COUNCIL on FOREIGN RELATIONS

Council Special Report No. 53
April 2010

Jeffrey Mankoff

The Russian Economic Crisis

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Contents

Foreword *vii*
Acknowledgments *ix*
Acronyms *xi*

Council Special Report 1
Introduction 3
Crisis Politics 7
Recommendations 14
Conclusion 21

Endnotes *23*
About the Author *25*
Advisory Committee *26*

Foreword

Nearly two decades after the fall of the Soviet Union, the character of Russia, its principal successor state, remains unresolved. So, too, does the character of Russia's relationship with the West. Though the intense U.S.-Soviet rivalry of the Cold War is over, Russia has not become the consistent partner that many on the outside hoped would emerge after the Cold War's end. The United States and Europe have taken issue with many elements of Russia's domestic trajectory and regional and international posture, including its democratic practices, energy-related activities in Europe, stance on Iran's nuclear program, and actions in the 2008 Russia-Georgia conflict. At the same time, many Russians are also disappointed with Western policies and actions, including sympathy for Georgia, U.S. plans for missile defense, and, above all, the enlargement of NATO. This has made for a mix of resentment and assertiveness in Moscow.

A principal factor enabling this assertiveness in recent years has been Russia's strong economic growth. Since 2008, though, Russia, like many other countries, has experienced a deep economic crisis. The question is how this crisis might affect Russia's domestic politics and foreign policy and, consequently, whether any change is warranted in U.S. policy toward Moscow.

In this Council Special Report, Jeffrey Mankoff examines just this set of issues. He starts by identifying three elements of the economic crisis in Russia: a financial crisis that hit Russian banks and firms, a sharp decline in the price of Russia's principal export commodities, and a recession marked by low domestic demand. He then analyzes the crisis's implications for Russia's political dynamics and foreign policy. Mankoff argues that economic distress has weakened Russia's principal instruments of international influence. Lower energy prices have reduced Moscow's power in that realm, while the crisis has decreased resources for Russia's military and for loans to its neighbors, diminishing Moscow's influence in the former Soviet sphere.

All of this, Mankoff contends, makes Russia less able to challenge the international order and U.S. leadership in particular. The economic crisis thus presents an opportunity to deepen American and European economic ties with Russia and integrate the country more firmly in the international system, something that could, over time, bring Russian and Western interests closer together. The report makes several recommendations to this end. Among these are, first, steps to facilitate trade, investment, and capital flows between Russia and both the United States and Europe. Second, the report urges U.S. congressional approval of the so-called 123 agreement that would allow Russia to reprocess used American nuclear fuel. This would benefit Russia financially and perhaps encourage it to play a stronger role in limiting Iran's nuclear development. The report also argues for leaving open the possibility of Russian membership in the World Trade Organization and helping Russia resolve obstacles to its accession, including disputes with Georgia, if Moscow makes progress on relevant reforms. Finally, Mankoff advocates U.S. and European Union efforts to strengthen governance in other post-Soviet countries in order to reduce their vulnerability to Russian pressure and discourage Russia from pursuing a dominant regional role.

As Mankoff argues, this policy agenda comes with some urgency. A strong economic recovery could well embolden Moscow and increase its resistance to the kind of integration that the report advocates. *The Russian Economic Crisis*, with its perceptive analysis and thoughtful recommendations, is thus both informative and timely. It makes a valuable contribution to the debate over how to deal with a weakened but still highly relevant Russia.

Richard N. Haass
President
Council on Foreign Relations
April 2010

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I would like to take this opportunity to express my gratitude to the Council on Foreign Relations for allowing me to write this Council Special Report on such a timely, and often misunderstood, subject. Particular thanks are due to CFR President Richard N. Haass, Director of Studies and Maurice R. Greenberg Chair James M. Lindsay, and George F. Kennan Senior Fellow for Russia and Eurasia Studies Ambassador Stephen Sestanovich for reading several drafts of the report and offering their comments and suggestions for improvement. Ambassador Sestanovich as usual also assisted with his words of advice and encouragement throughout the process. Without the assistance of the Publications team, headed by Patricia Dorff, and the Communications team, led by Lisa Shields and Anya Schmemann, the report—no matter how timely or persuasive—would never be read. I am deeply grateful to them as well.

Two drafts of the report were read and commented upon by an advisory committee composed of leading experts on Russia and international business and economics. Their names are listed at the end of the report. I would like to express a particular debt of gratitude to Professor Angela Stent of Georgetown University, who chaired the advisory committee with great aplomb, humor, and tact. The committee's judicious criticism helped me greatly. Not only did it allow me to tighten the argumentation and avoid obvious errors of fact, it helped clarify for me some of the debates running through the expert community on the wisdom and feasibility of engaging Russia. It goes without saying that the members of the advisory committee bear no share of the blame for any remaining shortcomings from which the report may suffer.

I owe an additional debt of gratitude to the research associates who made the writing and production of this report possible. Because of staff turnover, I was assisted in turn by Mark Holden, Parke Nicholson, Michal Lewin-Epstein, and Arpana Pandey. Each of them contributed in his or her own way; their assistance was the more impressive for the fact that none of them were Russia specialists when they began working on this project with me. If nothing else, I hope they have come away from the experience unscarred and with a deeper understanding of Russia's complexities. Finally, I would like to acknowledge BP p.l.c., whose financial support made this report possible. The statements made and views expressed herein are solely my own.

Jeffrey Mankoff

Acronyms

BRIC	Brazil, Russia, India, and China
bbl	barrel
CSTO	Collective Security Treaty Organization
EU	European Union
FDI	foreign direct investment
GDP	gross domestic product
G20	Group of Twenty
IMF	International Monetary Fund
NATO	North Atlantic Treaty Organization
START-1	1st Strategic Arms Reduction Treaty
WTO	World Trade Organization

Council Special Report

Introduction

Like much of the world, Russia has been in the midst of a serious economic crisis since the late summer of 2008. Although the worst appears to be over, Russia will continue to feel its effects longer than many other industrialized countries, largely because of a rigid economy burdened with an overweening state role. The recognition that Russia faces serious long-term challenges has emboldened President Dmitry Medvedev and others to call for far-reaching economic restructuring. If successful, their economic policies could undermine the semi-authoritarian, state-capitalist model developed under Prime Minister and former president Vladimir Putin. Although concrete reforms have so far been limited, Medvedev's demands for change (seconded in some cases by Putin) have acquired increasing momentum in recent months. The speed of Russia's recovery and obstacles along the way will play a major role in determining both the success of Medvedev's call for modernization and the course of Russia's foreign policy since a quicker recovery would diminish the pressure for fundamental reform and lessen the need for caution internationally.

In the short to medium term, Russia's focus on repairing and modernizing its economy gives the West a real opportunity to enmesh Moscow in the rules-based liberal international economic order and to deepen economic ties between Russia and the West, which can provide the capital and access to international institutions that Russia needs to boost its competitiveness. Such integration would help align Russian and Western economic, and eventually perhaps political, interests and give Moscow real incentives to be a responsible player in the global economy. The danger is that, should the Russian economy turn around quickly (presumably due to a rapid rise in oil prices), such a strategy of engagement will not have time to take effect. For that reason, the West also needs to hedge against the danger of a renewed Russian push for regional dominance. It should therefore encourage reform in post-Soviet states bordering Russia, whose weakness may tempt Russian leaders to pursue a strategy of regional integration and autarky rather than integration into global institutions.

CAUSES AND CONSEQUENCES

Although Russia's economic crisis is part of the global recession, its origins and progression are distinct. Russia's economy began faltering even before the worldwide meltdown of October 2008 set off by the collapse of the U.S. housing bubble. Despite claims from Russian officials and analysts that Russia's emerging, commodity-dependent economy was decoupled from volatility in global markets, Prime Minister Putin's heavy-handed threats against companies over back taxes, followed by the August 2008 Russian invasion of Georgia, triggered large-scale flight of foreign investment from Russia in the second half of 2008, just as global commodity prices were starting to fall. As a result, the Russian stock market plunged; the benchmark RTS index lost almost 90 percent of its May 2008 peak value over the subsequent ten months before rising again (as of early 2010 it was still a third below its peak).[1] Moreover, Russia's heavy dependence on the export of energy and other commodities became a vulnerability when commodity prices dropped as a result of reduced worldwide demand.

The Russian downturn has three components: a serious financial crisis affecting banks and several heavily indebted enterprises, a global commodity price crunch that slashed prices for Russia's major exports, and a recession characterized by sharply lowered domestic demand. That decline contributed to a downturn in Russia serious even by the standards of the global "Great Recession." The Russian economy, which had been growing by an average of more than 7 percent a year for the previous decade, began deteriorating; output rose by only 2.1 percent in 2008, before falling by 7.9 percent in 2009.[2] Even as month-to-month gross domestic product (GDP) began growing again in the third quarter of 2009 on the back of higher commodity prices, investment and consumer spending have not recovered. Credit is extremely tight, contributing to sharply lower domestic aggregate demand. And the recovery is likely to be protracted. The crisis and concerns about property rights have increasingly scared off foreign investors; foreign direct investment (FDI) into Russia fell by 45 percent in the first half of 2009 alone.[3] Moscow also spent $200 billion from the state's Reserve Fund to prop up the ruble. Preventing a run on the currency averted panic among holders of bank deposits, but further entrenched the country's uncompetitive industrial model while enriching favored banks and currency traders. These steps, along with efforts to mitigate the effects of rising unemployment (such as temporary employment and public works projects), mean that after running a budget deficit of 6.3 percent of GDP in 2009, yearly deficits will continue until at least 2012.[4]

Although a slow recovery is likely and the danger of a double-dip recession remains, it appears the worst of the crisis is now over. The Ministry of Economic Development projects that the Russian economy will grow by between 1.3 percent if average oil prices remain below $60/barrel (bbl) for the year and 3.5 percent if oil prices reach $69/bbl in 2010. The International Monetary Fund (IMF) forecasts 2010 economic growth at 1.5 percent.[5] Russia's recovery nonetheless remains imperiled by a weak banking system, heavy private sector debt, and persistent unemployment that threaten to keep tax revenue low even as spending on social services rises.[6] Recognition that these problems—along with Russia's susceptibility to oil price fluctuations—limit Russia's long-term competitiveness has been central to Medvedev's calls for reforms.

Much of the reason for Russia's halting recovery has to do with an economy that continues to rely on large industrial conglomerates and resource extraction, coupled with a heavy state presence. After a decade of gradual liberalization, Moscow reverted to a more statist, protectionist economic strategy around 2003. This reversal was accompanied by a turn toward greater authoritarianism at home and greater assertion of Russian power abroad. This reassertion of state control and resistance to global economic integration accelerated with the onset of the financial crisis; Moscow for a time halted talks on World Trade Organization (WTO) accession, bailed out politically connected companies, and stepped up pressure on foreign investors. By mid-2009, Russia's economic authorities started tacking back to the center with a renewed emphasis on fiscal probity, the relaunching of negotiations on Russia's WTO entry (following a brief, bizarre suspension in June), and concerted attempts by both President Medvedev and Prime Minister Putin to reassure nervous foreign investors—even though disputes over chicken imports and a judicial assault on foreign companies such as Hermitage Capital continued to cloud the horizon.

The effects of the economic crisis on Russian foreign policy are more diffuse but equally important, since Russia's crisis-driven foreign policy will shape the opportunities available to Western policymakers for dealing with Russia. At a minimum, the crisis has forced Moscow to reassess its self-perception as a rapidly rising power, particularly as other large developing economies (including Russia's putative BRIC partners—Brazil, India, and China) have weathered the crisis better. By exposing structural deficiencies in the Russian economy and highlighting the limits of its post-1998 resurgence, the crisis forced officials to pull back from sweeping claims about Russia's imminent return to great-power status and focus attention on problems closer to home. Such foreign policy caution might not endure in the face of another commodity price–driven boom. Yet given the modest economic prognoses for the coming year, Russia's foreign policy is likely to remain cautious for the near future.

A period of foreign policy restraint in Moscow gives the West a window of opportunity to encourage both fundamental economic reform in Russia and greater integration with the global economy. If successful, such integration would diminish the likelihood that a recovered Russia would again pursue regional domination and autarky as the basis for a revisionist foreign policy. The inability of Russian industries to compete globally has long forced them to focus on meeting domestic demand, which has plummeted in the course of the crisis. Yet because of their inability to modernize on their own, Russian companies have increasingly turned to partners in Europe (especially Germany, France, and Italy) for high technology. In the context of the crisis and President Barack Obama's promise to "reset" relations with Moscow, Russia has also appeared more receptive to political overtures from the United States and the European Union (EU), for instance on sanctions against Iran, strategic arms cuts, and the war in Afghanistan. Even so, renewed (albeit limited) growth and uncertainty about who will lead Russia after Medvedev's first term expires in 2012 create concern for the future. The crisis has meanwhile complicated Russia's relationship with its neighbors, in that Moscow appears less able to provide investment and subsidies as a means of maintaining political influence in the former Soviet Union, creating a parallel opportunity for the West to promote political and economic reform in the other post-Soviet countries.

Crisis Politics

As the West devises a strategy for coping with the effects of the Russian crisis, a critical element will be the fate of Medvedev's calls for reforming Russia's bureaucratic-oligarchic economic model. Without successful economic reform in Russia, it is unlikely that Moscow's willingness to pursue economic integration and a more restrained foreign policy vis-à-vis the West will survive the end of the current crisis.

Two principal obstacles impede the implementation of Medvedev's call for reforms: opposition from the entrenched bureaucratic-oligarchic elite and (less likely) the potential for popular unrest. The economic crisis highlights divisions within the Russian government. Putin's allies, many of them *siloviki* (that is, former members of the security services, such as Deputy Prime Minister Igor Sechin), tend to prefer larger fiscal stimulus and greater state intervention in the economy. They favor relying on the energy sector as the driver of development and promoting the creation of state monopolies in strategic sectors of the economy. Medvedev and his supporters, including Finance Minister Aleksei Kudrin, First Deputy Prime Minister Igor Shuvalov, and Minister of Economic Development Elvira Nabiullina, have called for greater restraint and a focus on macroeconomic fundamentals, along with privatization of many state firms. The standoff between these camps has limited the effectiveness of Moscow's anti-crisis measures and blocked attempts to move away from Russia's state-centric, resource-based economic model, especially now that global energy prices have begun rising again.

Currently, state-owned companies dominate many strategic sectors, including energy, defense, and aerospace, as well as gas and to a lesser degree oil, whereas sectors such as autos and aluminum manufacturing are dominated by nominally private firms whose oligarchic owners (such as aluminum titan Oleg Deripaska) benefit financially from their close ties to the state. Most Russian state companies are both inefficient and corrupt. Many appear to have siphoned off bailout money they received from the Kremlin to pay dividends, without resolving their debts. Private firms, on the other hand, remain the source of most growth and innovation. To move fully toward a model of innovation-led development as Medvedev has urged, the government would have to break up or force many state companies (as well as failing oligarch-owned conglomerates) into bankruptcy, freeing up assets for more productive, sustainable uses. In late 2009, both Medvedev and Putin called for auditing, and ultimately breaking up state corporations, but it remains unclear how successful this effort will be.[7]

Medvedev's calls to dismantle the state corporations in particular have met substantial resistance from within the bureaucratic-oligarchic elite. Yet neither the elite nor the private sector oligarchs, many of whom have benefited from their close relations with the state to weather the crisis (even as their fortunes have shrunk), is monolithic, and fissures within it are among the principal dangers to Russia's socio-economic status quo. Because the system is based on access to rents, distinct sectors, companies, and even individuals maneuver against one another to maximize their own opportunities for profit. Because of problems such as conditional property rights and political uncertainty, this maneuvering is conducted within a short time frame, and Russia's state capitalist system consequently has difficulty making long-term strategic decisions.[8] In the constrained circumstances of the past year, the Russian elite has stepped up its maneuvering for access to a smaller pool of available rents, which will increase competition and exacerbate fractures within the elite.

That competition could escalate further if Medvedev's push to break up state corporations continues to gather steam, especially since the push to dismantle them will be superimposed on the jockeying for position in advance of the 2012 presidential election. Efforts to unwind the state corporations threaten the positions of the *siloviki* whom Putin positioned on their boards. Medvedev's ability to carry out such a fundamental reform of the economy will play a significant role in determining the distribution of power within the ruling tandem as the election approaches. The basic dilemma is that the status quo guarantees short-run stability and profits, but at the cost of undermining the long-term competitiveness that is central to the elite's hopes for Russia's restoration as a major international power. Attempts to overhaul the system that threaten the elite's access to rents could prove profoundly destabilizing and ultimately derail reform altogether.

Compared with the threat of fissures in the elite, the danger from popular unrest seems limited, though it could become serious if the population is forced to suffer a period of prolonged deprivation. After all, the legitimacy of the semi-authoritarian system that has emerged in Russia since 2000 is predicated on delivering increased prosperity to Russia's citizens. Both Medvedev and Putin, who as president continually invoked the need to improve the country's living standard, particularly in his annual addresses to the Federal Assembly, have made this connection explicit.[9]

Even as the Kremlin worries about the potential for social unrest if the crisis drags on or worsens, it must contend with the uneven impact of the crisis in different parts of the country. In addition to the *monogoroda* (one-company towns) such as Pikalevo, where Putin flew in June 2009 to address demonstrators and personally demand the reopening of idled factories owned by Deripaska, unemployment is concentrated in specific regions, such as the politically chaotic North Caucasus and the metal-producing areas of the Urals.[10] Perhaps more worrying than the events in Pikalevo were the December 2008 demonstrations in Vladivostok and close to twenty other cities in the Far East in response to the Kremlin's decision to protect the struggling Russian auto industry by raising tariffs on the import of used cars. Uncertain whether it could count on the local security forces to crack down on the protesters, the Kremlin was forced to fly in a special police brigade from Moscow to deal with the demonstrations. Similar antigovernment protests in Kaliningrad in February 2010 show that such discontent exists in many areas.

An exacerbation of tensions between Moscow and regional authorities could prove particularly dangerous in the North Caucasus, which already suffers from a low-level insurgency fused with organized crime as well as Islamist radicalism. Instability there is serious, largely fueled by a dire economic situation and government mismanagement. Not only Chechnya—where Moscow's outsourcing of responsibility to strongman Ramzan Kadyrov has exacerbated distrust of the authorities—but much of the North Caucasus region, including Dagestan, Ingushetia, Karachevo-Cherkessia, and Kabardino-Balkaria, is at risk of sustained unrest if the crisis worsens. An upsurge in terrorism following the March 2010 attack on the Moscow subway could also reinforce the *siloviki* and shift the Kremlin's focus back to the security issues that dominated much of Putin's presidency at the expense of Medvedev's economic reform program.

THE CRISIS AND FOREIGN POLICY

The economic crisis and the government's response to it have also influenced Russia's relations with both its neighbors in the former Soviet Union and the West. Recent history suggests that Moscow's international behavior is more assertive when the economy is booming, and more accommodating in recessions. The 1979 invasion of Afghanistan, like the 2008 invasion of Georgia, occurred in the midst of booms and record-high oil prices. Conversely, Moscow's retreat from eastern Europe in the late 1980s happened after oil prices plummeted. That pattern is likely to persist during the next boom as well—unless in the interim the West can design a set of incentives that encourage Russia to believe that it has more to gain from being a participant in the global economy than from isolating itself inside the borders of the former Soviet Union. For the time being, a wide swath of the Russian elite has come to recognize that the crisis has made Moscow's pre–August 2008 pursuit of multipolarity untenable, creating an opportunity for patient outreach by the West to anchor Russia more firmly in the global liberal economic order.

In light of Russia's structural economic problems, President Medvedev has argued that Russia's current foreign policy should seek to promote modernization by opening the country to foreign capital, technology, and ideas. Success should be judged on "whether [foreign policy] facilitates the improvement of living standards in our country."[11] The emphasis on foreign policy as a tool for development has been increasingly pronounced during the crisis, as the elite has largely come to acknowledge that it cannot for the moment afford an ideologically driven, overtly confrontational foreign policy.[12] This perception appears based in part on the recognition that the crisis has undermined some of the principal levers Russia has used to exert influence abroad in recent years: energy, the military, and financial assistance to neighbors.

The crisis has largely discredited the notion, championed by Putin, of Russia as an energy superpower. Thanks to falling energy prices and a steep decline in its market capitalization, Gazprom has less money available for foreign acquisitions or the construction of new pipelines, weakening its push for greater market power in Europe. Meanwhile, completion of a new oil pipeline to China required a $25 billion loan from the Chinese government to Rosneft and oil pipeline operator Transneft. The loan allowed China to lock in guaranteed supplies for twenty-five years at a net price that will average only about $20/bbl. The deal underscores both Russia's need for foreign capital and the increasing power disparity between Russia and China.

Reduced European demand and lack of capital for investment have contributed to a serious decline in Russian gas output (production for 2009 is estimated to have fallen by at least 10 percent). The shortage of investment capital has also delayed plans to open up new production sites, notably at Shtokman and the Yamal Peninsula. These troubles increasingly call into question Russia's ability to meet projected long-term demand in Europe. The short-run fall in demand has meanwhile damaged Russian influence in Central Asia, where Gazprom has had to unilaterally reduce its purchase of gas from Turkmenistan, even as a new oil pipeline from Central Asia to China opened in December 2009, ending Russia's ability to control the Central Asian countries' access to world energy markets.

The crisis has likewise affected Russia's military. Although both Medvedev and Putin have long been committed to reforming the military from its Cold War–era structure, the armed forces' uneven performance in Georgia gave a new impetus to their plans for downsizing and restructuring. The financial crisis, however, has complicated the picture. Plans to downsize as part of a move toward a brigade-based force with a professional cadre of noncommissioned officers have foundered over lack of financing and resistance from the general staff and officer corps. At such a moment of uncertainty in the ranks, Russia has a clear interest in preventing the outbreak of new conflicts.

The crisis has also posed a major challenge to Russia's policy of post-Soviet integration, since Moscow now has fewer inducements to entice its neighbors into closer cooperation. That development is especially significant given that Russia has often pursued regional integration as an alternative to participating in global institutions. Russia's diminished ability to dominate the post-Soviet space creates an opening for the West to both step up its own (nonmilitary) involvement in the region and make the case that Russia has more to gain in the long run from global rather than regional integration.

The war with Georgia encouraged many post-Soviet leaders to reduce their dependence on Russia anyway, but the economic downturn accelerated this process. In recent years, Russia's influence over its post-Soviet neighbors was underpinned by its ability to dole out loans and subsidies, along with investment by Russian companies flush with cash. Initially, the crisis appeared to offer an opportunity to step up such financial support, as Russia's financial position remained stronger than that of many of its neighbors.

In the first half of 2009, Moscow announced it would lend $2 billion to Belarus, $500 million to Armenia, $500 million to Moldova, and $2.1 billion to Kyrgyzstan. In the face of Russia's own worsening financial position, the Kremlin failed to make good on these commitments, costing it heavily in credibility and influence with its post-Soviet neighbors. A dispute over Minsk's debts to Gazprom and flirtations with the West led Russia to freeze disbursement of its loan to Belarus in June; the furious Belarusians then boycotted a Collective Security Treaty Organization (CSTO) summit in Moscow later that month. Moscow's failure to follow through with all of its promised loan money likewise encouraged Kyrgyz president Kurmanbek Bakiyev to abrogate the deal reached with Medvedev in February 2009 to expel U.S. forces from their base at Manas International Airport. Moscow's failure to come up with the $500 million loan it promised Moldova encouraged leaders in the capital, Chisinau, to turn to the Chinese, who provided twice as much money. The crisis has likewise given Uzbekistan an opportunity to revert to the policy of trying to limit Russian influence in the region that it had pursued prior to the 2005 Andijan massacre, as it has sought to block further development of the CSTO's military capabilities.

Another area where the economic crisis has created a more fluid situation is on the question of Russia's integration into the global economic and financial architecture. Liberals on Medvedev's team see membership in the WTO as both part of Russia's campaign for respectability and critical to economic modernization. Statists like Deputy Prime Minister Sechin, along with Deripaska and other oligarchs who benefit from the lack of foreign competition, generally oppose Russia's global integration. They argue that liberalizing Russia's trade regime in line with WTO rules would only give foreign companies greater access to the Russian market, without providing any comparable benefit for the Russian economy (since the trade in energy, which comprises the bulk of Russian exports, is not governed by WTO rules and not subjected to import tariffs).

When Medvedev and Obama met on the sidelines of the Group of Twenty (G20) summit in London in April 2009, they affirmed their shared commitment to Russia's WTO membership.[13] Yet in mid-June, Moscow suddenly announced it was suspending negotiations on accession to the WTO in favor of building a customs union with Belarus and Kazakhstan that would then apply for joint WTO membership. Before long, though, Moscow did yet another about-face; the economic liberals now appear ascendant politically, even as the customs union came into effect at the start of 2010.[14]

The weakening of Russia's energy, military, and financial clout has made it more difficult for Moscow to openly flout international norms or aggressively challenge U.S. hegemony. Although Washington and Moscow remain far apart on many issues, relations have improved since early 2009. In part, the improvement seems connected to President Obama's commitment to resetting relations with Russia, but Moscow's changed international priorities in the context of the crisis appear to be playing a role too. The recognition that Russia's lack of competitiveness threatens its security has made elements of Russia's recent assertive foreign policy unsustainable. One example is arms control negotiations, where financial constraints imparted a new urgency to Russian leaders' calls for cutting the two sides' strategic arsenals in the accord signed in April 2010 to replace the expired 1st Strategic Arms Reduction Treaty (START-1). Moreover, trade between the two countries continues to increase despite the crisis, and Moscow has expressed a clear interest in deepening economic ties, arguing that "economic cooperation is the basis for the 'reset.'"[15]

Recommendations

Although it would be shortsighted to assume Russia's difficulties will be permanent, the crisis and its aftermath do present the West with an opportunity it has not had over the past decade to enmesh Russia more deeply into the liberal economic order while deepening economic ties between the United States/EU and Russia. Such integration would help align Russian and Western economic and—to a limited degree—political interests. Economic integration will also require Russia to make progress on a series of reforms in areas such as property rights, corporate governance standards, and efforts to tackle corruption, which Western policy can and should encourage. In the long run, economic integration could smooth the way for deeper political integration between Russia and Western institutions such as the North Atlantic Treaty Organization (NATO) and the EU. Russia's leaders will ultimately have to decide whether to pursue political integration, but promoting mutually beneficial economic interdependence is the best mechanism for aligning Western and Russian interests in a way that would make political integration a realistic possibility.

While the primary focus of U.S. policy should be on promoting Russia's economic integration, a subsidiary goal should be to strengthen the institutions of sovereignty and governance in Russia's post-Soviet neighbors, whose vulnerability has too often provided a temptation for Russian intervention. By promoting development and reform in vulnerable post-Soviet states such as Ukraine and Moldova, the West can help reduce tensions with Russia inside the former Soviet Union by lessening both the temptation for them to play Russia and the West off each other and the incentives for Moscow to take advantage of their troubles to exact concessions.

Western policy should therefore use the window of opportunity provided by the crisis to

– leverage Russia's need for foreign investment to promote economic reform,
– deepen bilateral U.S.-Russia economic ties (including civilian nuclear cooperation),
– encourage Russia to remain on the path to WTO membership, and
– promote reform and development in Russia's post-Soviet neighbors.

FOREIGN INVESTMENT

The downturn has made Russia a much less attractive destination for FDI, which has declined sharply, even as short-term capital flows and the stock market have rebounded. When commodity prices were skyrocketing, foreign investors were largely willing to overlook Russia's weak investor protection and barriers to foreign ownership, as well as the existence of the state monopolies. With the Reserve Fund—established to provide a cushion in time of crisis and to sequester the flow of petrodollars into the country over the past decade to limit inflation—set to run out by the end of 2010, Russia will need to turn to international capital markets to raise money and provide the investment capital it needs to restore growth (even in the energy sector, which is suffering badly from underinvestment).

Given the steep decline in foreign lending and investment along with the decline in tax revenues from energy sales, Russia needs to attract significant foreign investment to jump-start its economy and refurbish its aging infrastructure, and to implement Medvedev's ambitious reform program. Russia's need to resume foreign borrowing (on the order of $17.8 billion in 2010) represents an important opportunity to promote economic interdependence with the West.[16] Western governments and companies should use Russia's need for foreign investment as a lever to press for greater economic reform, particularly a greater commitment to transparency and the rule of law, as well as reduced tension over energy.

The mutual interest in deepening economic ties provides an opportunity to address the structural and institutional barriers to cooperation. The EU should therefore develop a mechanism to encourage legal and institutional convergence, perhaps on the basis of its *acquis* *communautaire* (similar to Europe's outreach to Turkey, though without membership as the end goal). The EU would encourage Moscow to bring its standards and procedures in line with European norms, while creating space for the negotiation of mutually acceptable compromises where EU rules are not appropriate. This effort should focus on reducing obstacles to foreign investment, such as Russian legal and judicial reform, and promoting the free movement of capital. Long term, these efforts could lay a foundation for discussions on creating an EU-Russia free-trade zone. They should be accompanied by a push to make it easier for Russians to travel to and reside in the EU, including discussion of eventually abolishing visas for short-term travel. At the same time, Europe's troubles have encouraged companies—including Opel and Mistral—to be more open to Russian investment, and the EU should lower the legal and regulatory obstacles to Russian firms that want to buy stakes in European companies.

U.S.-RUSSIA ECONOMIC TIES

Compared with Europe, the United States is less important as a source of FDI or destination for Russian exports (only about 4 percent of Russia's inward FDI comes from the United States, while bilateral trade with the United States totaled only $35 billion in 2008).[17] The lack of economic ties means that business interests in the United States and Russia cannot act as a restraining influence on bilateral relations. It is hardly accidental that Russia's closest partner in Europe is Germany, which is also the largest recipient of Russian exports and the second largest source of foreign investment into Russia.

Establishing an ongoing U.S.-Russia strategic economic dialogue with combined participation of government and business, such as that between the United States and China, would be one way of institutionalizing trade promotion. Russia also already has investment treaties with many of its European trading partners, which gives European companies legal recourse in the event of nationalizations or other negative outcomes. Washington and Moscow agreed in April 2008 to work toward a new investment treaty (the original, signed in 1992, was never ratified by the Russian Duma), but little progress has been made since. The United States should also work to revive this agreement.

Another area where the United States has an opportunity to deepen its economic ties to Russia is civilian nuclear cooperation. The Russian civilian nuclear industry (dominated by the state monopoly Rosatom) is an important source of revenue for the Kremlin; it will become still more so if oil prices remain relatively low. As part of a comprehensive strategy for reducing the threat from nuclear weapons, the United States and Russia should explore opportunities for Moscow to develop and sell civilian nuclear technology, subject to verification regarding the potential for dual use, and to play a larger role in reprocessing third countries' spent fuel.

The most basic step would be for the Obama administration to resubmit the so-called 123 agreement on civilian nuclear cooperation for congressional approval. The agreement, which the Bush administration withdrew from consideration in the aftermath of the Russo-Georgian war, would allow Russia to import U.S.-origin used nuclear fuel for reprocessing (much of the uranium used in power plants around the world is mined in the United States). Russia has the facilities for reprocessing spent fuel and its government has expressed an interest in expanding its presence in this market, even as the import of spent uranium into the United States is often politically difficult. The U.S. nonproliferation agenda would benefit from Russia's development as a worldwide center for uranium reprocessing, and Moscow would benefit financially from the commercial deals it could strike. One particularly promising avenue is U.S.-Russia cooperation to provide low-enriched uranium fuel to civilian reactors in third countries subject to their adherence to the Nonproliferation Treaty, a step that the U.S. nuclear industry and nonproliferation experts support.[18]

Ratifying the 123 agreement would also help the U.S. effort to pressure Iran on its nuclear program. Russia plays a major role in developing Iran's civilian nuclear capability, especially through Rosatom's work on the Bushehr power plant. The United States has long urged Moscow to cease its work at Bushehr, but it has been unable to offer Russia anything to compensate for lost revenue (at least $1 billion for completing the work, plus the possibility of additional contracts for Iranian power plants). Allowing Russia to become a major center for uranium reprocessing would go some way toward alleviating these financial concerns and increase U.S. leverage with Moscow, especially if packaged as part of a deal to end Russia's involvement in the Iranian nuclear program and support sanctions against Tehran at the UN Security Council.

WTO

Although WTO membership would boost the Russian economy, having Russia in the WTO also benefits the West. It would provide a legal framework and recourse for foreign investors, and would enhance the legitimacy of the liberal international economic order of which the WTO is an expression. For that reason, the West should emphasize that the door to Russian WTO membership remains open, and continue working with Moscow to amend Russian laws and policies that are inconsistent with WTO membership criteria or existing bilateral ascension protocols.

In the event that Moscow makes a serious effort to comply with these terms, the West should also encourage Georgia to sign a WTO accession protocol with Russia, and offer to mediate the disputes that have thus far prevented an agreement. Since the disagreements between Moscow and Tbilisi are largely political (stemming from the aftermath of last year's war and Russian recognition of South Ossetia and Abkhazia), convincing Georgia to not block Russian accession will depend more on politics than economics. Georgia's dependence on Western economic support gives the United States and its allies room to push for a resolution of outstanding issues, assuming Russia chooses to play a constructive role. The Obama administration should also affirm its support for "graduating" Russia from the provisions of the Jackson-Vanik amendment, thereby establishing permanent normal trade relations with Moscow. At the same time, the administration should emphasize to its Russian interlocutors that congressional support for Jackson-Vanik "graduation" is unlikely until or unless Moscow completes the steps necessary for WTO accession.

ENGAGEMENT ON RESOLVING MUTUAL ECONOMIC CHALLENGES

The West can do little to directly promote or hinder President Medvedev's rhetorical call for modernization, but it can engage Russia in areas of mutual economic interest, including discussion of concrete steps toward economic development. The economic crisis has undermined both Russia's belief that it was decoupled from global economic trends and the West's belief that its policies had overcome the markets' inherent volatility. Chastened by the crisis, the two sides have a renewed opportunity to search for options that neither was fully prepared to face before. The United States should therefore take the lead in establishing a series of working groups involving both the public and private sectors, perhaps in the context of the revived U.S.-Russia Bilateral Presidential Commission, to discuss best practices and areas of mutual interest, including corruption, energy security, innovation, banking oversight, and privatization. For instance, such discussions could focus on enhancing Russia's role in creating a more stable international banking framework, in part by encouraging the necessary reforms to Russia's own financial institutions. The Bilateral Presidential Commission is already doing some of this work, but it requires more participation by government agencies in both countries and more high-level attention in Washington (including from the president) than it has so far received.

AID TO NEIGHBORS

As demonstrated by the effects of the war in Georgia, support for Russia's economic integration—among both Russian officials and the international community—is jeopardized by Russian intervention in its neighbors' affairs. For that reason, and because some Russian leaders regard regional autarky as an alternative to participation in the global economy, a secondary aim of U.S. policy in the wake of the crisis should be to enhance the resilience of Russia's post-Soviet neighbors at a moment when Moscow is focused on getting its own house in order.

In partnership with the EU, Washington should develop a comprehensive program to strengthen the institutions of governance in the post-Soviet space, focusing in particular on fragile states such as Ukraine and Moldova. The elements of such a program should include reducing corruption, improving transparency and the rule of law, and lowering barriers to foreign trade and investment. As with Russia, a commitment to eventually bring the post-Soviet states into the WTO would provide a useful long-term incentive alongside the prospect of immediate financial assistance.

That effort would likewise be aided by a commitment from the Europeans to create a path toward eventual EU membership for Kiev and Chisinau. Belarus could eventually be included as well, subject to its adherence to norms on democracy and human rights. The EU's Eastern

Partnership is a step in the right direction, but its scope is limited and its effectiveness constrained by the absence of a defined U.S. role and the fact that it plays no part in Central Asia—the most volatile part of the former Soviet Union and a critical staging ground for the U.S.-led war in Afghanistan.

A particularly important step would be bolstering Ukraine against the possibility of a renewed crisis over energy. With the IMF already stepping in to ensure that contracted gas is paid for and uncertainty surrounding the course of Russo-Ukrainian relations following the election of Viktor Yanukovych as Ukraine's president in January 2010, the West needs to develop an effective mechanism to curb the risk of nonpayment, for instance, by underwriting a long-term IMF credit line for gas payments. In exchange, the West should press Kiev for demonstrable progress in cleaning up its murky energy trading sector, which undermines European energy security. The West should demand that Ukraine purchase Russian gas directly (bypassing the corrupt middlemen such as RosUkrEnergo that have used the gas trade to siphon funds to members of the Ukrainian elite), that the sales price of Russian gas to Ukraine be set transparently, and, most important, that Kiev gradually end its subsidization of energy prices, which encourages profligate consumption.

As in Russia, the economic troubles of the other post-Soviet states have increased their need for foreign credits and investment that the West is best positioned to provide. The United States and its allies should therefore leverage their ability to provide capital to promote economic and political reform. Enhancing the resilience of Russia's neighbors will make them less susceptible to Russian pressure in the long run, and consequently reduce the attractiveness to Moscow of pursuing regional hegemony at the expense of global integration.

Conclusion

Russia is still sorting out its response to what remains a persistent and serious economic crisis. As in the past, Russia's recovery will depend to a great degree on the movement of global oil prices. Despite a rebound in oil prices from their low of about $35/bbl in winter 2009 to roughly $75–$80/bbl in early 2010, Russia's economy remains in limbo, neither enjoying the windfall profits of 2007 and 2008, nor suffering the deprivations of late 2008 and early 2009. Such stability is beneficial; it allows Moscow to plan for the future. Yet a price of $80/bbl will not force Russia to undertake a comprehensive restructuring of the economy in line with the "innovation scenario" that Medvedev and other leaders maintain is necessary in the twenty-first-century global economy. Although Russia appears to have averted a large-scale social or political crisis for the time being, the failure to push through reforms means that Russia's recovery is likely to be slower and less complete than that of other major economies, which seemed to be inching toward recovery by the start of 2010.

As Russia struggles to get its economy back on track, its capacity for foreign adventures will likely remain limited. Yet Medvedev's focus on improving Russia's competitiveness provides an opportunity for pragmatic, economically focused engagement by the West. The United States and its allies have an opportunity to focus on concrete steps that buttress Russia's recovery and adherence to international economic norms. Although it has long been in the West's interest to build a pragmatic relationship with Moscow based on a limited set of mutual interests, the reality of the financial crisis has made that reconfiguration at once more feasible for the West and more urgent for Russia. It may take time for Western engagement to have an appreciable impact at the economic level, but Russia's present struggles mean that the West has a finite window of opportunity to take concrete political steps to show Moscow that if it plays by the rules, it will be accepted and respected as a player in the global economy. It is therefore imperative that the West and Russia make real progress on Moscow's economic integration now, before the crisis in Russia ebbs—and, with it, the opportunity to make the case that global integration is the surest way for Russia to achieve its goal of being a powerful and respected international actor.

Endnotes

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