 18, 2008).

But the most optimistic factor is that in the greenhouse conditions of the Cold War, the greater part of Europe has elaborated a socially-oriented model of economic development and a broad representative democracy relying on a sizable middle class. Russia, too, has opted for this path. America's middle class rose out of the post-World War II demobilization programs and FDR's New Deal aimed at attaining the same objective. As *The Economist* magazine wrote, state regulation had existed in the U.S. economy even before the George W. Bush administration launched its latest measures, specifically the government's sponsorship of the system-building mortgage corporations Fannie Mae and Freddie Mac. Therefore, the biggest danger posed by this crisis is the potential blow to this class and, consequently, to all the achievements of European civilization that laid the groundwork for domestic peace in postwar Europe. Maintaining the middle class and the achievements of European civilization can provide the only guarantee to prevent the materialization of Spengler's forecast for an "inward decline of the nations into a formless population" and a "slowly thrusting up of primitive human conditions into the highly-civilized mode of living." Elements of this can easily be seen in Europe's 20th-century history.

The systemic nature of the crisis of the historical West is acknowledged by German philosopher Jürgen Habermas. He believes the extolment of neo-liberal individualism has proven that there is a "historical impasse" and that the future lies in developing the theory of democracy along the European path. In any event, this is not the end of the road, as we are dealing with a radical transformation capable of giving a new lease on life to

European civilization at a new stage of historical development while maintaining the fundamentals of the market system and democracy.

This scenario requires a return to the Westphalian principles of international relations. One should remember that the 17th century exodus to America by the Puritans and other bellicose Protestants – unwilling to accept the compromise offered to them at the end of the revolution in England – imparted Europe with an opportunity to live by the Westphalian rules, which placed value-related and religious distinctions outside the interstate format. The return of the U.S. to European politics made it extremely politicized during the Cold War. Now it is time to part with this aberration and to begin living by European rules of tolerance.

History means too much to neglect its lessons today. Of genuine interest in this respect are the documents related to the Munich Agreement. Seventy years have passed, but these documents still remain classified. Is there really something worth concealing? These documents could shed some light on the degree to which efforts by London and Paris to appease Hitler were motivated by an unwillingness to go to war and the ideology behind the Agreement; i.e. the eagerness of the ruling classes to channel Nazi aggression to the East and thus avoid finding a solution to the overripe problem of the transformation of European society. This transformation became possible only after World War II and took the form of a geopolitical imperative of the Cold War.

HISTORIC MISSIONS OF YESTERDAY AND TODAY

Every great nation – and Russia and the U.S. in particular – has its own mission in history, with national crises and disasters sending the signal if the mission is accomplished. It is important to consider not only the missions that have been accomplished, but also those that will follow suit. If one looks at Russia's role in European construction – that is, its mission in Europe – one cannot but help agreeing with Pyotr Stegny who says that Russia's inclusion in the Westphalian system was prompted by its growing relevance in European affairs on the geopolitical, economic, cultural and civilizational planes (Pyotr Stegny. Comprehending a Shared History. *Mezhdunarodnaya Zhizn*, 10/2008).

Russia and the Soviet Union accomplished a mission of a historic scale, at least in what concerns the shaping of the political map of Eastern Europe where all the countries, including the former Soviet republics, have acquired clear-cut borders. This is in addition to the main mission – the disruption of two attempts to unify Europe by force that were made by Napoleonic France and Hitler's Germany. This accomplishment made it possible to build today's Europe. Who else could counteract Napoleon and Hitler on the ground as efficiently? In other words, in all previous eras, including the Cold War, Russia had the mission of cutting short "the flight of the Faustian soul into Limitless Space" in international relations.

It is too early to declare an end to Russia's geopolitical mission – as it is equally inappropriate to speak of the "end of history." However, the radically changing globalized world will force all leading countries to reformulate their missions. Russia continues to shoulder the burden of maintaining strategic stability – a carryover mission of the Cold War era. Tyutchev's idea that "Russia's very existence denies the future of the West" has gained a new meaning. Whatever role Russia had in disrupting the West's project of a global empire/world revolution after the end of the Cold War, its foreign policy independence makes any dominance on the Euro-Atlantic or the global scale impossible. The alternatives promulgated by Russia – equal interaction with the EU and the U.S., the general political unity of European civilization and the collective leadership of the world's leading powers – make up the content of this country's historic mission at the new stage. The demand for such changes was proven at the G-20 Washington Summit, which is widely regarded as a de facto expansion of the financial G7.

The crux of the matter is bigger than what Martin Gilman said about the importance for donor countries, including Russia, to set the tune in the current financial system in the same way that the U.S. did during the rise of Bretton Woods institutions (*Vremya Novostei*, November 11, 2008), although he is right too. A collective effort by all the main players towards reforming the present architecture in order to secure the world against similar crises in the future has much more importance now than the wish to emerge from the crisis ahead of everyone else.

The missions of other leading global players, like the U.S., have not been exhausted either – they are simply undergoing a reformulation. If "the promulgation of freedom and democracy" implies a historic mission, then the best way to accomplish it would be to set one's own example. It would be a good thing if the U.S. fought global poverty, developed alternative sources of energy, and resolved the entire spectrum of human problems, thus creating conditions for the normal internal development of all countries. One can hardly disagree with Fyodor Lukyanov when he said that the idea of democracy should be defended against efforts to transform it into a tool to serve geopolitical ambitions.

Renouncing the official revolutionary mythology would bring benefits too, not least because the latter blesses political violence. How should one fight terrorism if it picks up slogans of terror from the annals of European and North American history? Russia has renounced these myths and European countries are doing so in one measure or another as well, but the U.S. is taking its time. Is it because the entire exclusiveness of America's global mission is rooted in the myths of its War of Independence?

As Roger Cohen writes, "it has been hard to grasp in Washington that the same forces [...] that helped deliver the United States to the post-Cold-War zenith of its power [...] have now democratized power" (*International Herald Tribune*, December 16, 2008). An ever-growing number of countries are becoming engaged in the creation of history – independently or as part of various forums or integrating associations like the G8, the G-20, the EU, the Shanghai Cooperation Organization or BRIC (Brazil, Russia, India and China). Objective conditions are taking shape for a new moment of convergence in the Euro-Atlantic region – on the basis of civilizational products that can be proudly offered to the world. The same goes for the task of establishing collective leadership of the European civilization in global affairs (Sergei Lavrov. Face-to-Face With America: Between Non-Confrontation and Convergence. *Profile*, October 13, 2008).

Standing in this line is the settlement of differences over the patchy architecture of European security. The idea of a European Security Treaty allows the security interests of the entire Euro-Atlantic family to be drawn together. Attempts to preserve the status quo will only produce gleaming new holes, the same way it happened with the Treaty on Conventional Armed Forces in Europe or may happen yet unless Russia and

NATO manage to rebuild trust in their relations. Sergei Karaganov was quite correct in asking if Russia should continue to help the alliance by keeping up the pretence of good relations with it (*Rossiiskaya Gazeta*, December 9, 2008). And what will happen to the Organization for Security and Cooperation in Europe (OSCE) if Moscow withholds its interested participation in that forum? Will many European organizations not lose a greater part of their meaningfulness in the absence of close contacts with Moscow? Discussion about the treaty could help clear up these issues and, above all, tap a general answer to the main question of our time – the one about its meaning.

It is very unlikely that Russia's recognition of the independence of South Ossetia and Abkhazia produced a bigger crisis in its relations with the EU and the U.S. than the unilateral declaration of independence by Kosovo, which the Europeans and Americans supported. If anyone should refer to a crisis, this is most obviously a continuing crisis of misunderstanding that calls for joint handling on both sides.

A clear indicator of this is Washington's propensity to cite China's cautious conduct as an example for Russia to follow. However, unlike Russia, China is not a member of the Euro-Atlantic community and is not bound to the U.S. by a strategic stability relationship – the latter sphere contains all the points of Russian-U.S. contradictions. Moscow simply cannot overlook the issues that Beijing can keep silent on, since Russia's vital interests are at stake.

Implementing opportunities for collective action could play a decisive role in restoring the governability of global development in its current critical phase after the financial and economic crisis cleans the Augean stable of the entire international system inherited from the past and makes the rise of a new system inevitable.

The Berlin Doctrine

From Atlantic Unipolarity to a Pan-Eurasian Security Community

Adrian Pabst

In a little-noticed coincidence, President Dmitry Medvedev and the then Democratic Presidential Nominee Sen. Barack Obama delivered major foreign policy speeches in the summer of 2008 in Berlin. Notwithstanding important differences, both recognized the flaws of the prevailing international system and emphasized the need for a new global order that transcends narrow national self-interest and addresses common security threats. Crucially, President Medvedev and Sen. Obama each vowed to strengthen U.S.-Russian ties and to build broader alliances.

A few weeks later, the events in the Caucasus and the financial meltdown changed international relations and East-West ties fundamentally and irreversibly. The Georgian conflict not only exacerbated NATO's profound internal divisions but also underscored the West's lack of strategic vision and purpose.

In the foreseeable future America will remain the world's sole military superpower, but – especially since the disaster of Iraq, Guant3namo and Abu Ghraib – the U.S.A. (and her allies) have lost credibility and the moral authority to claim global leadership. Support for Mikheil Saakashvili's reckless aggression and his corrupt regime revealed once more Western double standards and the Atlanticist disregard for genuine democracy and justice.

Similarly, the economic crisis spelled the end of the neo-liberal 'Washington consensus' and confirmed the failure of the Western-dominated international architecture to regulate global finance or to reduce world-

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wide poverty and inequality. In conjunction with the demise of laissez-faire free-market ideology and the extension of state capitalism, new economic and financial centers will emerge in the BRIC countries as well as the Persian Gulf and South-East Asia. The rest of the world will no longer gravitate towards the Western orbit. Thus, the "Atlantic unipole" (Ira Straus) has already ceased to shape and direct global geo-politics and geo-economics. The utopia of a unipolar world order that was proclaimed by the Project for a New American Century now lies in utter ruins.

Paradoxically, the deepening recession that will dominate both national politics and international relations makes a pan-Eurasian security settlement more important and pressing than at any point in time since the end of the Cold War. From the economy via energy and ecology to secessionism, terrorism and cross-border crime, the leading countries in Eurasia have a strong and growing mutual interest in security cooperation. A new framework is all the more necessary since the prevailing security and defense organizations in East and West like NATO or the Shanghai Cooperation Organization (SCO) cannot cope with the emerging global constellation of overlapping spheres of influence where the rival, trans-national interests of "great powers" collide and their client states clash. This constellation portends more insecurity and conflict across the Eurasian space, especially in parts of Eastern Europe, the Balkans, the Caucasus and the Caspian, as well as Central Asia.

Presidents Medvedev and Obama face a fundamental choice. Either each continues the strategies and policies of his respective predecessor or both decide to put East-West relations on a new footing in order to try and avert further confrontation and conflict. If they can retrieve their foreign policy ideas as outlined in Berlin, then there will be sufficient common ground for an overarching security community extending from Vancouver to Vladivostok. If, moreover, the U.S. and Russian leadership can translate this vision into an institutional framework with real decision-making powers, then there will be sufficient substance for such a community to take shape.

EAST-WEST RELATIONS AFTER GEORGIA

Reactions to the crisis in Georgia revealed just how confused and outmoded the dominant thinking on European security and East-West relations is. Terms such as "totalitarianism," "appeasement," "imperialism" and "New Cold War" were applied to complex events that manifestly escape such easy categorization. Over-simplification is a poor substitute for cold-headed analysis and judgment.

Many Western politicians and pundits likened Russia's action in the Caucasus to the 1938 Nazi occupation of the Sudetenland or the 1939 Soviet invasion of Finland. Based on such dubious comparisons, they denounced what they saw as U.S. and EU appeasement of Moscow's growing belligerence. Those who draw these sorts of parallels live in the past but don't know their history. The new Russia is no liberal democracy, but anyone with basic knowledge of the Soviet (or Nazi) regime understands that the charge of totalitarianism and aggressive expansionism simply won't wash. Nor is it particularly persuasive to claim that the Kremlin is bent on rebuilding the Soviet Union. Instead, Russia under the diarchy of Prime Minister Putin and President Medvedev combines populism and authoritarian state capitalism with a neo-tsarist projection of central power and military force.

Likewise, regular Russian condemnation of Western colonialism and imperialism fails to acknowledge today's reality. Unlike Napoleon's 1812 march on Moscow or the 1941 Nazi invasion of the U.S.S.R., the U.S.A. and the EU do not have any plans to annex all ex-Soviet satellites or to colonize the whole of Russia. This false paranoia is reinforced by a culture of conspiracy and victimhood that besets large strands of Russia's post-Soviet elite.

However, it is hard to deny the growing hostility towards Russia now prevalent in America and the "new Europe." By recognizing Kosovo's independence, expanding NATO eastwards and establishing the U.S. anti-ballistic missile shield in Russia's Czech and Polish neighborhood, the West has betrayed its own promise of a strategic partnership with Moscow. Little wonder that the perceived humiliation of the Kremlin and the treatment of Russia as a third-rate power generate resentment and revanchisme.

The trouble is that when amnesia and historical illiteracy shape policy- and decision-making, a local crisis gets blown out of all proportion. Moscow's use of force in Georgia was not at all of the same order and magnitude as the Soviet suppression of Hungary's uprising in 1956 or the

Prague Spring in 1968. U.S. interventions in Washington's own Central and Latin American backyard in the 1970s and 1980s may prove a better comparison. Except, of course, that the White House and the Pentagon tend to engage in pre-emptive warfare and to practice regime change by force, whereas the Kremlin has thus far been largely reactive and left hostile governments in place.

Rather than Russia's excessive retaliation in response to Georgia's reckless aggression, it was in reality the escalating war of words between East and West that prompted unwise action and brought simmering tensions to boiling point. But history never repeats itself. The latest East-West confrontation is not a rerun of the Cold War. U.S. and Russian nuclear arsenals notwithstanding, neither country openly threatens the other's existence. Nor are East and West any longer divided by ideology. Rather, what we are seeing across the northern hemisphere is a nationalist-protectionist backlash against globalization, a (temporary) strengthening of the centralized bureaucratic national state at the expense of free-market global finance and a worrying intensification of post-democratic managerialism and political populism (as Colin Crouch has extensively documented in his book Post-Democracy published in 2004).

As such, the new East-West fault line is neither military nor ideological but instead geo-strategic. Not unlike the U.S.A. and its European allies, Russia and her fellow autocratic regimes in Central Asia seek to consolidate and extend their sphere of political, economic and cultural influence. What we are witnessing is a contest between rival blocs vying for trans-regional hegemony within the wider Eurasian space, with each "great power" backing client states and waging war by proxy. The latest examples include the West's support for Kosovo against Russia's ally Serbia and the Russian intervention in South Ossetia against the pro-Western regime in Georgia. Of course, there is no strict moral equivalence between East and West, but in geo-politics and international relations there never is. America, Europe and Russia have at different times been on the wrong side of aggression, war and occupation. Surely the world is not divided between good and evil, with Russia "either with us or with our enemies."

As things stand, Eurasia faces the prospect of more confrontation between the "great powers." The trouble is that in trying to extend their sphere of influence, they provoke each other and stir up small-country nationalism – from Croatia, Serbia and Kosovo to Ukraine, Moldova and Georgia. This, coupled with the threat of separatism, raises the specter of a Eurasian arc of insecurity stretching from the Balkans via the Caucasus to Central Asia and beyond.

THE EURASIAN ARC OF INSECURITY

Across the post-Soviet space and elsewhere in Eurasia, territorial borders are notoriously unstable. However, recent interventions on the Balkans and in the Caucasus have changed the dynamic in favor of secessionism. Taken together, Western recognition of Kosovo and Russia's support for South Ossetia and Abkhazia have strengthened the cause of violent separatism and unilaterally declared independence. However legitimate their claim to self-determination, breakaway provinces are little more than pawns in an escalating "great power" game. Moreover, unless a new security umbrella is put in place, violence could erupt in the other "frozen conflicts."

After the brutal confrontation in Georgia, a return to the status quo ante – as demanded by the U.S.A. and the EU – is both unrealistic and undesirable. The post-conflict settlements of the early 1990s settled nothing. The ceasefire accords failed to stop inter-ethnic strife and paramilitary fighting. Worse, separatist regions were abandoned in a geo-political no-man's land. A mix of U.S. disinterest, European indecision and Russian weakness limited direct foreign interventions and preserved an uneasy East-West truce. With the 1999 NATO war on Russia's ally Serbia over Kosovo, this fragile and vastly imperfect equilibrium became unhinged. After 9/11, the Bush administration continued President Clinton's NATO expansion and extended American unilateralism to Russia's southern rim, building military bases in the Caucasus and Central Asia and supporting pro-Western regime change through "color revolutions" in Georgia, Ukraine and beyond.

A resurgent Russia is determined to halt and reverse what she sees as Western expansionism in Moscow's backyard and a direct threat to Russia's national security. Prime Minister Putin and President Medvedev's intervention in the Caucasus is the first military fight-back in an attempt to restore Russia's "natural sphere of influence" and to defend what

President Medvedev called in the aftermath of the Georgian war Moscow's "privileged interests" in countries with which Russia has extensive historical and cultural ties. In response, the U.S.A. and its partners in Central and Eastern Europe have pressed for NATO enlargement to Georgia and Ukraine and called for international containment and isolation of Russia, all in the name of enlightened interests that serve sovereign nations and uphold the values of the self-anointed "international community."

SOVEREIGN POWER AND THE LIMITS OF INTERNATIONAL LAW

The defense and pursuit of "privileged" or "enlightened" interests risks violating the principle of national state sovereignty (whose roots can be traced to the 1648 Peace of Westphalia). This principle, which has been repeatedly invoked by Russia, is of course one of the cornerstones of international law.

By effectively elevating Russian national interests over those of its neighbors, the Kremlin comes perilously close to inventing its own variant of the Monroe Doctrine – with the key difference that America tends to see U.S. interest as synonymous with the interests of mankind and the rest of the world, whereas Moscow's outlook does not so far extend much beyond the post-Soviet space.

However, the existence of "great power" spheres of influence undermines the very foundations of the international system by causing permanent instability and provoking proxy wars. Indeed, as early as 2003 – the year of regime change in Iraq and Georgia – the Bush administration blamed the Westphalian system of state sovereignty for competition and war and sought to replace it with an alliance or federation of democracies under the sole leadership of America – an idea that inspired Sen. John McCain's call to abolish the U.N. in favor of a "League of Democracies."

Far from being a post-9/11 invention, the underlying neo-conservative ideology inspired the liberal interventionism of Clinton and Blair in the second half of the 1990s. Not only did it legitimate "humanitarian warfare" on the Balkans and in Kosovo, it also led to a fundamental change in international law, as codified in the principle of "Responsibility to Protect" adopted by the U.N. in 2005.

In principle, there is nothing wrong with limited military interventions aimed at preventing or stopping ethnic cleansing or genocide. However, without a transcendent account of justice and a proper supranational authority, the "Responsibility to Protect" – with few exceptions – has become an instrument of blackmail, intimidation and selective interference in the hands of the "great powers."

More fundamentally, the international system in its present configuration is caught in an irreconcilable contradiction between the twin principles of national sovereignty and territorial integrity on the one hand and the right to national self-determination and the "Responsibility to Protect," on the other hand. In the absence of a proper global and universally recognized authority independent of national veto power, individual "great powers" – chief of all the U.S.A. – arrogate to themselves the right to decide on legality and legitimacy. In so doing, they cease to be subject to international law whilst at the same time purporting to embody and defend the values and principles of the international community. Russia's sterile appeal to international law is therefore unlikely to prevent or mitigate the clash between rival, overlapping spheres of influence and interest.

Moreover, the core problem with international law is that it is constitutively incapable of limiting the power of states. This is so because the state monopolizes sovereignty in this sense that it alone has the power to decide on the "state of exception" – the suspension of the law for the sake of protecting the law against external threats and enemies (as political theorists like Carl Schmitt and, more recently, Giorgio Agamben have shown). In its present form, the inter-state system is clearly grounded in the primacy of national state sovereignty over international trans-statal law. As a result, unmediated absolute sovereignty creates the potential for violence within and between states that the central state purports to regulate on the basis of its monopoly on the use of physical force (as Max Weber argued).

While it is true that globalization and civil society have to some extent diluted central power and diffused state sovereignty, it is equally true that the ongoing economic turmoil has once more strengthened the power of the state in collusion with the market – at the expense of intermediary institutions and local communities. Crucially, recent security threats such as Islamic terrorism or cross-border crime have been used by states as a pretext to extend executive power to the detriment of legislative scrutiny and judicial oversight. However, not unlike transnational markets, transnational security threats have not as yet led to transnational structures which pool national state sovereignty in order better to protect collectivities. These problems are also reflected in the inadequate security arrangements in the Eurasian space.

THE INADEQUACY OF EURASIAN SECURITY ARRANGEMENTS

If international law cannot effectively limit the power of sovereign states, the only alternative to a clash of "great powers" is to pool sovereignty and to establish shared security structures. The Georgian crisis revealed once more how inadequate the prevailing security arrangements in the wider European and Eurasian space are. None of the existing organizations is capable of adjudicating trans-national, inter-state territorial disputes or resolving the fate of regions that seek autonomy. What Europe and Eurasia require is a different security architecture that can minimize the ubiquitous risk of conflict contagion and provide long-term political settlements.

Unsurprisingly, the dominant security organizations in Eurasia are all ill adapted to this imperative. NATO in particular lacks a coherent conceptual basis. Originally designed to provide collective defense guarantees in exchange for limited national sovereignty, the North-Atlantic Treaty Organization has been transformed into an attacking alliance, waging "humanitarian warfare" on the Balkans and converting Afghanistan to democracy by force. The NATO-Russia Council is nothing more than a talking shop designed to pacify Moscow and to provide a semblance of Euro-Atlantic cooperation. Eastward expansion has already proven divisive and destabilizing, precisely in Georgia and the Ukraine

Moscow looks to the Shanghai Cooperation Organization (SCO) as NATO's eastern rival, especially at a time when the West faces a growing insurgency in Afghanistan and mounting resistance by Pakistani militants who threaten to cut off supply routes. By coming to NATO's aid in Afghanistan, member-states like Russia and China hope to establish and legitimate the SCO internationally. Moreover, the Kremlin hopes to forge closer ties between the SCO and the Collective Security Treaty Organization (CSTO), a military alliance of Russia, Belarus, Armenia, Kazakhstan, Tajikistan, Kyrgyzstan and Uzbekistan that includes mutual security guarantees. Yet Russia's current alliances are limited in scope and reach. More fundamentally, both the SCO and the CSTO are founded on the absolute supremacy of sovereign states and do not have any provisions to pool the sovereignty of their members.

The European Union is the only framework where sovereignty is bounded and shared by member-states and power is diffused. Moreover, the EU is a growing civilian force and Eurasia's single largest trading partner. But its post-national constitution and economic clout are not matched by its geo-political weight. Since the 1991 common foreign and security policy, the EU has neither developed a shared geo-strategic vision nor put in place the necessary military capabilities. Crucially, the Union is deeply divided over Russia, with the UK and "new Europe" opposed to the EU-Russia strategic partnership favored by Italy, France and Germany. Without a collective Ostpolitik, how can Brussels hope to engage Russia and offer a credible alternative to NATO?

With 56 member-states from Vancouver to Vladivostok, the OSCE is of course the only genuinely multilateral forum that focuses on conflict resolution and conducts field missions in the Caucasus and elsewhere in Eurasia. However, the organization's effectiveness is seriously undermined by a lack of political authority and the absence of independent capabilities.

THE BERLIN DOCTRINE

Dmitry Medvedev's speech in Berlin on June 5, 2008 on his first trip to the West as President set the tone for renewed reflections on an expanded Euro-Atlantic Community that includes Russia not on Western but instead on shared terms. Sen. Obama's speech in the same city on July 24, 2008 echoed the desire to overcome the current East-West divisions and to build a new global order on the basis of universal values.

Critics will contend that all this was empty rhetoric void of any substance. They will assert that a 21st-century pan-European security community is utopian and that East and West will continue to diverge, as they have done since at least 2003. However, without a common framework that is based on new rules binding on all and that extends to Russia (as well as possibly China and some Central Asian countries), trans-regional security threats in the wider Eurasian space such as terrorism or separatism and cross-border security problems such as organized crime cartels will only intensify. The Obama administration has already acknowledged that the U.S.A. is unable to solve global problems alone and that America will have to forge new partnerships in order to confront shared security threats. There is thus a unique window of opportunity to develop a new security doctrine and a new security framework.

Indeed, all the dominant security concepts since the end of the Cold War are conceptually flawed and geo-politically obsolete. The post-1989/90 world order of multilateral cooperation and boundless globalization failed in Somalia, Rwanda and the Balkans. Post-9/11 U.S. unilateralism and conversion to democracy by force was defeated on the battlefields of Iraq and Afghanistan as well as, more recently, in Georgia. The "global war on terror" that briefly brought Russia and the Atlantic community together was purely tactical and always lacked any substantive geo-strategic basis.

By contrast, the post-Cold War vision of a Euro-Atlantic security Treaty as enshrined in the 1990 Paris Charter that transformed the CSCE into the OSCE might have provided a starting point for a pan-European "security community" (Karl Deutsch) – had it not been for the "unipolar moment" (Charles Krauthammer) that drove a permanent wedge between NATO and Russia and prevented any genuine rapprochement between East and West. Now that the "Atlantic unipole" has conspicuously failed to provide an effective and reliable security umbrella even for the West and its new allies, it is imperative to replace U.S.-led Western unilateralism with a pan-Eurasian settlement that includes Russia and perhaps also China and Central Asia.

President Medvedev has repeatedly offered his European and Atlantic counterparts to put in place a Treaty on European Security. In his address to the World Policy Conference on November 8, 2008 in Evian, President Medvedev stated that his idea is to convene a pan-European security conference with the participation not only of individual states but also of international organizations active in Europe, including the EU, NATO, the Council of Europe and the OSCE. Dubbed "Helsinki-2," President Medvedev's plan is of course modeled on the OSCE's forebear, the CSCE – a two-year process of sustained east-west engagement in the 1970s that was instrumental in mitigating the binary logic of the Cold War and establishing a common framework for regular discussion and multilateral negotiation. With the OSCE's remit effectively reduced to the "low politics," neither the NATO-Russia Council nor the EU's strategic partnership with Moscow ever provided a comparable platform.

President Medvedev's plan lays emphasis on international law, but given the existing tensions and contradictions, what is required is a profound overhaul of the international legal system. Based on a revised set of principles that codify shared sovereignty, a European Treaty on Security could make a contribution to a proper reform of international law. Here there is common ground with the EU's post-national political structure.

In addition to internal inconsistencies, the main obstacle to President Medvedev's initiative is a lack of political will on the part of EU leaders and the U.S. government. It is clear that President Medvedev's intention is to change the terms of the debate on the future of security in Europe away from NATO towards a new body that includes Russia as a founding member. As such, his proposal is unacceptable to most EU countries and virtually all NATO allies.

With NATO determined to press ahead with eastern enlargement and the EU divided on Russia as well as lacking a coherent geo-strategic vision, President Medvedev will make little progress at a multilateral level. The Kremlin has long given up on joining NATO or forging a substantive partnership with the Union in the area of security or even defense. It views NATO as a Cold War relic and the EU as little more than a common market with some crisis management capabilities. As a result, the Russian leadership will probably try to rally bilateral support for its initiative among major European powers such as France, Germany, Italy and Spain. However, the greatest and most pressing challenge will be to convince the Obama administration to take the Russian proposal seriously. President Medvedev needs a road map that sets out a credible process from the status quo to a new pan-Eurasian security settlement.

HOW TO GET FROM HERE TO THERE AND AVOID THE BIG BEAR TRAP

Left unchallenged, the current dynamic that drives East-West relations will lead to further estrangement, confrontation and conflict by proxy.

Neither Russia's full integration into the North-Atlantic alliance nor her total encirclement is realistic or desirable. Now the choice is between isolation and engagement on common terms. The West needs to give Russia equal ownership of a joint framework to devise principles and mechanisms for a new security doctrine. By accepting equal ownership of a joint process, the West could in exchange press Moscow for a permanent political settlement of Europe's outstanding territorial conflicts.

A first step would be to set up a high-level U.S.-Russian commission charged with rethinking bilateral relations. Based on the wide-ranging agreement signed in April 2008 by former Presidents Vladimir Putin and George W. Bush, such a commission could recognize shared interests in addressing common security problems in the Eurasian space and coordinate joint action to fight the most pressing threats. With confidence-building measures, improved U.S.-Russian relations are a condition sine qua non for an overarching Eurasian security structure.

A second step would be to convene a security conference with the participation of the U.S.A., Russia, the EU, possibly China, separatist regions and their (former) masters. The participant parties to this conference could then debate and devise new policies and mechanisms for crisis prevention and crisis management. In addition, they could devise new criteria for dealing with unrecognized states, and agree new rules of military engagement in the event of separatism that would be binding on all parties.

If successful, such a security conference could gradually evolve into a pan-Eurasian security community. Building on the achievements of the OSCE, such a community could help develop a shared security strategy. One concrete purpose could be to invent new concepts and policies dealing with the tension between national sovereignty and territorial integrity, on the one hand and national self-determination and the "Responsibility to Protect," on the other hand. In the event of sufficient political support from the main powers, such a community could set up a permanent security council and regular ministerial meetings to exchange information and best practices, oversee the implementation of peace accords and political settlements, as well as work on arms control and the reduction of nuclear warheads.

Western politicians and pundits will contend that this is to fall into a bear trap. Surely the Kremlin is pushing for a collective framework in order to veto NATO enlargement, block the U.S. anti-missile shield, bring in China to dilute Western power, as well as impose neutrality on Ukraine, Moldova and Georgia. Perhaps. But within a multilateral framework based on strong bilateral relations, it is unlikely that Moscow could dictate conditions unilaterally.

* * *

At the dawn of the 21st century, East and West appear to have adopted a 19th-century mindset of "great power" spheres of influence in order to address security problems left unresolved by 20th-century institutions that are either divisive (like NATO) or divided (like the UN and the EU) or just feeble (like the OSCE and the Council of Europe). Little wonder that violence and war erupt with frightening frequency.

With East-West ties at their lowest since 1986, President Obama and President Medvedev have the opportunity to change the current dynamics and to put U.S.-Russian relations on a new footing. But a new dOtente between global powers requires more than better bilateral cooperation. By reconfiguring the prevailing security arrangements in the wider European and Eurasian space, the U.S.A. and Russia could lock in progress in their bilateral ties and extend this to their allies and partners in Europe and Central Asia. The existing institutions lack a coherent conceptual basis to address contradictory principles and the reality of diffuse sovereignty and a complex power matrix. Within an overarching pan-Eurasian framework, states and organizations could come together to develop new concepts and policies in order to adapt the norms of international law to the new geo-political constellation. They could also devise new ways of blending global principles with local practices.

Now it depends on the political will and courage of the American and Russian leadership to translate their common vision of a multi-polar and multilateral order into the reality of shared institutions and concrete policies. Nothing less than a new security doctrine is at stake. As the symbol of absolute war, East-West division but ultimately a world that stands united, what better name than – Berlin Doctrine?

Action and Counteraction

Can Russia and the U.S. Reach Agreement on Missile Defense?

Victor Yesin

Washington's plan to deploy a European segment of its missile defense system is a most sensitive issue and a major pet peeve of Russia-U.S. relations. Many observers agree that the ability of the sides to find a compromise solution to this problem would be indicative of the prospects for bilateral ties in the years to come.

PASSIONS OVER THE THIRD POSITION AREA

The planned third position area of a U.S. global missile defense system would include silos with interceptor missiles in Poland (the Ustka military range near the town of Slupsk in Pomeranian Voivodeship) and a missile defense radar in the Czech Republic (the Brdy military area near Jince, 60 km south-west of Prague). The first and second position areas of the ground-based echelon of the U.S. strategic missile defense system are deployed on the territory of the United States – in Fort Greely, Alaska and at Vandenberg Air Force Base, California, respectively.

The decision made by Washington in late 2005 to deploy a third position area near Russia's western border was taken by Moscow as a threat to its national security. (For more on this subject, see "Missile Defense Challenges" by Pavel Zolotarev in *Russia in Global Affairs*, No. 3, July-September 2008.) To allay Moscow's fears, the George W. Bush administration made several attempts between 2006 and 2008 to convince the Russian leadership that the third position area was not directed against Russia.

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However, Russian and even some U.S. experts found Washington's arguments untenable. The U.S. experts included Theodore Postol of the Massachusetts Institute of Technology; George Lewis of Cornell University; Richard Garwin, holder of the U.S. National Science Foundation's award; Philip Coyle, former deputy director of the National Nuclear Security Administration's Lawrence Livermore National Laboratory; David Wright of the Union Concerned Scientists NGO; and others.

Russian President Dmitry Medvedev, in his annual address to the Federal Assembly on November 5, 2008, said that Russia would take measures to "effectively counter" the U.S. plans to deploy elements of its missile defense system in Eastern Europe. The Russian leader proposed refraining from plans to decommission a missile division deployed in Kozelsk, near Kaluga, and deploying Iskander missiles in the Kaliningrad Region, "if necessary." Also, the president said measures would be taken for electronic jamming of the new installations of the U.S. missile defense system.

Medvedev's statement enhanced the concerns of Old Europe about the deployment of the third position area. French President Nicolas Sarkozy, who held the rotating EU presidency then, warned against pushing for the implementation of the missile plans and proposed discussing the problem at a summit of the Organization for Security and Cooperation in Europe. The Italian Prime Minister Silvio Berlusconi supported the French president.

Addressing the Council on Foreign Relations, an influential nongovernmental organization, on November 15, 2008 in Washington, Medvedev emphasized that Moscow would "take no action unless America takes the first step." In his view, the missile defense problem could be solved either by establishing cooperation between Moscow and Washington in building a truly global missile defense system, or if the U.S. took into consideration Russia's present concerns.

This statement was followed shortly by reactions from the political leaders of the Czech Republic and Poland. Czech Prime Minister Mirek Topolánek said Russian inspectors might be allowed to visit the U.S. missile defense radar in the Czech Republic, while Polish Foreign Minister Radoslaw Sikorski said his country was ready to agree to the presence of Russian observers, although not permanent presence, at the planned U.S. missile defense base in Poland. This would be a factor of confidence in the difficult negotiations with Russia on the missile shield, he added.

Meanwhile, access for Russian observers to the U.S. missile defense facilities in the Czech Republic and Poland was discussed way back in April 2008 at a meeting between Vladimir Putin and George Bush in Sochi. However, both Prague and Warsaw categorically rejected such a possibility. Later, they changed their position – probably due to Moscow's declared plans to counter the U.S. missile defense system in Europe with Iskander missiles, and due to the position taken by the leaders of France and Italy with regard to the U.S. missile plans.

The positive changes in the settlement efforts were torpedoed by decisions made at a meeting of the North Atlantic Council on December 2-3, 2008 in Brussels. The meeting's final communiqué declared plans to build a "NATO-wide missile defense architecture" that would include the European-based U.S. missile defense assets. The communiqué makes no provision for Russia's participation in working out a concept for this Europe-wide integrated missile defense system and, consequently, in identifying its targets (i.e. against what missile threats it would be targeted). So, a hypothetical European missile defense system, including the third position area of the U.S. missile defense system, would have a capability targeted against Russia. NATO's readiness to "explore the potential for linking United States, NATO and Russian missile defense systems at an appropriate time" does not change much for Moscow.

NATO's decisions were largely determined by the goals of the previous U.S. administration. By concluding bilateral agreements with the Czech Republic and Poland for the deployment of the third position area without consultations with other NATO partners, Washington sought to bury the idea of building a European-Russian missile defense system, which was acquiring real shape then. After a series of joint computer-assisted command post exercises, which involved, among others, Russia, the United States and Canada, the parties agreed their approaches not only to a Europe-wide missile defense architecture but also to the compatibility of their missile defense assets and command information systems. Now, Russia has been actually excluded from the European missile defense configuration.

An analysis of various options for building a European missile defense system is planned to be prepared for a meeting of NATO defense ministers, scheduled for February 2008 in Kraków (Poland), and a respective report will be submitted to a NATO summit meeting, to be held in April. With regard to Russia, NATO has only confined itself to vague and unbinding words about the need for continued cooperation between the two parties in missile defense.

A CHANCE FOR A COMPROMISE?

It would be naive to expect Barack Obama to radically change his predecessor's policy concerning the deployment of a global missile defense system. Yet, he may introduce some adjustments to it. The economic recession, total cash shortages, and the need to cut defense spending may cause Obama to postpone the deployment of the third position area – especially as there is an objective reason for that: the two-stage version of the existing three-stage Ground Based Interceptor (GBI), planned to be deployed at the Ustka military range in Poland, now exists only on paper. The Washington-based Center for American Progress said in its report, published in December 2008, that the United States "should not deploy a missile defense system that has not been proven to work properly." Interestingly, the CAP is headed by John Podesta, who was co-chairman of the Obama-Biden Transition Project.

One of the two ways proposed by Medvedev for solving the missile defense problem – namely, the establishment of Russian-U.S. cooperation in building a truly global missile defense system – is hardly practicable in the foreseeable future. There are no required prerequisites for this, while the negotiability of Russia's 2007 proposals for the joint use of early warning radars in Gabala (Azerbaijan) and Armavir (Russia's Krasnodar Region) has already been exhausted. The consultations on missile defense and strategic offensive armaments, held by Russian Deputy Foreign Minister Sergei Ryabkov and U.S. Acting Under Secretary of State John Rood on December 5, 2008 in Moscow, confirmed this conclusion.

At the same time, the second of Medvedev's options – namely, that the U.S. should take into account Russia's concerns – can be translated into life if both parties display balanced approaches and readiness for reasonable compromises.

If Washington is sincere in stating that the deployment of the third position area is aimed at intercepting only those long-range ballistic missiles that can be launched from the territory of Iran or other Middle East countries, then an acceptable solution can be found, which would consist of two mutually complementary elements.

The first element is Washington's return to control and verification measures as regards the third position area facilities and the limitation of their combat capabilities. The measures, proposed by U.S. Secretary of State Condoleezza Rice and Defense Secretary Robert Gates at "two-plus-two" meetings in October 2007 in Moscow, provided, among others, for restricting the radar's angle of view and not activating any missile-defense system based in Poland and the Czech Republic until a real missile threat emerged. Unfortunately, the U.S. later actually waived many of its proposals.

At the same time, Moscow should not insist on a permanent presence for its observers at the U.S. missile defense sites in the Czech Republic and Poland. The "almost permanent presence" for Russian observers, proposed by Radoslaw Sikorski, would be quite enough. It would ensure an acceptable compromise, as round-the-clock control by means of surveillance cameras would be supplemented with periodic, yet regular and unimpeded visits to the missile defense sites by Russian observers accredited to the Russian embassies in the Czech Republic and Poland.

The second element of the solution would be the assumption by the United States of international legal obligations with regard to the structure and composition of the third position area facilities: 10 silos with Ground Based Interceptors and not one more at the Ustka military range in Poland, and one radar and not one more at the Brdy military range in the Czech Republic.

For its part, Russia could assume a legal obligation to refrain from deploying Iskander missiles in the Kaliningrad Region, provided the U.S. assumes obligations with regard to the third position area. This measure would allay concerns in some European countries, caused by Moscow's plans to deploy Russian missiles near their borders.

Speaking of a global missile defense system in general, effective steps that could reduce tensions in Russian-U.S. relations include establishing a joint center for the exchange of data from early warning systems and notifications of missile launches. Presidents Boris Yeltsin and Bill Clinton made a decision to establish a Joint Data Exchange Center (JDEC) in Moscow back in 1998 and signed a respective memorandum on June 4, 2000. However, the center has never been put into operation due to red tape, although the parties already agreed on a site for the center, its structure, a list of required equipment, and functional duties of its personnel. In 2007, Putin proposed establishing two data exchange centers instead of one: one in Moscow and the other in Brussels. But this Russian initiative has not been followed up.

The JDEC could be the first step by Russia and the U.S. towards building an interlinked early warning system, the importance of which increases with the proliferation of ballistic missiles in the world. This system does not necessarily need to be joint, which is hardly practicable in the foreseeable future. It would be enough if the present Russian and U.S. early warning systems, which now operate autonomously from each other, were interlinked via the JDEC and would thus guarantee the prevention of unintentional nuclear war between the two countries. After all, no one can rule out an accidental launch of a ballistic missile or, which is much more dangerous, a provocation by third parties which may include non-state actors, such as terrorist and extremist organizations. In the future, this interlinked early warning system could be joined by other countries, in particular France and China, which are now building early warning systems of their own. Such developments would undoubtedly enhance strategic stability in the world.

The missile defense issue must be resolved as part of general efforts to normalize U.S.-Russian relations, which have seriously deteriorated after the Five-Day War in the Caucasus. All attempts to solve the missile defense problem will fail unless Moscow and Washington achieve mutual understanding, predictability of their actions, and, finally, mutual confidence with regard to each other's intentions.

Towards a Different Europe

"Ring the Bell". Boris Yefimov, 1962

“To set Russia and the EU on the road towards an innovative future of cooperation and shared interests, based on the twin concepts of modern governance and market economies, one should not have, like the Europeans of the 1950s, too many illusions. There are still forces at work which pull in the opposite direction, both in Europe and in Russia. Not to mention in the U.S., which has a vested interest in avoiding close Russian-European cooperation.”

The Logic of European History

Rapprochement between Russia and the European Union

Stefan Schepers

Sometimes, one can see history in the making, but one cannot yet see its direction. The generally unconstructive attitude of the Saakashvili regime towards Russia and its military attack on the breakaway province of South Ossetia, followed by an unnecessarily harsh Russian military response, brought a chill in the relationship between Russia and the European Union (EU), just at the moment that progress appeared possible on a new, comprehensive agreement. It was soon followed by a major crisis in financial markets, which started at and was largely caused by Wall Street, the center of the U.S. financial system, and which spread to Europe, causing much economic havoc.

As the British political economist John Gray has written, this financial crisis marks the end of one particular model of the market economy (the Anglo-American model of 'free' market capitalism) and the end of the U.S. unilateral dominance of global affairs. Great powers mostly end by a combination of war and financial debt, as shown in the previous century by the end of the British Empire and the Soviet Union. In the future, the U.S. too will be no more than one power among several others. Both events require thus careful thinking about the new opportunities arising worldwide and for future cooperation between Russia and the EU.

In order to avoid giving prominence to those with Cold War reflexes or an economic interest in a new arms race, one should take some distance from daily events and try a historic perspective. By innovative thinking about a future constructive relationship between Russia and the

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EU, based on trust and mutually beneficial cooperation, these crises can be turned into political and economic opportunities for both. It can also help to strengthen the position in global affairs for both.

It requires for the Europeans to accept that Russia, this great ancient civilization, will never be like themselves, just as they are learning that America is going a different way from theirs. However, some key features of the EU, such as its rule of law or its welfare system, will undoubtedly benefit the Russian people and the further growth of its economy. It requires for the Russians to realize that Europe, in the framework of the EU, has undergone fundamental changes which they should properly learn to appreciate. Rapprochement with the EU is possible without Russia giving up vital economic or security interests, because the EU is not what many in Russia seem to think it is.

THE OLD, DANGEROUS BALANCE OF POWER

Throughout the past four centuries, various powers have sought domination of the economically and culturally rich European mainland, while one power with a special geographic position, Great Britain, usually tried to prevent it. The old Russia of Moscovia, still pre-occupied with controlling the Mongol threats, only in the 17th century could start building a modern state. Peter the Great turned to Europe for inspiration.

The permanent shifts in the balance of power were an indirect result of the Westphalian Peace Treaty (1648), which introduced the concept of the modern state, making every ruler sovereign within his realm. It succeeded to pacify Europe after the devastations of the religious wars, but it led the basis for new conflicts, because the relations between the new states were based purely on power, without the moral constraints of a superior authority, a role the Church had sought to play before, or the civilizing restrictions of the rule of law.

Political and economic systems are closely intertwined. Just like the feudal organization of society corresponded to the agricultural economy of the times, so the modern state, with its bureaucratic organization, provides the political frame for the emerging industrialization and increased trade. The interactions with technological innovation, made possible by science, and growing competition in open but regulated markets, brought more welfare for their populations as well as the emergence of a new, professional and industrial middle class.

The modernizations of Russia in the 17th and 18th centuries nevertheless left it with a primarily agricultural civilization until the late 19th century when industrialization and the emergence of a middle class took off, a bit later than in Western Europe, confronted as it was to the vicissitudes of the tsarist regime.

This middle class in Western Europe soon demanded to become involved in political decisions which affected its interests, leading first in Holland and England, then elsewhere in (Central, Northern and Western) Europe to the strengthening of parliaments. From advising the ruler, they achieved co-decision (over the annual budget and laws) until in the 19th century parliaments came to represent the sovereign people and they became the ultimate decision makers about all state affairs. In the early 20th century, the introduction of universal voting rights, involving farmers and workers, and later women, completed liberal democracy.

The new involvement of people in state affairs led to an important change in attitude. Until the 19th century, people had thought of themselves in religious, class or local terms. In just a couple of generations, their identity became now dominated by the new state, which was the source of their newly achieved economic welfare and personal freedoms. An emerging welfare state aimed to distribute the benefits from economic progress more equally. Germany and Sweden were among the countries leading the way towards social democracy. The governing and business elites thus could bind the population into loyalty through implementing both liberal and social democratic objectives. They promoted a new national identity feeling among the people through the universal education system and the new communication media (newspaper, radio and, much later, television).

Rational balance of power games, with limited warfare, became impossible now. It still remains beyond understanding how this civilized, well faring Europe, in August 1914, suddenly went to war. People had in mind a limited war, being home by Christmas, victorious. But technology had changed the paradigm of warfare at the same time as loyalty to the new nation state allowed mass mobilization. Europe and Russia suffered their first great economic and social-cultural devastation of modern times.

The revolutionary climate after the war, the collapse of the many a traditional regime, the successful coup d'Otat of the Communists in Russia, the growing strength of Communist parties in other countries, the spread of the American financial crisis of the 1930s to Europe, the resulting social misery, the Spanish civil war, all led to great fear among the middle and working classes for their future welfare. Economic and social instability provided a fertile ground for fascist and nazi regimes in several countries.

Another generation of Europeans was to suffer the calamities of war, made worse again by the advance of technology. Never before in history were so many citizens victimized, and never before were they so acutely aware of it, being brought up in the culture of Enlightenment and the belief in continuous economic and social progress and an ever better life for their families.

The time was ripe to seek to remedy the basic flaws which the Westphalian state organization had brought with it, inadvertedly because of the impossibility to foresee all economic, technological and political consequences of systemic changes.

INNOVATIVE COOPERATION AMONG STATES

The process of West-European integration was a direct result of the devastations of the First and Second World Wars. There was a pressing need to create lasting peace between Germany and France and to rebuild the economy. It was now recognized that the modern, capitalist economy was driven by science and technology, as much as by capital and labor, and that it needed open markets to flourish. It was equally well understood that social stability is an essential prerequisite for business investments and economic growth and for preventing political adventurers coming to power. Business, trade union and political elites (from six countries to start with) united behind the idea of a new organization of politics and economy in Western Europe.

These twin objectives (peace and welfare) could only be achieved if two conditions would be fulfilled: there needed to be economic interdependence as never before in order to give companies the competitive markets which capital-intensive science and technology-based production required; and the absolute sovereignty of the nation states needed to be relativated by integrating them in a new system of joint governance and by imposing a rule of law on the member states. A new form of cooperation among states was designed by Jean Monnet, the French government official who initiated it: no longer based on international law, it became a supra-national organization in which the governments cooperated within the self-imposed rule of law. The EU has some characteristics of a federal system, but its originality is certainly that it leaves a greater role to the nation states.

The establishment of the predecessor organizations (ECSC and EEC) of the present European Union became a rapid political and economical success, based on the twin concepts of liberal and social democracy. Business confidence and social stability returned despite the necessary restructuring of whole economic sectors. This was achieved first in agriculture, then in the industrial sectors through the Single Market and finally by the creation of the Economic and Monetary Union (with a common currency, the euro). It is still ongoing in some sectors (such as services or energy).

Economic growth and technological innovation created the highest and most equally distributed welfare Europeans ever enjoyed. Above all, the possibility of another war between Germany and France, or any other of the member countries, has become today unthinkable. The success was such that an ever increasing group of countries sought to join, to begin with the country which saw itself apart for centuries, Great Britain. By 1995, there were fifteen countries in the EU.

Following the implosion of the Soviet Union, this system of political and economic organization was rapidly extended to the countries of Central and Eastern Europe, with the purpose of consolidating liberal democracies there too, re-structuring the economies and building social democracies for their citizens, by fully integrating them into the European Economic and Monetary Union. Thus the system of peace and social market economies could be extended from Northern, Western and Southern Europe to these Central and East European countries, stabilizing them politically and social-culturally. For these reasons too, the unstable countries of the Balkans are now brought gradually within the EU orbit, though not (yet) as full members.

This historic process is driven by a desire of stabilizing state relations, bringing lasting peace, and by stabilizing societies by providing extensive and high quality welfare systems, such as public health, unemployment benefit, retirement pension, and education for all. The average income of (Western, Northern and Southern) Europeans has never been as high in history. No wonder that other (Central and Eastern) Europeans, faced with difficult economic re-structuring, were eager to join. No surprise that the vast majorities of EU citizens do not want a return to earlier, purely power-based politics and look bewildered at nationalist adventurers in the Balkans or in Georgia.

The overall success of the EU, achieved through many ups and downs, is based on the original division of the competences of the modern state: security and welfare of citizens are handled nationally, but macro-economic and monetary policies are decided at supra-national EU level. The decision making system is such that no single country can impose its will on the others (through qualified majority voting among governments). Two institutions (Commission, appointed, and Parliament, elected) normally represent the general European views and interests, one institution (Councils of Ministers) represents individual member state views and interests. A European Council of Heads of State (France) and Prime Ministers sets the long term policy direction.

The great challenge for the 21st century now seems to use the experiences with building peace and prosperity in Europe to achieve similar results between Europe and Russia.

QUALITY OF LIFE AS NEW POLITICAL PRIORITY

As the American author Jeremy Rifkin has rightly remarked, Europe has moved towards innovation of the social-cultural paradigm of its peoples. He claims that Europe is showing the direction of societal and economic development of modern societies, not his home country. This, too, may be another late effect of the Westphalian Peace and the developments which it set in motion; it is certainly also an effect of the results achieved by the EU.

Political systems are interdependent with the functioning of the economy, and both influence, and in turn are influenced by, invisible trends in a society, by the way people see their place in it and by their aspirations for their personal life. The near disappearance of the farmers class in the 20th century, demographic change, the prominence of the professional and middle class and the extension of the middle class quality of life to the workers class, the more than half-century of peace and economic progress shared by nearly all citizens through the welfare distribution systems, public education, free communications and access to information, the decline of religions too, have all led to a different European outlook on life and society. Philosophers have spoken of a post- or trans-modern culture, one which is still influenced by the fundamental ideas of the 18th century Enlightenment, but which is moving on to applying them differently.

Having achieved to establish the rule of law among their nation states, it seems that the present historic objective of Europeans is to also tame the capitalist industrial economy. It has deep roots in German and Scandinavian social democracy and their successful management of the market economy coupled with a welfare state system. It is the basic model of every EU member state, though with different elaboration.

The new overriding goal is sustainable economic development. Just as before limitations on the working of the capitalist economy were introduced in order to protect workers, now limitations are sought for the benefit of the environment and for public health reasons. Even if some measures (for example, in the agrifood sector) may also have a protectionist side-effect, they nevertheless are driven primarily by a strong new social-cultural paradigm which no longer believes in economic progress for its own sake.

It is not just soft thinking: the cost of environmental degradation is usually much higher than the measures to avoid it. Moreover, it forces companies to invest in research and innovation and thus creates new competitive advantages in global markets. A growing part of Europe's GDP comes from eco-friendly businesses. Rising costs of public health systems, coupled with demographic change, make disease prevention a budgetary necessity for governments, hence the growing link between public health and environmental policy objectives. People enjoying a rather good life want to continue as long as possible to do so, which is the cultural basis for the widespread support for such policies.

THE EVER WIDER ATLANTIC

All these developments inevitably influence also Europeans' view of the external world. They seek to export their own model of stabilizing state relations through the rule of law by promoting regional cooperation in other continents or by stimulating the growing role of global organizations. Welfare for all citizens requires economic growth, which today is driven by trade and technological innovation, all of which require stability. Therefore European political and economic elites unite in these goals which drive increasingly the emerging EU foreign policy. It is a far cry from traditional state relations based on naked economic exploitation and military power. The latter of course still has a role to play in maintaining peace and stability among states, though in a different way than before in history (instead of going to war, Europeans by far prefer peace keeping).

One can see the shift most clearly in the EU's strong support for international cooperation on climate change and other environmental issues, seeking to bind other countries through negotiated treaties under the auspices of the UN. One notices also prudent changes in its trade relations with developing countries, or in its support for people stricken by wars or natural catastrophe, or its promotion of human rights (even though often inconsistently).

Another American author, Robert Kagan, has said that "Americans come from Mars, and Europeans from Venus." Most Europeans regard this as a compliment (though most Americans do not). Despite the fact that the EU is driven by new societal and governance concepts, it is not becoming a giant Switzerland. It cannot afford this, because its economic and geopolitical interests and its historic and cultural links stretch across the globe and require sometimes a military capability. Therefore, the EU now starts to seek its own military structure, or rather to streamline those existing in the member states. There is no support for building a new military power, but the present waste of resources must be reduced, if only for budgetary reasons. It will take a couple of decades to get there.

Therefore, Europeans give lukewarm support to the NATO Alliance, dominated still by the U.S. Inevitably however, the two sides of the Atlantic will disagree more and more over what to do and how, simply because their social basis has grown apart already and will continue to diverge. The U.S. is still driven by a messianic capitalist and political ideology. The democracy concept which it promotes worldwide is a purely liberal one, without the social democratic (welfare distribution) component. Its capitalist market views are much less tempered by regulation and government intervention.

Europeans have long lost such ideological beliefs (which in fact hide hard American economic interests). They have recently been strengthened in their views by the war in Iraq and the collapse of the American-style financial system. They have culturally moved on towards seeking a balance between the goals of liberal and social democracy. They are now going further by introducing new political concepts, such as sustainable economic development. Although many of these ideas also exist in the U.S., they are by far not as dominant and widespread as in the EU.

While Europe and North America thus share a number of societal beliefs (liberal democracy, human rights, etc), and while they are still cooperating militarily within the NATO alliance, their societies are drifting apart. Social democracy is not taking root in the U.S. Even after the present financial crisis, it is likely that systemic change will not happen as it did in Europe over the past decades.

The NATO Alliance thus is likely to see in the future ever weaker support. There is already widespread unease or clear opposition against NATO military actions outside Europe, or its expansion into areas which were never in Europe's sphere of influence. This is particularly so in the countries of Western, Northern and Southern Europe. These are already more advanced into new thinking about European and international relations, having experienced the benefits of peace based on reconciliation and economic growth far longer than those who joined the EU only recently and who often look more in the rear-mirror of history than to future opportunities. The new roles of NATO are driven by the traditional U.S. political views and the interests of its military-industrial complex. Obviously, one should not overlook also the role of the industrial-military complex in some European countries (Britain, France) in helping to promote Cold War reflexes. But the reluctant support among Europeans will be waning rapidly as soon as they understand that the new Russia is no threat for them as the Soviet Union was.

A NEW RAPPROCHEMENT

From the late 18th till the early 20th century, Russian intellectuals and artists played a prominent role in Russia and in Europe; they were both Russian and European. The re-discovery of the culture of rural Russia could not have occurred without the new insights acquired by intellectuals and officers in Europe. In turn, key elements of European modernism came from Russia. This great exchange ended abruptly in 1917, when the victory of Communism stopped Russia's own liberal and social democratic developments and sealed the country off from the rest of the world. Having suffered three invasions (from Napoleon and Hitler and from Western consultants in the 1990s), Russians are understandably a bit apprehensive now about renewing the old link and exchanges.

The logic of history, however, points to extending the innovative ideas for realizing peace, economic progress and social stabilization to Russia, as well as to Turkey. For centuries, both powers have been Europe's key neighbors. Both have taken from European civilization, and given to it. What could be achieved between France and Germany and other European countries should now be achieved with them, though using of course different technocratic arrangements (realism does not permit EU membership dreams, unless one seeks to derail the whole European political stabilization process).

Despite its enormous energy resources, Russia still has a long way to go towards modernizing its economy, rebuilding its scientific and technological capacities and providing social stabilization through distributing the newly acquired welfare across the population. Despite the misery and suffering which Communism caused, it did move the Russian farmers and workers into modern views of life and society; their social and cultural paradigms now look closer than ever to those of people in Europe. Communism has failed in its economic policy, but it does leave a country behind with the aspirations of the late 20th-early 21st century.

Russians have irreversibly been modernized now, like Europeans, but Russia has the task of (re-) building the structures of a modern society, which Europe could start doing several decades earlier. Only the twin concepts of liberal and social democracy correspond to the aspirations of modern people and only these allow to build a respected and stable modern country. This is the common interest which political and business elites in Europe discovered in the 1950s and which still drives deep in popular beliefs the present EU policy processes, despite all short-term technocratic or political difficulties and the ups and downs of the process.

This does not imply that European models can simply be transposed to Russia. There are no two identical liberal and social democracies in Europe; each country has developed its own version taking into account specific historic, demographic and economic conditions, and political and social-cultural circumstances. There are equally various forms of the market economy in Europe, with more or less state intervention, more or less consensus building between business and trade unions, leading to highly developed welfare state models with a high degree of equality but also of citizen tutelage, or to more limited provisions with more personal responsibility of citizens in other countries. None of these systems is rigid and they are all in constant evolution, experimenting with new ideas or benchmarking with other EU countries. No doubt Russia will develop its own version, which may well see a stronger executive and a weaker parliament, and a more interventionist government in economic affairs, perhaps a smaller welfare state to start with.

Provided the direction is clear, convergence between the EU and Russia will appear ever clearer on the horizon and cooperation between both will be facilitated ever more. It is in the EU's self interest to cooperate with Russia in its move towards its own forms of liberal and social democracy. The first step is to gradually open markets to trade and investment, so that Russians can experience first hand the ways in which contemporary European societies and economies function, and that Europeans can achieve better understanding of the characteristics of Russia. Since times immemorial, business has been a great transmitter of innovation, in all areas, from ideas and art to organization and technologies. Indeed, businesspeople, through their support of think tanks and other activities to stimulate creative thinking, played a leading role in the EU's own developments.

Therefore, in addition to increased economic cooperation, more extensive exchanges should be promoted, in particular among the young and the cultural elites, which have a great multiplying capacity. The methods of the French-German reconciliation can serve as useful examples. European exchange programs (such as ERASMUS among university students) should be developed with Russia too. While politicians have to remain careful in day-to-day policymaking, others should be able to speak frankly and to develop new ideas and new consensus, which can become later the basis of new policies. We must lay the basis for a new relationship at the same time as tensions from the old still exist.

Of course, a strengthening of liberal democracy in Russia is needed, to start with the so-called material part of it (civic and human rights, press freedom, etc), which is quite compatible with a strong central government, as General de Gaulle showed in France. After President Putin focused on strengthening the economic framework of the state, a task not sufficiently appreciated in Europe, Europeans hope that President Medvedev will focus now on modernizing society itself, in line with the economic modernization already achieved.

A second and more difficult step in the rapprochement should be the recognition by Europe of Russia's security fears. They have historic roots, and while Europeans may perceive them as unfounded, given their belief in their own new world views, they are real enough for Russians. There is a proven method from the Cold War days to do so. Between the EU and Russia, there should be as many "Finlands" as possible, to start with Belarus and Ukraine. These countries are free to determine their own political and economic models, even to join the European Economic Area (an extension of the EU market without membership), but they should remain neutral and not join any military alliance. As the former German Chancellor Helmut Schmidt wrote, Georgia has never been part of Europe.

The same approach thus could be tried in the unstable region of the Caucasus, involving both Russia and Turkey. Both countries have traditional interests there, but they can be dealt with in modern ways, bypassing traditional power politics. It is in fact also a European interest to assist and to cooperate with both countries in preventing this whole region sliding backwards into a pre-modern chaotic political and economic condition. The EU is well placed to support the development of these countries in the same liberal and social democratic direction as it has gone itself, respecting the interests of Russia and Turkey and avoiding interference; the peoples of this region must find their own ways into the modern civilized world.

To set us on the road towards such an innovative future of cooperation and shared interests, based on the twin concepts of modern governance and market economies, one should not have, like the Europeans of the 1950s, too many illusions. There are forces at work still which pull in the opposite direction, both in Europe and in Russia. Not to mention in the U.S., which has a vested interest in preventing close Russian-European cooperation. Therefore, it is urgent that Russia seek to improve its communications with Europeans. This cannot be done by old style propaganda. It requires again to recognize the fundamental changes in Europe and to respond to them with openness.

Maybe, there is an obstacle in the minds of Russians who seek to define themselves in the mirror of the U.S., instead of looking to their own history and to Europe, the civilization which is closest to their own. Europe and Russia have grown partly from the same roots, and both have benefited from the past exchanges and cooperation. Maybe it dates from the Cold War Communist-capitalist dichotomy, but it is bypassed by events, by the divergent political, economic and social-cultural evolution in Europe and the U.S., the emergence of new political and economic powers in the world, or by fundamental financial and technological shifts in the economy.

Obviously, the Russian tendency to revert to methods of policymaking, internally or externally, which the Europeans have relegated to history, does not contribute to confidence-building. Europeans like to see a friendlier and more at ease Russia. However, if Russia continues to seek and find its own modern economic and political organization, it is likely that it will find it as beneficial as Europe to use less harsh methods of old style power plays.

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It will take more than a couple of years to get there, maybe a generation, but it is worthwhile for Europe and Russia to seek to move in that direction. It is the direction which matters, and the process to go forward on many different aspects of rapprochement.

The direction defended here requires to be examined first by those groups which always and everywhere have been the vanguard of new developments, intellectuals and artists, and businesspeople. The intellectual father of supra-nationalism and of the EU, Jean Monnet, was a brandy producer; many leading businesspeople have played an influential goal setting role for politicians, and they continue to do so in the EU, together with other stakeholders from civic society. Russian and European businesspeople have a strategic interest to contribute to innovative cooperation between Russia and Europe; they need to do so by looking beyond short-term issues, thus helping to relativate them. They must take account of the governance realities at home, by focusing first on consensus building among the elites, before offering new ideas for consensus to the people at large, which is the responsibility of politicians.

Rapprochement between Europe and Russia will not come automatically; it needs to be nurtured and maintained as a final goal during the vicissitudes of short-term political problem solving. It requires to further spread the spirit of mutual reconciliation and respect and the desire to build welfare for all people, which has served Europe for sixty years. The method of Jean Monnet, building this new vast space of peace and prosperity step by step, will be helpful again. Politics will follow, but first we must return to the great intellectual, artistic and business exchanges of the past, for a better common future.

Legal Options for Russian-EU Cooperation

What Russia Should Do to Advance Its Relations with Europe

Georgy Velyaminov

The present bilateral cooperation between Russia and the European Union rests on an extended Partnership and Cooperation Agreement of June 24, 1994, concluded between the European Communities and their member states, on the one part, and the Russian Federation, on the other part. This Agreement is usually described as bilateral – between Russia and the EU. But strictly speaking, the Agreement is multilateral as one party that signed it was Russia and the other included the then 15 member states of the European Community, the European Coal and Steel Community, and the European Atomic Energy Community, plus these three organizations per se – that is, 18 international legal entities. Considering the changes in the EU that have taken place since then, the 'Community' as the other party to the Agreement is now represented by 29 international legal entities. According to Article 104 of the Agreement, "the term 'Parties' shall mean the Community, or its Member States, or the Community and its Member States."

This formal feature of negotiability has an important practical value – negative for Russia – as it concerns procedures for harmonizing and approving (ratifying) EU agreements and for their entry into force. For instance, the Russia-EU Agreement, signed in June 1994, entered into force only on December 1, 1997, as three more states joined the EU after its signing.

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As regards matters of regulation, the Agreement is a full-scale international treaty on a multifaceted partnership in the following areas: politics ("political dialogue"); merchandise trade; cooperation in business and investment, including the establishment and operation of companies; cross-border services, in particular in transport and communications; the movement of capital, financial services and payments; the social sphere; competition problems; intellectual property protection; industrial and economic cooperation; standardization; statistics; customs; the protection of consumer rights; science and technology; culture; education; agriculture; energy; the environment; the harmonization of legislations; etc. Naturally, the cooperation between the two parties was not equally agreed for all the areas and has not become equally intensive.

The very status of the document as a *partnership* agreement is higher in the hierarchy of agreements concluded by the EU with third countries than just a trade or economic agreement. "Partnership" can be understood as cooperation based on the common goals and principles specified in the Preamble to the Agreement, including democracy, human rights, rule of law, a socially-oriented market economy, etc.

Special mention should be made of the mutual granting by the parties of most-favored status – not only with regard to merchandise trade but also to certain types of services, the establishment of companies, the provision of banking and insurance services, the movement of capital and current payments, etc. The Agreement also streamlined the mutual use of anti-dumping procedures and countervailing measures. Characteristically, the Agreement's provisions are based on the rules and criteria established by the General Agreement on Tariffs and Trade and the General Agreement on Trade in Services. Articles 10, 11, 12, 13, 18, 47, 51 and 94 of the Agreement have direct references to the two organizations' provisions. Thus, Russia, which is not a member of either the GATT or the GATS, was made partly bound to act within the norms of the two General Agreements.

Article 3 of the Partnership and Cooperation Agreement provides that the parties "shall examine together in the year 1998 whether circumstances allow the beginning of negotiations on the establishment of a free trade area." However, things have not budged an inch since then. It must be said, though, that this task is not simple and its solution requires gradual and selective measures. A free trade area must not be a "union of pedestrians and horsemen," like, for example, the North American Free Trade Association (NAFTA) where Mexico proved to be a raw material appendage and a cheap labor reserve with regard to the United States and Canada.

The PCA also contains an important provision about a "political dialogue" that should be established between the parties. Analysts say that it is in this field that the parties have achieved the most significant progress since the Agreement entered into force. One can also mention the success achieved by Presidents Dmitry Medvedev and Nicolas Sarkozy on August 12, 2008, at the height of the South Ossetian crisis, in agreeing on six principles for the settlement of the conflict. The French president acted as the President of the European Council and in the spirit of the 1994 Agreement.

On the whole, an analysis of the Agreement suggests the conclusion that it has proven adequate from the point of view of Russian interests. Importantly, the 1994 Agreement was agreed and signed at a time when the West was euphoric over the disappearance of the threat of the expansion of Soviet Communism, which loomed large during the Cold War. Now the situation has changed: considering the increased number of EU member states, the principle of consensus used in concluding such agreements, and the unbridled anti-Russian activity on the part of some U.S.-influenced partisan members of the EU, it is difficult to expect an early resumption of a negotiating climate that would be favorable to Russia. Characteristically, the negotiations on a new Russian-EU agreement were suspended on September 1, 2008, as a kind of "sanction" pending the withdrawal of Russian troops from Georgia.

PROSPECTS FOR CONCLUDING A COOPERATION AGREEMENT

Although the strategic base and interests for the continuation of cooperation between Russia and the rest of Europe objectively remain the same, the tactical goals of the Parties seem to have switched places. Whereas in the early 1990s the EU was more inclined to include in the Agreement non-binding general provisions pertaining to humanitarian and liberal values, now it is speaking of a strategic partnership based only on common interests. The Europeans would like a new basic document to provide for everything, down to the smallest detail. Russia, for its part, rightly fears binding provisions that would bring about minimum positive results – especially now that the EU has admitted new members, some of which have taken an intransigent attitude toward cooperation with Russia. This attitude was graphically illustrated first by Poland's and then Lithuania's "vetoes" which blocked for months the beginning of negotiations on a new agreement.

Russia wants the new agreement to be "a serious document that is at the same time not burdened down with specifics," as President Dmitry Medvedev said in an interview with the Reuters News Agency. "It is more of a framework, after all, setting out the main outlines for development over the years to come." According to Russian interests, more specific issues should be regulated on an on-going basis by bilateral agreements.

There is a belief that the enlargement of the EU to the East and the Balkans only plays into Russia's hands – supposedly it is easier to negotiate with the united EU than with individual countries. In fact, however, Russia would prefer to negotiate practical issues of cooperation directly with interested EU member countries. The present situation only allows individual EU members to use their EU membership to serve their own interests. For example, Poland, regardless of the EU, held direct negotiations with the U.S. on the deployment in that country of elements of a U.S. missile defense system directed against Russia. However, when it came to the need to promote the export (re-export) of low-quality Polish meat to Russia, Warsaw used all EU instruments to exert pressure on Russia. Lithuania behaves in the same way – it can limit transit across the Kaliningrad region and restrict the visa regime there in a "sovereign" way, yet it uses the Brussels levers to ensure Russian oil supplies for the needs of a Lithuanian oil refinery.

Energy is the basic factor of interdependence between the EU and Russia. But the parties differ on the nature and essence of how this interdependence should be codified in their bilateral agreement. The EU is strategically interested in geographically accessible Russian energy resources; yet it seeks – in an absolutely inadequate way – to diversify its energy imports, especially gas imports. In the course of negotiations on a new agreement with Russia, the EU will apparently insist that Moscow ratify and implement the Energy Charter Treaty, signed in 1991 (including the Transit Protocol), which provides for predominantly Western investment (and its protection) in the extraction and transportation of hydrocarbons from Russia. Meanwhile, the Charter does not provide for preferential treatment for Russian investment in the energy infrastructure in EU countries. Also, its mechanisms for ensuring the transit of Russian hydrocarbons have proven ineffective; in particular, they are unable to protect against the siphoning of transit gas by Ukraine, which is a party to the Energy Charter Treaty. Moreover, the EU has been making undisguised efforts to limit access to EU infrastructures (networks and underground storage facilities) for Russian hydrocarbon suppliers and to divide energy monopolies, including foreign suppliers, into oil and gas extraction, transportation and marketing companies.

Naturally, while negotiating a new agreement, Russia is interested in ensuring a balance between guaranteed supply and demand within the framework of its energy security concept and in achieving a situation where its massive investment in hydrocarbon production and transportation will not be in vain but will be guaranteed by demand. At present, it would be much more attractive and reliable for Russia to meet its pragmatic interests through "separate" agreements with individual partners, patterned after the North Stream or South Stream agreements. Russia has found it productive to legalize such projects in private contracts, rather than in interstate agreements. The energy policy still remains within the purview of individual EU countries, but if this policy were in the competence of the EU, the projects would have been blocked by the Polish-Baltic faction in the EU under strong U.S. pressure.

In general, oil and gas resources must be under effective state control as national property everywhere in the world – and Russia is no exception. This postulate cannot be ignored in the relations between Russia and the European Union, either.

The European Union is also interested in unimpeded and inexpensive transit flights by civilian airlines over Russia's territory. During negotiations, the Europeans will likely insist that Russia abolish trans-

Siberian overflight fees for EU airlines. Like in the energy sphere, Russia's transit capabilities constitute a security factor. Russia could make the EU's demands conditional on the solution of the problem of transit from the main part of Russia to the Kaliningrad area across Lithuania and Poland and on the visa regime issue in general.

Apparently, the EU – in keeping with its "tradition" – will try to use the new agreement to impose on Russia commitments on its "democratization," human rights, etc. The Chairman of the Committee on Foreign Affairs of the European Parliament, Jacek Saryusz-Wolski, a Polish adept of democratic messianism, said in an interview with the Russian *Vremya Novostei* newspaper (September 18, 2008): "Those who say, 'Let's just trade with Russia; let's not insist on discussions on human rights and democracy,' are in fact not friends of Russia. The true friends are those who say that Russia deserves the same freedom that we have." "Friendly" help, the way Saryusz-Wolski sees it, should, for example, provide for sanctions against Russia, which he unsuccessfully tried to push through the European Parliament in light of the Caucasian conflict. Such verbal attacks on the part of the EU over alleged human rights violations in Russia or the unfreedom of Russian mass media should be adequately counted, for example, by evidence of gross violations of political and social rights of ethnic, including Russian, minorities in Latvia and Estonia. However, Brussels consistently ignores these facts, although the protection of the rights of ethnic minorities was given special mention in the 1994 Agreement.

In light of Russia's proposal for creating a new European security system and as a follow-up on the 1994 Agreement's provisions about "political dialogue," it is essential that the new agreement bind Russia and the EU to pool efforts in building a pan-European security system and for an early prevention of armed conflicts.

When it came to saving the pro-American regime in Georgia in August 2008, the EU showed an extraordinary interest and efficiency in negotiations with Russia. But when the United States tried to impose anti-Russian missile defense systems on individual EU member states, the EU washed its hands of it, arguing that it was a matter of bilateral relations of the Czech Republic and Poland with the U.S. The deployment of U.S. missile defense systems and other similar actions must be a matter of pan-European security and must be regulated in negotiations between the EU and Russia. The new Russian-EU agreement must provide for equal and mutually advantageous opportunities for the parties for settling any threatening crisis situation.

It would be advisable for Russia to propose that the new agreement describe as counterproductive the export of "colored" revolutions. Efforts to expand the so-called "space of democracy" in the post-Soviet space not only violate the fundamental international legal principles of respect for the sovereignty rights and of non-interference in internal affairs of other states, but they have also seriously impeded the development of some newly independent states and aggravated the internal political situation there.

MOVING IN RIGHT DIRECTION

It seems that in its home and foreign policies Russia adheres to the same principle: "Movement is everything; the goal is nothing." However, the question "Where?" remains. As regards foreign policy, there are only two options for Russia. The first one is self-sufficiency. This option has been chosen by the great Asian powers India and China. They can afford it, as they can use their inexhaustible human potential. For Russia, this path would certainly be a dead-end. The second option is development in an alliance, cooperation and integration (its rate may vary) with other countries. The best example is the European Union. Unfortunately, Russia does not have partners yet, who would want to integrate with it.

The Chairman of the Central Bank of Russia, Sergei Dubinin, proposed a bold idea that Russia and the U.S. conclude a bilateral agreement on the establishment of a "New Entente." Although I do not share Dubinin's view on Russia's role in the Entente of the early 20th century, I cannot but agree that a New Entente could be a great and salutary benefit for Russia. On the other hand, a U.S.-Russian "Entente Cordiale" does not seem practicable in the foreseeable future; moreover, it is utopian. Suffice it to say that the U.S. already has an "Entente" that suits it perfectly well – this is the anti-Russian NATO, where Russia is not welcome. NATO and a "New Entente" cannot coexist either, as they would be incompatible with each other. Obviously, overcoming the firmly established American idiosyncrasy for Russia will take at least as many years as it took to foster an enemy image of Russia.

It would be more reliable to proceed from what is really possible. Naturally, this "possible" will not be achieved overnight or with the wave of a magic wand. It will require a gradual integration of Russia into really partner and allied relations with the European Union, which may outgrow into EU membership in the long term. French President Nicolas Sarkozy, in his speech at an international conference in Evian on October 8, 2008, expressed confidence that Russia could become a privileged partner of the EU in defense and security. Earlier, on September 23, 2008, addressing the 63rd Session of the UN General Assembly, he proposed building a common economic space across the continent, which would unite Russia and Europe. This idea, which was first expressed by Charles de Gaulle, could help determine Russia's path and destiny within the framework of the kindred European civilization.

The gradual construction of a strategic alliance between Russia and the European Union must be a general strategic benchmark for Russia, which could be mentioned in the new basic agreement with the EU – provided, of course, that the EU duly reciprocate and that the present political situation becomes less acute. Such an alliance could be based on a pan-European security system, firm mutual obligations in the sphere of economic cooperation, including the energy sector, and the harmonization of Russian and EU legislations – initially, in the field of economic, trade, financial and investment regulation. It would be advisable that Russian and EU observers participate in the working out of relevant regulations in EU and Russian legislative bodies.

These efforts may meet opposition from Washington, which may continue for as long as the U.S. views or deliberately portrays Russia as a potential threat. The establishment of truly partner relations between Russia and the European Union could help allay Washington's "fears" concerning Russia.

The top priority task for Russia now is consistently overcoming the bugbear image, made of Russia for Europe, and not sliding into remilitarization in response to the Georgian provocation, which would be to

U.S. liking. It is exceptionally important that the resumption of negotiations between Russia and the EU be preceded by a large-scale and continuous publicity campaign – especially in the Western mass media and though diplomatic channels – aimed at building a peaceful image of Russia in foreign policy and foreign trade.

What image of Russia could be attractive to Europeans? I think it is the image of a reliable shield for European civilizational humanitarian values, the image of a buffer that has for centuries protected Europe against Eastern waves of aggressive despotism and authoritarianism, and the image of a solid supplier of raw materials, energy and (potentially) food. This true image of Russia must be consistently brought home to every European and American.

There are essential differences in Russia's and the European Union's views on the parameters and the format of political and economic problems that need to be agreed in a new strategic partnership agreement. The anti-Russian position of some of new EU members stands in the way of achieving mutually advantageous Russian-EU accords on a new agreement. In addition, the EU's negotiability has been undermined by the need to achieve consensus among all the 27 member states. In these circumstances, the "common denominator" attainable today for inclusion in the new agreement can only be minimal, and codifying this minimum in the agreement would be counterproductive for Russia.

The above suggests that Russia is not interested in speeding up work on specific provisions for a new agreement with the EU. One of the reasons is that the 1994 Agreement – throughout its period of validity – showed that it was adequate to the development of mutual cooperation, even though its parameters and terms were not ideal. In addition, the possibility of annual renewal of the agreement lets the parties maintain for some time a sufficient level of legal groundwork for their cooperation.

Regrettably, international politics now ignores the principle of "cooperation among states," proclaimed in the Helsinki Final Act, which provides for promoting mutual understanding, confidence, and friendly and good-neighborly relations. This principle is as binding as, for example, the principle of territorial integrity.

Meanwhile, the U.S. ambassador in Budapest advises the Hungarian authorities to suspend negotiations with Moscow on the construction of the South Stream gas pipeline across Hungary. Simultaneously, the U.S. ambassador in another EU country, Sweden, tries to persuade the Swedes to prevent the construction of the Nord Stream gas pipeline across the Baltic Sea. Such actions are not only a direct embodiment of the undisguised policy of containing Russia but also are a gross violation of international law, including the Helsinki Accords. They undermine the Russian-EU partnership and actually are nothing else but ***non-military aggression***.

In negotiations on a new agreement with the EU (as well as in cooperation with China and at the United Nations), Russia should put forward and uphold ***a proposal for denouncing and renouncing the policy of containment in all its forms as a threat to peace and as an impediment to the development of friendly and good-neighborly relations between states, and for prohibiting both military and non-military aggression.***

After the Oil Boom

Russian Energy Investments in Europe in the Era of Recession

Andrei Bely

Record-high oil prices in the recent years brought an illusion with Russian oil and gas companies that their easy profits would continue forever. The financial crisis and the subsequent recession have taught them a harsh but useful lesson: even enormous hydrocarbon resources are not enough for prosperity.

Five Russian majors (Rosneft, LUKoil, TNK-BP, Surgutneftegaz and Gazprom-Oil) have more energy resources than the leading Western companies, while Gazprom is the world's leader in natural gas resources. However, the Russian corporations are behind their major rivals in terms of capitalization and stable position on the market. Owing to their diversified investment structure, international oil and gas companies influence the formation of the norms that provide stability both inside and beyond individual countries. Even their occasional performance setbacks in underdeveloped countries do not undermine their reputation as successful global players. Stability in the market helps them counteract the volatility of oil prices.

When oil prices were high, Russian companies could easily attract financial capital. Short-term profits earned them stable credit ratings and encouraged them to take long-term loans for large investments. However, the liquidity crisis froze many long-term investment projects. Even such major Russian companies as Gazprom, Rosneft and LUKoil, which increased their profits by 30 to 40 percent over the last year, have

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not achieved an island of stability in the ocean of financial turmoil. The loss of capitalization and overall profits only complicates their investment prospects, which, in turn, will have a long-term effect on their future development.

Russian corporations that made profits only by raising prices ignored the need for onward development and diversification of investment activities. Meanwhile, the latter measure must be used to develop and improve the resource base and enter new sales markets – especially as global economic recessions are always accompanied by a growth of protectionism and its political manifestations. This is why transnational energy companies usually abide by – and help consolidate – the international practice that protects their investments in other countries.

Moscow, however, only responds to actions of the West.

The situation for Gazprom is complicated by its long-term commitments, whose fulfillment requires stable gas supply from extraction sites to the European Union's borders.

In view of the abovementioned changes in the world energy system it is natural to ask a question: Does Russia really need an international investment regime?

RECESSION AND POLITICIZATION OF THE ECONOMIC SECURITY ISSUE

The financial crisis has already caused countries to toughen their economic security measures. State interference in the economy, expropriations and forced sales of assets have become common practice even in such liberal states as Britain.

The revision of liberal economic values was also behind the new measures taken by the EU Energy Council for the EU internal market. On October 10, 2008, the Council proposed allowing all EU states to take protective measures with regard to investment in transport facilities. National governments will be able to restrict access to investment in gas transport networks for non-European companies; in other words, protectionist actions by EU member-states will be legalized. Of course, the Council's conclusions are not tantamount to barring access to investment, yet they justify introduction of economic security measures.

In this context, diversification of investment by Russia must be carried out within the frameworks of a political strategy for protecting its investments abroad. Yet the international political context weakens Russia's positions – Russian actors have to operate outside of Russia in an atmosphere of mistrust and absence of protection means against investment risks, as well as absence of stable relations with neighboring states, which are becoming systemic factors of the global energy system.

The development of a long-term investment strategy in foreign markets is a vital need, but legal mechanisms for protecting energy investments are not always backed with foreign-policy moves. In addition, Moscow's demands – made with an injured air – that the West revise its approach to Russian energy companies rarely come home to its Western partners. Moreover, the decisions by the EU Energy Council emphasize potential risks involved in the economic security policy in EU countries.

THE POLITICAL PROBLEM IS NOTHING NEW

According to Immanuel Wallerstein, the bifurcation of international relations began with changes in the rules that regulated cross-border political and economic ties.

The global economy is now witnessing two opposite trends. On the one hand, the increasing politicization of the economic security issue undermines the liberal market norms. On the other hand, this causes a pressing need for international legal protection of investments against possible discrimination.

The liberalization of EU gas markets is a graphic illustration of these two opposite trends on the way towards a common market. The closure of the doors before outside investors acquired a pan-European dimension in September 2007 when the European Commission approved the Third Energy Package to restrict non-European investment in EU transport facilities. This document became part of a logical chain of the development of a common liberalized EU energy market.

Making energy markets open to competition has always met with political opposition. The first fights over this issue began in 1989, when the EU discussed the possibility of introducing the successful experience of the UK in liberalizing electricity and gas markets was. Seven years of negotiations were crowned with the adoption of a directive of the European Council and the European Parliament, which endorsed the main principles for opening markets. The principles include separating transportation from production and supply; working out transparency rules that would facilitate access to transportation for all competing suppliers; and opening wholesale markets for companies competing for sales networks.

However, the process of opening up the gas market has been delayed because gas transport networks belong to suppliers, which deny access to them for competitors. The European Commission's proposal, made in the autumn of 2007, was intended to increase competition among gas suppliers. To this end, suppliers needed to be separated from their transport networks, thus removing barriers to markets for suppliers that do not have pipelines of their own.

The Third Energy Package, in its original wording, was blocked by the European Council which bowed to the demands of some of the EU states and their companies that showed strong opposition to this initiative. Nevertheless, the European Commission turned to the EU competition law in order to legitimize –through legal action – complete separation of transport companies and suppliers in terms of property. On October 10, 2008, the EU member states sealed a compromise based on a consensus on the exclusion of non-European investments if this is required by security considerations. At the same time, attempts have been made to lobby for establishing a unified European gas transport company, where investment limitations would be introduced. A unified gas transport system would create real prerequisites for the emergence of a single gas market, where networks and supplies would belong to different owners.

The adoption of such measures to protect Europe against "unwanted" capital should not be surprising, considering the EU's efforts to strengthen its economic security.

The politicization of the energy security issue began after the events of January 2006, when a Russian-Ukrainian gas price conflict interrupted gas transit to Europe for some time. Russian gas supplies began to be viewed through the prism of security and geopolitics. Subsequent agreements between Moscow and Kyiv have not removed the threat of a crisis recurrence, which happened three years later. In 2009, gas transit to

Europe was halted on a much larger scale; this time the termination of supply was initiated by Russia, which has given additional arguments to those who advocate the politicization of energy relations with Moscow and those who propose establishing a unified gas transport company in Europe, with ensuing protectionist measures.

The EU poses as the only effective international regime for cross-border investment in the energy sector, which it believes justifies its moves to restrict access to its market. Thus, the European Union distances itself from other international investment regimes, such as the Energy Charter.

INVESTMENT RISKS IN SAFE EUROPE

Russian oil and gas companies look at investment risks in the European Union through rose-colored glasses. Indeed, the EU economic space is more predictable and transparent than most of the other regions in the world. Nevertheless, real and latent investment risks in the EU do exist. Today they concern Gazprom, and tomorrow they may affect Russian oil companies as well.

First, there is a risk of actual expropriation of assets after the introduction of forced competition and restricted access for foreign capital. The discussion of the Third Energy Package makes this risk more tangible. In addition, pursuant to the EU competition provisions, the European Commission is taking steps to initiate legal proceedings against suppliers that have transport assets. This may directly affect the investment already made by Gazprom in gas transport networks, which are particularly ramified in the Baltic States and Eastern Europe.

Second, investment may also be limited for ecological reasons, and, at worst, assets may be expropriated. Many energy investments have come under the pressure of standards of the Kyoto Protocol and the EU directive on emission reductions. Russian investments in oil refineries may be affected by this pressure as well.

Third, it is not ruled out that investors from Russia will be barred – for security reasons – already at the pre-investment stage. Such cases are many, and the best known of them involves Britain's Centrica. Calls to restrict Russian investments are heard even from such friendly countries as Germany.

Fourth, risks emerge when partners fail to fulfill their contractual obligations. For example, Russian gas suppliers conclude a contract to supply gas to a distribution market at a certain price, while local authorities amend the price according to their political favors. Such conflicts may happen in the Baltic States where Gazprom has a large share in heat power distribution. It should be noted that failure to comply with one's contractual obligations does not entail the application of security provisions of the Energy Charter Treaty (ECT).

Apart from the European Union, which remains the largest source of revenues for the Russian oil and gas sector, the restrictions may also be applied in the Balkans and Turkey. Russian investors view that region as an alternative to the EU, but EU legislation applies to Balkan countries, as well as they are parties to the 2005 Energy Community Treaty.

Combining competition legislation with energy security issues is becoming a long-term tendency of the EU internal market. This situation is not in Gazprom's favor, although the latter has been making great efforts, struggling against complete division according to property. Gazprom is trying to influence the European Council through the lobbies of its European partners. But these efforts will it bring nothing – either in what concerns European competition legislation or limitations on investment in the EU – as the Russian gas giant has to rely on companies that are its rivals in EU distribution markets.

What political and legal mechanisms are needed to protect investors in the European Union?

NEW EU RULES VERSUS ECONOMIC LIBERALISM

The international investment regime has traditionally been regulated by bilateral investment agreements providing for international arbitration. However, these agreements do not always clearly specified rules for resolving conflicts. In addition, agreements of this kind are very sensitive to political changes in the signatory countries.

During the years of the rapid development of energy markets, an attempt was made to streamline the protection of private investment within the framework of the Energy Charter Treaty (ECT). This was the first document in economic history to include multilateral provisions for protecting investors against discrimination and illegitimate expropriation. In addition, the ECT mechanisms for settling disputes allow one to initiate legal proceedings directly against the European Community.

However, the treaty has lost its legitimacy after Moscow's refused to ratify it, which was the result of Gazprom's lobbying efforts. The corporation has objections against transit provisions of the ECT and against its Transit Protocol, which is still the subject of international negotiations.

In June 2006, experts of the Gazekonomika Research Institute, which is close to Gazprom, pointed to the absence in the ECT of provisions that would ensure pre-investment protection against discrimination. They failed to take into account the fact that investment arbitration rules make no distinction between pre- and post-investment stages. Yet, the criticism by Gazekonomika was justified because non-discrimination at the pre-investment stage increasingly depends on relations of reciprocity, bypassing provisions of the international treaty. These rules of reciprocity serve as a pretext for the European Union to restrict investment in transport facilities.

In light of these restrictions, one can assume that if the negotiations on the ECT were held today, the treaty would not be signed even by the EU member states themselves. But the treaty has been in force for ten years now, while the interest of European energy companies in it further grew after the emergence of the Third Energy Package. These companies view the Charter's investment provisions as a legal guarantee against property division and as protection against the expropriation of energy property.

Russian experts from the Russian Gas Society and the Institute for Energy and Finance Foundation contrast European law with constitutional rights of the EU member countries concerning the protection of property at the national level. But their reasoning does not take into account legal monism, by which the majority of European countries abide: international law is integrated into national legislation through the ratification of any treaty. The monism means that national legislation cannot oppose decisions of a European court or laws of the European Union. At the same time, the ECT prevails over EU legislation, because the European Community is a party to the Charter.

At the same time, the European Commission has grounds to deny Gazprom non-discrimination, using the security provisions in the ECT and those adopted by the Council. The proponents of the EC's position argue that the monopoly on gas exports in Russia, which lacks economic grounds and which even Norway has given up, is the main and only argument for justifying the security measures.

The situation with investments in the oil industry is simpler: arbitration is possible there within the ECT frameworks, as there is no oil exporting monopoly company in Russia.

In addition, the January 2009 crisis has confirmed that the transit mechanisms, provided for by the ECT, can prove necessary in situations when transit to Europe is halted. During the conflict with Ukraine, after Russia resumed gas supply to the EU but Ukraine did not resume gas transit yet, the Russian leadership and Gazprom urged Kyiv to comply with ECT transit provisions. However, Moscow refrained from resorting to the ECT legal mechanisms against violator countries. Meanwhile, using international mechanisms for settling disputes would have been less painful politically than proving to be an unreliable gas supplier to consumers in the EU.

This conflict may have consequences for direct access to European markets for Gazprom. After the January 2009 events, the Europeans will find it difficult to give it direct access to investment after it has proven to be an unreliable gas supplier unable to find a political solution to the conflict with a transit country without halting gas supply to its clients. And on the contrary, the settlement of the crisis using intermediary mechanisms within the ECT frameworks would have let Russia save face and accuse Ukraine of violating the transit provisions.

But can the Russian state and Russian companies use legal mechanisms of the ECT which has not been ratified yet? This question remains open and requires careful analysis of various political and legal options.

RUSSIA AND THE ENERGY CHARTER TREATY

Russia has not ratified the ECT and applies it on a temporary basis (that is, its provisions remain in force if they are not at variance with Russian legislation and the Constitution). Therefore, there arises a possibility of using its investment provisions to oppose restrictions in the EU. Such an approach to the treaty is practiced for the first time in international practices. According to the Vienna Convention on Treaties, provisional application ceases after a treaty enters into force. In case with the ECT, this already happened in 1998.

According to the Vienna Convention, a state can choose either to start full application of a treaty, or revoke its signature from it. Russia has chosen a "golden mean" of its own – it has refrained from the full application of the ECT, yet it has not withdrawn its signature. Thus, Moscow's application of the ECT to protect Russian oil companies in Europe, for example, becomes the subject matter of an international arbitration proceeding, without Moscow's consent. Russia does not relish the prospect of being ranked among Latin American regimes, such as Bolivia, so it does not contest international arbitral awards. In particular, it signed and ratified the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards even when it was part of the Soviet Union.

The situation has been exacerbated by the application of the ECT against Russia by YUKOS shareholders, who argue that Moscow has violated the ECT expropriation provisions, using them in a discriminatory manner against their company. YUKOS is seeking an arbitral award precisely over the provisional application of the Energy Charter Treaty by Russia. An arbitration proceeding is yet to begin but the case has already been forgotten by the public opinion both in Russia and the West. A hypothetical decision by an arbitrator in favor of or against YUKOS would not mean that Russian oil companies would automatically have a similar right to defend their interests in Europe.

Russia's uncertain position on the ECT may backfire on the Russian state (if an arbitral award is made in favor of YUKOS) and on Russian oil companies (if they are denied the right to use ECT provisions against the EU). Meanwhile, Russia recognizes arbitration decisions, even though it does not participate in drawing up norms and rules.

The absurdity of the situation with the provisional application of the ECT makes one ponder what system, apart from the EU legal system, Russian investors can turn to if problems with the EU arise.

Moscow will have to formulate its position and choose one of the following options:

• Withdraw from the ECT, leaving its economic players to the mercy of EU legislation and renouncing high posts in that organization, which would limit Moscow's influence. As a result, political mistrust of Russia would grow, and the spiral of security problems would continue to unwind. The European Union would have every reason to use restrictive measures not only towards Gazprom but also towards the Russian oil industry;

• Accept the ECT in its present wording, renouncing its provisional application and reaching a compromise with the EU, particularly on transit issues. Difficulties may arise, above all, for Gazprom due to its legal monopoly on gas export and due to limited access to networks for other gas producers. The gas giant is not ready for changes that could remove conflicts between Russian legislation and the Energy Charter Treaty. Russia may ratify the ECT with a reservation that its provisions shall not apply to the gas industry. However, considering the importance of gas for the EU, it is unlikely that Brussels will consider such ratification sufficient. In addition, it would be difficult for Moscow to demand that Ukraine comply with provisions that Russia itself has declined to observe;

• Offer a clear alternative that would be acceptable both to Russia and the European Union. It could be a new document based on the ECT or a possible Russian-EU Agreement, which would contain clear-cut provisions on non-discrimination at the pre-investment stage and specify mechanisms for settling transit disputes. Regular gas conflicts with Ukraine require a new approach for settling them. However, this approach involves a risk of losing new negotiations, whose results would have to be renounced. This is what happened, for example, to the Transit Protocol, which was initially supported and partly initiated by Moscow.

Obviously, Russia avoids making a decision for the time being. A wait-and-see position makes sense if there is a clear political strategy behind it. In this case, the Russian position is based on expectations of high oil prices and on the liberal investment regime in the EU countries. However, protectionist sentiments in Europe are growing, while a further decline in oil prices may weaken Russia's positions at negotiations with the EU.

WHAT TO DO?

Russian companies have overestimated their own strength and have been affected by the financial crisis more than their Western partners. The dependence on European markets, finance and technologies requires drawing up a detailed economic strategy aimed at diversification and innovation. Only in this way can Russia move from a policy of "protecting the weak" to the "stimulation of the strong" and clearly formulate its position on investment and the international investment protection system. Otherwise, Russian actors will have to abide only by the European rules of the game in their relations with the EU.

When entering the international investment market, Russian companies and the Russian state must become sources for developing international energy law. So far, Russia's participation in this process has been passive. Russian corporations underestimate investment risks in the European Union, while the Russian energy strategy lacks understanding of how this country should build its relations with international arbitration institutions.

The conflict between EU legislation and traditional liberal norms calls into question the possibility of protecting investment in the EU on the basis of EU laws. The present vacuum of international rules and regulations on investment movements gives Russia a chance to offer an alternative of its own – a new international investment agreement based on the ECT. It could be concluded starting with the oil industry, which needs investment security most. Such an agreement would also be good for the power industry, where the liberalization process is already well under way.

As regards the gas industry, it first needs to be depoliticized by both Russia and the European Union. This is impossible unless regular conflicts between Russia and Ukraine are stopped. The transit conflicts only confirm the need for universally accepted rules, rather than annul it. One can draw an analogy with the law of the sea: the existence of pirates does not call into question the Treaty's validity but it requires additional political efforts to combat anomalies.

To this end, Russia should start a political dialogue with various states and regional groups in Europe, similar to the existing German-Russian energy dialogue. But above all, this requires a political decision by Russia to move towards an international Energy Treaty.

Building and Re-Building Nations

Punch (Great Britain). 1914

> *If a region or a self-determining ethnic group has no external borders, it is difficult for it to set the goal of secession or radical separatism. All former Soviet republics that have become independent, as well as Abkhazia, South Ossetia and Chechnya, had external borders. The absence of such borders imposes limitations on separatism and stimulates the search for peaceful solutions.*

A Testing Ground for Modernization and a Showcase of Success

What Should Russia Do with Abkhazia and South Ossetia?

Mikhail Delyagin

Russian support for Abkhazia and South Ossetia, which came about as a result of a number of circumstances, may play the role of a catalyst for Russia's modernization, but the two territories are very different and require different approaches.

A spontaneous development is likely to turn Abkhazia into a Russian health spa and military appendage, and this is unacceptable because it is fraught with complicating relations and losing existing opportunities. Rather than focusing on using Abkhazia as a potential health resort, Russia should build the missing financial and technological elements of its own economy there. By creating instruments of modernization outside its territory – where they would be protected from Russian kleptocracy and monopolies – Russia could see a dress rehearsal of its own modernization.

South Ossetia does not exist as an economic entity due to its small size and extremely low-level management. Russia must bring rudimentary order to South Ossetia's finances and thus lay the groundwork for the reunification of the Ossetian people within the Russian Federation.

ABKHAZIA TODAY: PRIMITIVE SERVICES

The Abkhazian economy can be described as providing primitive services. The war and the blockade have reduced the region's population to slightly over 215,000 today from 525,000 in 1989. The population's ethnic composition is: 44 percent Abkhazians; 21 percent Armenians; 21

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percent Georgians (including Mingrelians and Svans); 11 percent Russians; and one percent Greeks. More than a quarter of all residents receive pensions and social benefits.

Abkhazia is a zone of special interest for Russia and Turkey – where a 500,000-strong ethnic Abkhazian community lives. Trade accounts for 60 percent of Abkhazia's GDP, while hundreds of thousands of Russian vacationers brought in about one third of all tax revenue and 40 percent of export earnings in 2007.

The electricity generated by the Inguri hydropower plant – currently operating at 70 percent of its output capacity – is divided between Georgia and Abkhazia, with the latter exporting about 40 percent of its share to Russia's neighboring Krasnodar Territory. Georgian-Abkhazian cooperation in this case is pegged to technological objectivity – the plant's dam is located in Georgia, while the powerhouse and four diversion-tunnel plants are in Abkhazia. Another hydroelectric plant near Sukhumi has been destroyed, and there is no need to rebuild it because of a low demand for electricity. Before the war, a total of 21 small hydroelectric plants were operational, but only two of them could resume working now.

The government deems it unnecessary to raise foreign investment in the energy sector, yet the deteriorating state of the main assets there calls for large-scale investment and the problem is still open about where to get the money. Electricity prices increased sharply in 2008.

The state of highways leaves much to be desired. Old cars and buses account for the bulk of vehicles and the region has no money to replace them. However, Abkhazia has two convenient airports with newly-repaired runways and three fit-for-operation seaports.

The region's railway is single-track and is used to take tourists to Sukhumi and to export coal. The railcars are worn out and need either capital repairs or a write-off. Station buildings are in a state of disrepair, although ticket offices have been connected to the Russian Express-3 system of railway ticket reservations and sales. The last domestic Abkhazian passenger train stopped running in 2008.

Mobile phone operator A-Mobile, a joint venture between the Abkhazian government and businesses, broke the monopoly of the Akvafon company, affiliated with Russian mobile giant MegaFon, in late 2006.

The promotion of essential-oil plants, tobacco and vegetables dominated Abkhazia's agricultural sector prior to the war, but their export and processing stopped in later years. Farming turned into a tool of survival and almost all agricultural land is now used to grow corn and some tobacco to meet local demand. The livestock, goat and sheep population has decreased sharply – first, because of theft and slaughter, and also because of shrinking feed stockpiles.

The production of vegetables and citrus fruits for Russia and to meet tourist demand continues to grow, but remains an artisan activity. Until very recently, Abkhazia's own production of meat and dairy products met only 40 percent of local demand. Even vegetables, fruit and vegetable oil are now imported in large amounts. The number of tractors and other farm equipment has plummeted and 90 percent is long overdue to be replaced.

Abkhazia did not have a single functioning beef, dairy or canning plant until very recently when Russian investment started coming in; and the essential-oil industry has not sent any signals of being alive. Only 60 production facilities out of 183 are operational at the moment, and general production output has plunged more than 90 percent.

It is worth noting, however, that 2007 saw an increase in the manufacture of construction materials – in the run-up to the 2014 Winter Olympics in Sochi, while tourism is providing stimuli for agriculture and winemaking.

The Abkhazian economy saw heavy losses in the first quarter of 2008; profit totaled 59 million rubles, but only made up 53.4 percent of total losses of 110.4 million rubles. Total losses grew 36.2 percent over the previous year. The budget for 2007 – and for 2006 as well – was deficit free, as the region simply did not have enough money to cover the deficit. Revenues of 1.43 billion rubles were 15.1 percent above the initial target, with "injections from abroad" – quite possibly Russian aid – totaling 434 million rubles. Expenditures stood at 1.42 billion rubles and education was the main area for state spending (174.8 million rubles) after the army and the police (484 million rubles). The 2008 budget showed revenue increasing to 1.6 billion rubles and spending rising to 1.59 billion rubles (with almost one half of this amount, or 733.6 million rubles, to be used to pay salaries). Amid a background of inflation and continuing economic growth, this testifies to the waning role of the budget in GDP.

The banking system is made up of fourteen small banks that started opening correspondent accounts in Russia in 2004. The system became profitable in the first quarter of 2008 – a fact that reflects its move from the shadows into daylight.

Exports and imports correlate as 3:7 and the shortfall is covered by earnings from tourism. Russia accounts for two-thirds of Abkhazian foreign trade. Raw materials and unprocessed agricultural products make up over 90 percent of commodity exports, of which citrus fruits account for 35 percent; coal (80,000 to 100,000 tons annually), fruit (mostly persimmons), hazelnuts, tea and vegetables for 20 percent; and round timber for 20 percent. The latter mostly consists of valuable species of trees cut through predatory practices in mountainous old-growth beech, oak and chestnut forests and exported to Turkey.

Abkhazia leases its sea shelf to Turkey for fishing and this brings in up to 15 percent of all export revenue, but locals say the Turks have largely thinned the fish population in the shallow coastal waters.

The Bzyb timber factory, which sells sawn lumber, parquet and other fine wood products to European countries, and Abkhazian Wines & Waters – which used to export 1.5 million bottles of wine a year to Russia before a trade embargo was imposed on Abkhazia – provide for the larger part of the region's industrial exports and up to 10 percent of all exports. Moreover, Abkhazia offers investors a wide assortment of investment projects, the greater part of which will be snatched up after the recognition of independence.

AREAS OF SPORADIC DEVELOPMENT

The recognition of Abkhazia by Russia has reanimated production, as producers, who were previously targeted at providing services to tourists or at preparations for the 2014 Winter Olympics, are expected to receive access to the Russian market. The revival concerns citrus fruits and wine production, although one should not underestimate the stringent internal barriers in Russia (such as difficulties in gaining access to Moscow's markets).

The traditional specialization of the farming sector is likely to reemerge in three to five years, as the growing of essential-oil crops and tobacco will oust corn from the fields.

Budget revenues may increase due to the possible production of oil by Russian companies on the Black Sea shelf (data that Georgia submitted to U.S. companies in 1998 puts the shelf oil reserves at 200 million tons). However, the damage to the environment may spoil the region's main resource – recreation, and impair bilateral relations over the long term if the project does not include environmentally-friendly technologies.

Small-scale privatization – the sale of shops, catering facilities and abandoned construction sites – is unfolding in Abkhazia. Standing next in line is the privatization of large facilities with the participation of foreign investors. Here the Abkhazians intend to do everything in their power to keep the balance between Russian and other investors, above all from Turkey.

Modernization in exchange for ownership will become the main line of action, as Russian investors hope to appropriate the facilities they will modernize. The mismatch of interests (the authorities will seek maximum control) will trigger commercial conflicts that will be settled individually.

The application of standard schemes of development is quite possible – privatization will provide the government with money for modernizing the transport and energy infrastructure (for instance, the physical wear of power transmission lines outweighs the benefits of the republic's excessive energy supplies). This, in turn, will facilitate the growth of tourism, which will work as a drive for agriculture and the services sector. The scheme "construction-operation-leasing" will be first applied to tourist facilities and then to some larger facilities.

Russian experts claim that the Abkhazian coast might become "a golden coast of the Black Sea and the gold vein for Russian tourism," since it is "a second Sochi" – and more conveniently located. While the tourist market was artificially nurtured in Sochi, its rise in Abkhazia – in Gagra, Pitsunda and Sukhumi – was historic and took shape many decades ago.

The revival of tourism – about one million tourists a year visited Abkhazia during the Soviet era through a voucher system and about the same number came on their own – will require transparency in the structure and history of real estate ownership, so as to dispel apprehensions about the illegal seizure of property.

In recent years, Russian investors have been actively buying up land (or, more precisely, the rights to long-term rent) in Abkhazia. They choose to keep their acquisitions quiet, considering them the groundwork for the future. It will take investors about two years to assess Abkhazia's attractiveness (and the authorities could shorten this period) and another two to three years to build new and renovate old hotels.

A reverent and almost religious treatment of nature by the Abkhazian people and their commitment to the idea of independence, including independence from Russia, constitutes an important feature when considering the situation in the region. Abkhazian officials have promised to stand in the way of possible "grabbing" by foreign investors, thus exposing their patriotism, which is an unalterable factor of Abkhazia's investment climate.

This patriotism is sometimes overshadowed by the worst traits of the local mentality in the coastal resorts, which many Russians visiting the Sochi region know from experience – the desire to sponge off of others, thinking along the lines that "all outsiders are my debtors," laziness and envy even towards the small achievements of others.

According to Abkhazia's Chamber of Commerce and Industry, when the Russian Conti Group purchased "the remainders of the walls" of Hotel Abkhazia in Sukhumi for 60 million rubles, some politicians used the transaction as a ploy for demagogy. Russian industrialist Oleg Deripaska offered to buy Stalin's dacha for $10 million, but politicians and the media caused a stir around the proposal. As a result, the dacha remains abandoned and dilapidated. Frequent cases of groundless overpricing and extortion among the local bureaucracy scare away even Russian investors.

ABKHAZIA AS AN OUTSIDE TESTING GROUND FOR MODERNIZATION

The greater part of the region's potential can be tapped only with the aid of Russian financing and through access to its markets, which makes Moscow's policy a key factor in Abkhazia's development.

The key task is to raise the quality of management in the region, including state administration. Management today combines zeal with the absence of elementary skills. It is enough to mention that Abkhazia does not accumulate data for calculating the inflation index and the authorities have to make judgments about the economy based on cost indicators.

The transfer of trivial knowledge and skills by Russian managers and experts, which was previously blocked because Abkhazia was not officially recognized, will speed up its development and will help Russia train specialists for its own modernization. These people will be unique due to their experience with constructive creative activity in Abkhazia (rather than stealing) and because of their zeal to win (as opposed to the current defeatism of Russian red tape).

Abkhazia needs standard mechanisms for promoting its image, including making its virgin and fervently-protected natural surroundings popular. It should stress the idea that the denial of Abkhazian recognition is fraught with destruction of the environment. The West is usually not prepared to help people, but it quite often supports them together with some nice-looking “shrubs.” Just a single film about Abkhazia’s natural wonders on the National Geographic Channel would do more for the region than any big investor.

Communication systems must be developed to a level where they can be embedded in the global financial network. It is also important to develop education and medical consultations via the Internet.

Russia needs its own offshore zone, as such zones are not only tools for tax evasion, but also levers of global manipulation of capital. Big business needs such zones, including Russian business. The latter has to use the offshore zones of other developed countries now, which makes business more dependent on those countries. In addition to the partial disclosure of data by offshore companies, unofficial channels are available to Western countries to monitor money flows in the zones they control, which provide them with clues on how to influence the owners of the capital.

As Russian business makes its way to the global arena, it will need offshore zones controlled only by Russia. These zones will turn into instruments of global maneuvering for Russian capital along with the inflow of foreign capital. It would be dangerous to place offshore zones inside mainland Russia because they will be instrumental in evading taxes, like what happened in the 1990s. That is why these zones should be located in special outside territories.

Abkhazia may take on the role of an offshore financial center, along with the Kaliningrad Region. Since most countries have not recognized Abkhazia, the functions of a registration center may be delegated to a Russian town close to the border. Abkhazia would get dividends in the form of salaries of token directors and business activity, while Russia would get an instrument of global business maneuvering not subject to external controls.

Russia needs a seaside resort that is close, but along with assigning that role to Abkhazia it is essential to protect the environment. The region may grow into an analogue of Montenegro for Russians in terms of it being an inexpensive seaside holiday and there could be investment in real estate as early as in the next two years. It is time to drop the Soviet-era mania of erecting concrete edifices, oil refineries and all such things in recreational areas. Poverty dictates that the Abkhazians cannot choose investors, so control over environmental standards of production facilities in the region should become Russia's responsibility.

Tourism from Russia, the main factor in Abkhazia's development, needs an infrastructure. The Soviet-era defense industry has developed a mass of efficient technologies, including so-called "killer technologies" which make all previous technologies impractical. Small hydro stations that can produce electricity for customers virtually with any water source, as well as the production of super-cheap gasoline, cement, modular structures, etc. could give a powerful boost to Abkhazia's economy.

In Russia, these technologies are blocked by domestic and international monopolies that exploit old technologies, and by bureaucratic inertia. Sukhumi is free of such bureaucracy and monopolies, while it badly wants development "at whatever price." That is why Abkhazia could become a testing ground for the large-scale employment of such technologies; even more so because it already played this role in the Soviet Union in what concerned research in the dolphinarium, the apery, and at defense facilities.

SOUTH OSSETIA TODAY: A DISASTER

The Republic of South Ossetia covers 3,900 square kilometers, which makes it larger than Moscow only by a factor of three. It is located on the southern slopes of the Greater Caucasus Range. Assessments indicate that prior to the Georgian attack in August 2008, it was home to about 80,000 people, of which 40,000 lived in Tskhinvali, the region's only city (24,000 of those citizens have become refugees). Georgia's aggression erased the greater part of remaining production facilities and left a sizable number of buildings damaged.

The region's poverty threshold stood at 3,062 rubles a month in the forth quarter of 2007, or 23.5 percent below Russia's average, while South Ossetians have incomparably smaller incomes. This is a sign of impoverishment.

South Ossetia's industry consisted of 22 small factories before August's Five-Day War. In essence, these were workshops that turned out 61.6 million rubles worth of products, not including VAT (according to 2006 figures), and output was shrinking. The quality of state administration can well be seen in the fact that there were still no statistics for 2007 when Georgia launched its military operation.

A total of ten factories out of all the existing enterprises report to – that is, are controlled and administrated by – the Economics and External Economic Relations Ministry. Only seven of them functioned in 2007, while output fell 11.6 percent, or by 3.3 million rubles, even without factoring in inflation. The greater part of production facilities stand idle and the operating equipment is in constant need of repair. Even successful factories have a shortage of workers, are in debt and have a shortage of working capital.

The area planted with wheat soared more than ten-fold in 2008 to 1,500 hectares from 130 hectares, and the authorities expected a harvest of more than 2,500 tons of grain. This huge increase was a result of plans to purchase milling equipment by September 20 – the 18th anniversary of South Ossetia's declaration of independence. This would have justified growing wheat in the region. The flour would then be taken to the republic's state-run bakery, which has been importing expensive flour over the last 15 years, thus killing its own business. Officials promised that domestic flour production would reduce the cost of flour to 8 rubles per kilogram from 15 rubles. Also in 2008, the South Ossetian Agriculture Ministry solemnly imported two DT-75 tractors with equipment, and purchases of several more "pieces of farm machinery" were expected before the year-end.

SELF-RELIANCE AS A GOAL

Russia's goal is to bring South Ossetia's economy and living standards to the average level of Russian regions that make up the South Federal District (all of which are in depression except for the Rostov Region, the Krasnodar and Stavropol Territories) by 2011.

A total of 16 billion rubles will be allocated to restore the first 750 examined facilities under a restoration plan for 2009-2011 and another 9.5 billion rubles will be needed for priority measures. In all, allocations for the restoration of South Ossetia will reach 25.5 billion rubles (10 billion rubles in 2009) and this figure will likely increase. For instance, Russian Transport Minister Igor Levitin has requested 40 billion rubles to rebuild roads in North and South Ossetia from 2008-2015.

Some of the money will come from the budget of North Ossetia, which means that South Ossetia will be plugged into Russia's budgetary system. One can also surmise that the region could be united with North Ossetia after it reaches the average economic level of the South Federal District.

Exports of South Ossetian products to Russia will remain insignificant due to limited transport and production capacities. A poor infrastructure and low-quality – mainly for psychological reasons – services impede the development of tourism.

In addition to the rehabilitation of housing, transport and energy infrastructure, South Ossetia needs a few more things to prosper:

- A military base to defend against possible future aggression (after the Georgian Army regains its combat capability); the maximum involvement of the local population in building and servicing the base and who will serve under contract in the Armed Forces;
- A focus on using local resources rather than those imported from Russia;
- Training of local personnel.

The lack of financial control constitutes a specific local feature.

While Abkhazia has risen as a state, South Ossetia has emerged as a community of people who defended themselves against extermination. Statehood has not taken shape there – mainly due to a small population and scarce natural resources.

The scale of economic activity in the region is insignificant. One of the biggest local plants, Emalprovod, has a workforce of 130 employees, and the director of a timber factory, one of the more-or-less successful enterprises, said that the sale of 50 tons of equipment as metal scrap was the most realistic source of income. He said the 175,000 rubles (minus shipping costs) the factory might get for it "will give a real stimulus to the production development."

From the 1990s to 2004, South Ossetia received the lion's share of its earnings through smuggling from Georgia to Russia, and an attempt by the commander of the Border Guards of Russia's Federal Border Service to stop the smuggling resulted in his resignation.

Georgian President Mikheil Saakashvili stopped the smuggling in order to weed out separatism, and although some private trade with Georgia still exists, South Ossetia has actually changed over to living in dependence on Russia – despite denials of the fact. Experts have more than once accused the Russian military and the South Ossetian authorities of financial embezzlement due to gross overstatements in the number of people eligible for benefits from Moscow.

In 2008, South Ossetia's Committee for State Control and Economic Security held inspections at the instruction of the region's leader Eduard Kokoity. They discovered huge misappropriations of electricity and natural gas, mostly by private companies. The main cause of shortages in the collection of payments for electricity and gas was the lack of electricity meters in villages, untrimmed trees that often caused cable breakdowns on power lines, and wear and tear of the gas pipeline equipment. In a number of cases power line maintenance technicians called on the public to damage meters and promised them the chance to not pay for electricity in exchange for bribes.

The recognition of South Ossetia's independence creates prerequisites for financial control, including control over Russian money. The region's development must set an example of how to establish rigid financial control in conditions that are the least conducive to it, as well as show that there are financiers capable of exercising such control.

The measures specified above will be quite sufficient for South Ossetia's success provided financial control is introduced, as no sensible policy will be possible without it. That is why South Ossetia needs outside financial administration. If the measure proves efficient, the region may move on to self-financing (which means the implementation of defense, infrastructure, tourist and personnel training federal programs on its territory without direct budgetary transfers).

The objective of the South Ossetia project is to normalize life in the region with a view to reunifying the North and South Ossetian people within the Russian Federation. Given South Ossetia's full dependence on Russia, it will set an illustrative example for other ethnic groups in Georgia to judge Russia's ability to promote development. Turning South Ossetia into "a showcase of prosperity" will weaken the political regime in Georgia. However, if South Ossetia remains a showcase of misery with living standards even more dismal than those in the impoverished regions of Georgia, this will mean Moscow has failed.

Is "Constructive Nationalism" Possible?

The Negative Potential and Creative Construction

Leokadia Drobizheva

The 2008 developments concerning Kosovo, Abkhazia and South Ossetia have once again demonstrated the obvious conflict between the principles of the right of nations to self-determination and the territorial integrity of states. They have also shown how difficult it is to address the challenges of separatism. The interest in the phenomenon of nationalism has again increased in the world. Experts and politicians are trying to define various types of nationalism and to understand the difference between ethnic nationalism and civic nationalism, and what potential the latter type of nationalism has. Obviously, ethnic nationalism is not gone. But if its manifestations are inevitable, is it possible to have it acquire liberal, non-violent forms?

KEYS TO UNDERSTANDING NATIONALISM

Debates about the strength, influence and practical implications of nationalism have been going on unabated for decades. U.S. historian Michael Lind in the 1990s described nationalism as the most powerful force in the world. A decade later, U.S. political sociologist Michael Mann said that nationalism was far from dead. Another U.S. historian, Jerry Muller, last year discussed the persistence of ethnic nationalism (*Foreign Affairs*, March/April 2008). Back in the 1970s, Elie Kedourie pointed to discrepancies between what nationalists declared and what they did in practice. In subsequent decades, this subject was discussed by

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Ernest Gellner and Eric Hobsbawm. The matter at hand was, above all, ethnic nationalism.

Political philosophers distinguish between ***ethnic*** and ***civic*** nationalisms. Well-known historian Hans Kohn described the latter as Western nationalism, similar to that which appeared in France and Great Britain. It is also known as rational nationalism, based on loyalty to the state and free self-identification. It is from this angle that the United States interprets "nation."

Ethnic, or ethnocultural, nationalism is considered to be irrational as it appeals to the "call of the blood" and "shared history," and is based on loyalty to the people who have a certain cultural base. This model is called "German" and it is the closest to Russian ideas of nation and nationalism.

Two circumstances cause one to raise the issue of ethnonationalism again.

The first one is the growing gap between populist, ideologized political views and scientific research into nationalism.

The second is a desire to draw public attention again to the variability of nationalism, which defines society's attitude to it.

Nationalism is defined as an ideology where the interests and values of a nation as a group have priority over other interests and values. A nation must be as independent as possible; as Gellner wrote, it seeks to have a "political roof." In complex, multi-ethnic states this may mean a desire for autonomy or even secession. Thus, nationalism is always a political movement aimed at gaining or retaining political power, and is always a challenge for the center.

The phenomenon of nationalism is like an iceberg: the greater part lies hidden beneath the surface. Depending on the social and political context, the submerged part may surface, exposing its round or sharp edges. The task of society is to develop such an attitude to nationalism that would not let the iceberg sink the unstable ship of a multi-ethnic social system during the transition to democracy, and upset the fragile balance in the world community.

The attitude towards nationalism over centuries changed in cycles. After World War I, new states emerged on the ruins of great multinational empires of the late 19th century under the banner of national self-determination. But this positive valence of nationalism quickly exhausted itself already during the first postwar decade, even before the coming of fascism, with its expansionist goals and ensuing consequences – chauvinism, racism and anti-Semitism.

The end of World War II, the liberation of European nations from the Nazi occupation and the breakup of overseas colonial empires gave rise to a new euphoria of self-determination. However, the liberal tradition of supporting self-determination of nations was again adjusted due to manifestations of racism and militant ethnicity. The mistrust of developed democracies towards nationalistic beliefs strengthened the alliance of nationalism with leftist anticolonialism.

The emergence of newly independent states on the territory of the broken-up Soviet Union in the 1990s caused apprehensions among Western countries, although they provided full support to some of them. However, ethnic conflicts in the former Soviet territory and the former Yugoslavia confirmed the ambivalent and dangerous nature of nationalism.

Since nationalism of the "third wave" in its aggressive manifestations continues to be an obvious threat at the beginning of the 21st century, it is important to analyze precisely those of its types and forms that can be compatible with the transition to a democratic society.

The problem of the compatibility of democratic transition and nationalism is not new, but this does not make it less difficult. Recognized experts in the field of democratic transition viewed domestic unity and a stable common identity of citizens as crucial conditions for the success of democratization. And vice versa, ethnonational differences leading to various forms of nationalism and the growth of national movements are viewed as an obstacle to democracy in society.

Ethnonational problems and nationalist aspirations remain in developed democracies as well (for example, the Basque Country in Spain, Corsica in France, Quebec in Canada, Northern Ireland and Scotland in the UK, and Flemings and Walloons in Belgium). However, experts point out the readiness of the majority of the population of those countries to cope with emerging difficulties by nonviolent means and through democratic institutions. But even in such circumstances, acute forms of ethnonationalism, brought about by unsolved problems of national and territorial unity and identity, are incompatible with democracy.

This conclusion is logical from the point of view of democratization. But it remains debatable from the position of nationalism. A free expression of the will of the people is possible only in a democratic society, and ethnic leaders do not always use democratic procedures with good intentions. It was not accidental that the leaders of ethnic movements in the Soviet Union (for example, the leaders of the Popular Front in Estonia or Sajudis in Lithuania) demanded first of all more democracy in the country.

A group of researchers, led by U.S. scientist Tedd Gurr, made cross-national studies and concluded that ethnic groups in democratizing societies receive significant opportunities for political mobilization. The problem is that developing democracies do not yet have a stabilizing resource – the traditions of dialogue and lengthy negotiations, the required level of tolerance, and effective institutional mechanisms for achieving inter-group accord, which are used by states with a longer democratic history.

In these conditions, of paramount importance are three theoretical and methodological principles, which have proven effective.

First, nationalism should be considered in a historical perspective, taking account of the difference between, for example, nationalism of the 18th century and that of today and of the fact that each specific type of nationalism can transform into another type. Hans Kohn successfully demonstrated this approach in studying Europe. He came to the conclusion that the history of nationalism was a constant degeneration of rationality into madness, which manifested itself most vividly in National Socialism, with its wars, violence and messianic authoritarianism.

Second, Kohn also showed in his study how important a comparative, cross-cultural principle is for analyzing nationalism. It makes sense to compare the following two understandings of "nation" established over the last two centuries: the "French" one which stems from the idea of a free community of citizens of a state based on political choice, and the "German" one based on culture and common origin.

But even these long-established forms are changing. Anthony Smith, who took a more global view on the phenomenon of nationalism than the Europocentric Kohn, refrained from drawing a sharp opposition between "Western" (civic) and "Eastern" (ethnocultural) types of nationalism. After all, both models have a cultural and a territorial basis.

Rogers Brubaker wrote in the 1990s that the ethnic and civic models of nationalism not only overlap, but they can even change their meaning to the opposite over time.

And ***third,*** even those scholars who openly hold constructivist positions (if they are not biased experts) recognize the importance of the context, as, for example, Ronald Suny does [constructivists and, in particular, instrumentalists view ethnicity as a mental construct created by the individual himself – Ed.]. Nationalism achieves more success where there has formerly been a territorial, linguistic or cultural commonality and a common historical memory, which is used as starting material for an intellectual nationalist project. The experience of the Scottish, Basque, Estonian and Lithuanian nationalism confirms this conclusion.

It is the social and economic context that determines the development of the nationalist discourse, and nationalist policies and practices. Scholars and politicians holding constructivist and instrumentalist positions attach key importance to the elites' efforts to interpret the notion of "nation" and shape national identity. But how big is the resource of the intellectual power of the elite which expresses and shapes the ideas of nationalism? And how ready are various social groups and the entire population to support its ideas? This depends on the state of society. One should take into account the level of economic development, the political structure of the state, social and cultural factors, including the dominant norms and values in society, the degree of trust toward political institutions, the sense of citizenship and mutual understanding of citizens, the degree of awareness of the unity of the state, and other factors.

TYPES OF NATIONALISM

The study of inter-ethnic relations in the Soviet and post-Soviet space has revealed six types of nationalism.

Classic nationalism is the one where all cultural considerations – the need for an official language, preservation of a nation's normative and artistic culture – as well as historical, geopolitical and economic arguments are subordinated to the goal of broadening state autonomy and later independence (secession). This type of nationalism was mostly widely spread in the Baltic republics, where nationalists used an entire range of arguments – from criticizing the Ribbentrop-Molotov Pact to demanding control over the use of natural resources to seeking economic autonomy.

The dominating elites in autonomous republics within the Russian Federation embraced a different ideology and pursued a different policy. Not a single of these republics – be it Tatarstan, Bashkiria, Yakutia or Tuva (except Chechnya) – ever raised the issue of their full independence from Russia. They only spoke about “divided sovereignty,” implying that some of their powers could be delegated to the federal center. Some of the republics asked for more rights in the financial, economic, cultural and political spheres, while others sought control over their own natural resources and their culture. Claims to extended rights were the loudest in Tatarstan in 1990-1993. This type of nationalism can be called ***parity*** nationalism.

The ideology and political practices of autonomous republics were centered on the separation of powers between them and the federal center. It was implied that coexisting ethnic groups (for example, Tatars and Russians in Tatarstan) would enjoy equal rights, which was manifested in the legislative recognition of two official languages, concurrent discourses of the republics’ political leadership, and in dominant social practices.

In some republics, for example Bashkortostan and Yakutia, the focus in ideology and politics was made on the economy and culture, yet priority was given to ideas that were in line with ***economic*** nationalism.

In Karelia and Komi, where the titular nations were ethnic minorities, the efforts largely focused on the support for their cultural identity and languages. This corresponds to the ideas of ***cultural*** nationalism.

In other republics, particularly in North Ossetia and Ingushetia, ideas of protection dominated: protection of one’s territory, influence over this terrotory, and the return of previously lost lands. Volga Germans, for example, tried to restore their autonomous republic in the Volga Region, while the Ingush sought to move the administrative border between Ingushetia and North Ossetia and to incorporate the Ingush-populated Prigorodny District of North Ossetia into their republic.

The ideas of ***protection*** nationalism were also embraced by the ideologists of Russian nationalism – the protection of the ecology of Lake Baikal; the protection of Russian villages by “village prose” writers; and the protection of the peasantry, which had lost its most active part –

kulaks (the more successful and efficient farmers), who were dispossessed and executed or resettled to unpopulated areas in the 1930s.

In the post-Soviet territory, attempts were made to implement the ideas of ***modernization*** nationalism. In the late 1980s, when people in the Baltic republics linked hands in the Baltic Chain, which stretched from Tallinn through Riga to Vilnius, Moldovans remembered about their kinship with Romanians; Armenia launched a war for Nagorno-Karabakh; while young reformers at the heart of Russia lamented the outflow of funds from Russian regions to other Soviet republics. They believed that successful efforts to modernize and bring more democracy to Russia would motivate independence-minded republics to join the Russian Federation.

Regional leaders, too, cited modernization as an argument for autonomy – for example, in Tatarstan where the authorities feared a return of Communists to power in Moscow in 1993. The ideas of private land ownership and public investment cannot be implemented by restoring the former regime. Modernization nationalism usually appears in better developed regions in multi-ethnic states (for example, Russia of the late 1980s-early 1990s, compared with most of the other former Soviet republics; Tatarstan, compared with less developed regions of Russia; or Catalonia, compared with other provinces of Spain).

NATIONALISM AND THE STATE

Nationalism cannot be understood in isolation from the state. Nationalism is always an attempt to legitimize ideologically the seizure of control over the state. At the same time, it is also a reaction to excessive state interference felt by ethnic minorities.

It is quite natural for the federal center in a multi-ethnic state to seek to homogenize the population in order to prevent nationalism from evolving into separatist movements. However, in spite of the good intentions, the shaping of the sense of community very often turns, at best, into a function of the bureaucratic machine enforcing unification and assimilation. And it is for this reason that such attempts are rejected or criticized by citizens.

Opposition to these attempts does not necessarily come from ethnic minorities. The unification tendency may not be to the liking of ethnic Russians in certain regions where they make the majority of the population. For example, in North-West Russia, in the Urals and in the Southern Federal District one can often hear people say: "The Center does not know what we feel" or "The Center does not take into consideration our interests, and this prevents the building of a civic nation and the unity in the country." In regions populated by other ethnic groups, such sentiments are acquiring an ethnic tint.

Thing like that take place in other countries, as well, including those with long-standing and strong democratic traditions. Belgium, Canada and Switzerland have not avoided the tendencies of ethnic nationalism. John Breuilly has shown in his works that nationalism can be a product and a consequence of state nation-building. Failures of such experiments bring about the opposite result – increasingly manifest outbreaks of ethnic nationalism.

Daniele Conversi explains that an excess of overly zealous centralism often caused a homeostatic reaction, which in turn gave rise to strong nationalist movements in the periphery. Tedd Gurr also wrote about nationalist growth accompanying state efforts to achieve ethnic homogenization of society. In Spain, for example, the government's actions caused ethnic minorities to mobilize and brought about the rise of the Basque and Catalan nationalism, imparting a political tint to the cultural markers of these ethnic groups.

The reaction of the Russian and Ukrainian minorities in Moldova to the Moldovan government's discriminatory policy towards the Russian and Ukrainian languages in the early 1990s was bitter, as well. A similar situation took place in South Ossetia and Abkhazia in the late 1980s-early 1990s as a reaction to the policy of Georgia. Another controversy involved the decision by the State Duma of the Russian Federation to prohibit the replacement of the Cyrillic script with the Latin alphabet for the Tatar written language. The decision caused protests among Tatar intellectuals.

In the majority of ethnic movements in the post-Soviet space, political frictions over the status of languages have undoubtedly played a mobilizing role. The status of a language is becoming a social resource in modern society; therefore, the ideologists of ethnonationalism assign as much importance to it as they do to the struggle for other resources – natural or political. In general, ideologists build ethnic – mostly culturally marked – boundaries in conflicts over various resources.

Other interests may also serve as the reason for this kind of demarcation. For example, for ethnic Russians who live in other ethnic territories of the Russian Federation, the divider is access to participation in regional power. It has become a mechanism of social categorization and comparison, and in some cases, a mechanism of contraposition between ethnic groups.

Psychologists believe that the fewer differences between contacting ethnic groups, the stronger their claims based on these differences. Perhaps, this is why industrialization, urbanization and globalization have not erased ethnic boundaries completely, as was predicted in the times of Max Weber and Karl Marx and by contemporary theorists of globalization. Thomas Friedman patently shows this in his book *The World Is Flat,* where he analyzes new "silicon valleys."

THE POSSIBILITY OF LIBERAL NATIONALISM

Nationalism still embodies the categorization of oneself and "others." But this does not imply that the differences are due to an irreconcilable antagonism. Several types of nationalism can peacefully coexist within one state. The very recognition of the fact that nationalism can be different suggests that some of its types and forms can, under certain circumstances and to a greater or lesser degree, be combined with liberalism and democracy.

The most important of these conditions lie in the field of political ethics. A mere desire of ethnic leaders is not enough to manipulate the masses. The experience of one person may prove to be insufficient, but the experience of many people can teach a lot. And then the ideologists of nationalism themselves start looking for ways to avoid violence and antagonism.

The problem of the compatibility of nationalism with liberal values came into the limelight after the publication of Michael Lind's article "In Defense of Liberal Nationalism" (*Foreign Affairs,* May/June 1994). Lind argues that "prejudice against nationalism, even liberal, democratic, constitutional nationalism, is a mistake." This prejudice results in "reflexive support for multinational political entities, especially despotic ones." The perception of nationalism as an outdated phenomenon from the archaic past is a prejudice that does not conform to political practices.

Not all cases of separatism are bad, and the policy of supporting the integrity of multinational states by all means is not always good.

Similarly, the secession of one or even several nations does not mean that every multinational state is ready to collapse like a house of cards. At the same time, the multi-ethnic nature of a state is not an insurmountable obstacle to the state's democratization. It is only important to work out a mechanism to separate powers between ethnic groups. Lind cites Belgium, Canada and Switzerland as successful examples. He does not think one should be afraid of superpowerful multinational states, like the former Soviet Union or modern Russia – provided, of course, such states are built on a voluntary basis. Lind argues that nationalism is quite compatible with liberal values, if two essential conditions are met – the possibility of a free choice by a person of his/her nationality, and the ensuring of the rights of cultural minorities through peaceful means.

The interest in the compatibility of nationalism with liberal values – an ideological nonsense only recently – is growing before our eyes. And this is not accidental. Ethnic cleansings, aggressive separatism, and declarations of self-determination – all these problems faced by the West today have to be addressed not overseas but in its own or neighboring states. Russia also has to look for answers to external and internal challenges of nationalism, which are becoming ever more powerful and diverse. The matter at hand is not only the position of the Russian leadership on the status of Kosovo or Abkhazia, but also the situation that has taken shape in Russian regions, as well as the ability of various ethnic groups to realize their community, and their readiness to implement their interests through non-violent means.

The *Nation and Nationalism* journal held a discussion following the publication of the book "On Nationality" by David Miller. Miller disputes the belief that nationalism is the ideology of rightwing forces that support authoritarian regimes and that are hostile to liberalism and democracy. He defines liberal nationalism as a combination of social democracy inside a country and an exceptionally liberal doctrine of formal equality in the international arena.

Brendan O'Leary, who participated in the discussion, emphasized the need to apply liberal standards toward minorities. Indeed, peoples that have gained sovereignty in newly independent states often themselves do not respect the rights of minorities – examples of that can be found in post-Soviet countries as well. O'Leary holds that liberal public opinion should seek the introduction of procedures and precautions to guarantee the collective rights of minorities and individual human rights. Unfortunately, his recommendations resemble advice to an enlightened public opinion whereas newly independent states exhibit a deplorable absence of relevant traditions, institutions and agreed political procedures for implementing the proposed measures.

ATTAINABILITY OF THE IDEAL

The analysis of the theory of nationalism suggests that liberal nationalism is possible if the following conditions are met:

- statehood is declared on behalf of all citizens living in the given territory, or on behalf of the nation understood as a community of people living in that territory;
- the state has a liberal-democratic system which ensures the supremacy of law, universal suffrage, a representative system of government, elective government as a form of implementation of the principle of representation, and the separation of powers between the legislative, executive and judicial branches;
- the state ensures political and legal equality of its citizens, including the right to be elected to public office;
- the state allows pluralism and freedom of political activity, the freedom of speech, and the right to formulate and advocate political alternatives; the possibility of internal differences in discussing values, ideals – including national, ethnic, cultural and linguistic ones –and the essence of the community and its boundaries in a manner that is acceptable to the parties involved in the discussions and that is void of extremism and violence;
- there are political institutions that ensure cultural diversity and minority rights;
- the state ensures the free right of the individual to choose his/her nationality.

Most of these principles are characteristic of developed, or consolidated, democracies. This is actually the ideal. Trying to formulate such an ideal for all times and for all nations would mean falling into a dangerous illusion. Democracy is a process of the development, expansion and renewal of ideas, principles, institutions and procedures. Liberal nationalism can also be renewed in principles, institutions and procedures, while remaining the goal that nationally oriented social forces, leaders and authorities seek to achieve, although they do not always succeed.

Democracy per se does not guarantee the achievement of many goals, among them general welfare, peace, and the solution of ethnonational problems. Yet it makes sense to focus on the discussion of conditions under which nations would prefer their self-determination not as secession but in the form of various types of autonomies, and when nationalism (in the case of Russia this is largely ethnonational separatism) could be channeled into a liberal course.

Such conditions can be objective and subjective. ***Objective conditions,*** which enhance readiness for liberal forms of nationalism, include the following aspects.

The ***first*** one is the ethnic composition of a given territory. The smaller the proportion of the titular nationality, the more it must reckon with the will of the other part of the population, think of ensuring support from it, liberalize its ethnic policy, and proclaim goals and tasks, whose achievement would guarantee the unity of the entire multi-ethnic community.

The ***second*** one is the territorial position. If a region or a self-determining ethnic group has no external borders, it is difficult for it to set the goal of secession or radical separatism. All former Soviet republics that have become independent, as well as Abkhazia, South Ossetia and Chechnya, had external borders. The absence of such borders imposes limitations on separatism and stimulates the search for peaceful solutions. This does not mean that liberal nationalism, for example in Chechnya, is doomed; it only means that in Tatarstan, for example, it has more chances, and that over time Tatarstan can become a model for others.

The ***third*** aspect is the resources of a self-determining group and the level of its modernization. The matter at hand is not just material resources that ensure the group's economic self-reliance, but also intellectual ones. The larger the number of intellectuals and competent people in the group who are familiar with the international experience and international approaches to the solution of ethnonational problems, the greater the chances for negotiations conducted with account taken of the interests of the parties involved. The composition of the political elite and the level of its professional training are of particular importance in this respect. It was much easier for Estonians, for example, to find liberal solutions to ethnic problems than it was for Moldovans. Tatars have more opportunities in this regard than, for example, Chechens or Tuvinians.

The possibility of liberal nationalism also depends on internal and external ***subjective factors***.

First, the greater the legitimacy and stability of the central government and the greater its cohesion and organization, the less chance the regions have to play on differences in the government and to lead things to ultimatums in interaction with it. At the same time, it is easier for them to agree on the separation of powers and areas of jurisdiction.

Second, much importance is attached to the level of development of democratic organizations in a state which ensure the participation of representatives of ethnic groups in the government and a voice for them in the mass media, and to the presence of stable state mechanisms for managing conflict situations.

Third, one should not expect the liberalization of ethnonationalism or the weakening of separatism, if there is an escalation of chauvinistic nationalism in the state and if national resources are distributed arbitrarily.

Fourth, one should always bear in mind that an excessive number of educated people impedes their career development and causes the discontented ones to lay emphasis on cultural claims. Nationalism becomes a safety-valve for frustration, while absence of demand for intellectuals develops into a riot of fringe intellectuals. Therefore, success in stabilizing the escalation of ethnonationalism goes to those regional leaders in Russia who seek to integrate potential and non-extremist ideologists of nationalism into government structures or to use them in some other way. Tatarstan and Yakutia are examples of successful attempts to extinguish ethnic extremism in such a way.

Fifth, external influence is becoming increasingly important. Hopes for international public support or, on the contrary, international protests adjust the behavior of leaders in (potentially) separatist territories and in the center. There is a more reliable way to settle conflicts than a show of strength: a clear formulation by the international community of its position on such issues as possible forms of self-determination; the attitude to the Helsinki principles, extremism and terrorism; and the involvement of politicians, public figures and scientists in the solution of ethnic problems and in efforts to ensure peaceful coexistence among people of different ethnicity.

Naturally, the aforementioned conditions for the emergence of liberal forms of nationalism are not always present. And even their presence does not guarantee the achievement of the desired goals. Nevertheless, they create and broaden possibilities for liberal nationalism and the prevention of violence.

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