



RUSSIA in GLOBAL AFFAIRS

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Unlearned Lessons of the Past

Fyodor Lukyanov, Editor-in-Chief

The arrival of spring was marked by several anniversaries in Russia and the world. Sixty years ago, Winston Churchill delivered his famous speech in Fulton, which is generally viewed as the beginning of the Cold War. Other notable dates include the 75th birthday celebrations of two famous statesmen – the first president of the Soviet Union, Mikhail Gorbachev, who put an end to the Cold War, and the first president of post-Soviet Russia, Boris Yeltsin, who put an end to Soviet Communism. Finally, Russia acknowledged the 50-year anniversary of the 20th Congress of the Soviet Communist Party, which made the first attempt to liberalize Soviet society decades before Gorbachev and Yeltsin.

How relevant are those historical dates to our present times? Quite relevant, I must say, since the consequences of those events still have an effect on our lives today. This is the general belief of the contributors to this issue, who provide an in-depth analysis of the “echoes of history.” “Since Communism held the

reins of state power for 70 years, its contribution to the country’s transformation is crucial for understanding Russia’s past, as well as its future,” maintains **Anatoly Vishnevsky**.

The Cold War was largely a result of a mutual misunderstanding between two former allies – the Soviet Union and the United States. Each party imagined aggressive intentions on the part of its opponent, which, in reality neither really had, argues historian **Vladimir Pechatnov**. Today, the issue of mutual understanding between Russia and the West is a relevant topic once again, **Sergei Karaganov** believes. “We have gone through the tragedy of confrontation. We should not get ourselves involved in a farce as well,” he points out. State Duma Deputy **Konstantin Kosachev** writes about the inertia of thinking among Western politicians who prefer to follow the habitual path and view today’s Russia as an enemy. **Dmitry Furman** comments on the present Russia-West confrontation for influence in the post-Soviet space. He

views this confrontation as a continuation of the Cold War that was waged by the West and the Soviet Union, only now it “entails a smaller space and a different alignment of forces.” **Arkady Moshes**, **Leonid Grigoriev** and **Marsel Salikhov** analyze Russia’s positions in Ukraine, a key post-Soviet state.

Vitaly Shlykov writes that at the dawn of reforms Russia missed an opportunity to turn the Soviet economy, overly militarized in the Cold War years, into the engine of an economic miracle. Now Russia has a second chance, and in order not to miss it again, it must analyze its former mistakes. **Gavriil Popov** points out that the inability to learn from one’s own mistakes results in their recurrence with more serious consequences. He argues that the Russian authorities have not learned the lessons from the unsuccessful attempt to transform Soviet society, made by **Nikita Khrushchev** 50 years ago.

Vladimir Mau warns about the dangerous sense of euphoria due to the favorable situation on the energy markets, rather than achievements in economic reforms.

Does Russia need to orient itself to some specific model for its development? Our country borders two powerful centers of economic gravitation, the European Union and

China, each representing a different model of social, political and economic system. Today, Russian analysts have resumed heated debates as to which path to follow – the European or Asian variety.

Nadezhda Arbatova and **Timofei Bordachev** discuss ways for Russia to build its relations with the EU, especially as the Russian-EU Partnership and Cooperation Agreement is set to expire in 2007. The choice of a future model for the parties’ mutual relations will largely shape Russia’s further development. **Sergei Porshakov** analyzes one of the aspects of orientation to Europe, namely corporate governance models in Russia and the EU.

Vladimir Portyakov compares the economic potential of Russia with that of China and India, two countries that are now in the focus of analysts around the world. The author names the more probable areas for cooperation in this “triangle,” where Russia now has slower growth rates.

In our next issue, we will provide an in-depth look at the “rise of Asia,” as well as consider Russia’s role in addressing various global problems. This subject will be discussed in July at the G8 Summit in St. Petersburg, which for the first time will be chaired by the Russian Federation.

Live History



“If there is no project for radical transformations, sooner or later there will emerge a program for building Communism, or some sort of a bureaucratic national idea. Unfortunately, no conclusions were drawn from the 20th Congress of the Soviet Communist Party, thus, when breaking away from Communism, we fell into the same trap that Khrushchev had fallen into before.”

Modernization and Counter-Modernization in Russia

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Modernization and Counter-Modernization in Russia

Anatoly Vishnevsky

Soviet Communism expired so quickly that it never had time to consult a doctor. Moreover, since Communism was thought to be absolutely healthy, it is not surprising that no one demanded a diagnosis during its lifetime. What is surprising, however, is that the vanquished system did not draw serious attention from pathologists, while there is no scientifically grounded post-mortem conclusion.

Undoubtedly, Russia lived through great changes in the 20th century, and since Communism held the reins of state power for 70 years, its contribution to the country's transformation is crucial for understanding Russia's past, as well as its future. Therefore, we must ask ourselves: What elements of the Soviet experience in Russia deserve to be taken into the new century and what elements must be totally rejected?

I believe Communism's influence on the modernization process is a major factor in understanding its historical role in Russia's development.

CATCH-UP MODERNIZATION

Modernization, as understood by this author, is the transition from agrarian, rural and holistic societies to contemporary indus-

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trial and post-industrial communities, predominantly located in cities, which espouse individualism amongst its inhabitants.

If looked at from this angle, modernization is universal. It represents a path that is taken by all societies that have reached a high level of development. It also encompasses societies that have regular contacts with modernized societies or societies undergoing the modernization process, and seek to replicate the achievements of other societies ('catch-up modernization').

All-embracing modernization may be described as a product of the universal mechanism of evolution. Interpreted in Darwinian terms, it is a process that introduces more efficacious methods of social activity, economic rules and cultural norms to the center of a given society, while pushing less efficacious ones to its periphery. Modernization's major feature consists of importing ready-made economic and demographic assets that have proved their efficiency in equally modernized social and economic spheres to other territories.

Modernization forms a great axis around which history's main events have turned since the end of the 18th century – the time of the industrial revolution in England and the Great French Revolution. As modernization gradually spreads to ever more new countries and regions, especially in the 20th century, it has been acquiring increasingly more features of catch-up modernization. The material achievements of West-European societies that pioneered modernization and the consequent profound changes were not specially conceived or planned. They derived from the spontaneous development of new forms and norms of economic activity in public and private life. Over a space of centuries, that development proliferated to ever-greater sections of society. As a result of such development, Western Europe elaborated upon, and proved the efficiency of, an individualistic type of personality, together with a system of liberal values.

On the other hand, societies pursuing catch-up modernization show a totally different picture. They always develop along a more or less consciously conceived plan, where the desired results are always known in advance and seeded from above. In this situation,

government paternalism moves to the forefront, while economic and political liberalism, so beneficial for spontaneously developing societies, turns into an obstacle.

Compared with pioneering modernization, catch-up modernization opened up an era of unprecedented materialistic Messianism and innumerable projects and programs. Their authors are usually found among elitist quarters of society that are familiar with the achievements of other societies and concerned by the degradation of their homelands, above all in military and economic spheres. State power always becomes the real executor of catch-up modernization projects, which helps it to accumulate immense influence; this is incompatible with the spirit of liberalism and democracy.

Totalitarian political regimes of the 20th century, including Communist ones, were the offspring of catch-up modernization. Russian Communism, with all of its assets, was just one example of that development; it resembles in many ways other cases of this type of modernization process.

THE NEW OLD WORLD

The Bolsheviks' project for modernizing Russia was characterized by its dualism: it attempted to combine the material and technological achievements of the much-criticized West with the idealized values of a Russian peasant community – wage leveling, abolition of money, paternalism, etc. From its very conception, this modernization project shared many common traits with many other similar projects that budded in Russia in the pre-revolutionary epoch. This was more than just a superficial resemblance. It stemmed from the origins of these projects, which were conceived with a medieval vision of the world in mind. By contrast, Western pioneering modernization operated with a new vision of the world that corresponded with the new social and cognitive reality.

The medieval picture of the world relies on the predominance of a “heavenly order,” that is, the presence of a supreme force standing over an individual and supporting everything from some kind of a divine center. This is a picture of the world based on

determinism, which comes forth as a philosophical concept, outlook and ideal.

This picture perfectly corresponds with the idea of building a society that puts an end to private ownership, chaotic market forces and anarchy, and that arranges everything according to a plan. The early Socialist utopists used such ideas as the cornerstones of criticism, which they leveled at the world order. Marxism inherited this ideal and handed it down to Russian Communism.

Such perception of the world is syncretic in that it rules out analysis and social self-criticism. This consciousness requires faith and allows only an interpretation of the world in terms of good or evil, or whether its values are genuine or unreal.

For countries that pioneered modernization and passed through the crucibles of the Renaissance, Reformation, and Enlightenment, as well as the economic and political revolutions of the new times, this new vision was an essential condition for future progress. Since the new world was becoming much more complex than the previous world, the deterministic picture was insufficient for understanding it. Thus, syncretistic knowledge soon gave way to differential analysis that made it possible to understand the growing internal diversity of society, as well as the inexhaustible diversity of nature.

Adam Smith's description of the great changes in England's economy as a consequence of the division of labor and free exchange of commodities provides one of the early instances of that analysis. His breakthrough was only part of the revolution in the world outlook that embraced all aspects of knowledge, including social ones. It brought to life a new picture of the world, which was not built or governed from above upon someone's plot. Instead, it grew from below. It was a product of self-organization, whose results were not predetermined — at best, they had some degree of predictability. This revolutionary outlook made the *creationist* picture of the world recede, and an *evolutionary* picture took its place, while the syncretistic method of cognition gave way to analytical description.

However, this process did not occur simultaneously around the world or in equal degree. Societies undergoing the process of

modernization find themselves at different stages of development, which justifies the coexistence of both pictures of the world, the old and the new. Moreover, the development of each society eventually reaches the point where a clash between the two pictures becomes inevitable. Almost in all cases this clash results in a compromise between the old and new systems. Marxism and its offspring in the form of Russian Communism were just one version of such compromise.

This sort of compromise overturns the previous religious creationism and provides a boost to an evolutionary materialistic vision of history. It emphasizes the possibility for analytic — including social — cognition (such as Scientific Communism). Simultaneously, it sets forth a purely creationist task of building a more perfect world.

Building a perfect world is a religious idea in essence even if it is dressed in secular vestments. Standing in opposition to it is the idea of self-organization, which presupposes that the determination of its targets is embedded in the very development. This idea was clearly formulated by Adam Smith, who formulated the “Invisible Hand” of the market theory. Yet Marx and Engels, the German thinkers of the mid-19th century, and Vladimir Lenin in the early 20th century, failed to embrace such a concept. The reason was not due to any mental limitations on the part of those outstanding intellectuals. The root cause lies in the historical limitations of the picture of the universe, which had become obsolete in England but was still popular in Germany and Russia.

Nor should we forget the *political nature* of the Bolshevik project. It was meant for the masses and was supposed to be understandable at once. Lenin had to address the peasants in a language familiar to them; hence he could not break the frame of a picture they understood.

Nobel Prize winning poet Boris Pasternak commented correctly that “Lenin steered the flow of thought — and henceforth, the country.” That was not real governance, however, but rather “political technology,” as we tend to refer to it today. Real pro-

cesses depend not on ethereal thoughts, but on how numerous economic, demographic, public and political factors interact.

The implementation of the Bolshevik project produced an almost classical example of combining “instrumental” modernization with an archaic world picture. While the former stands for the accelerated development of industries, science, technology, urban areas, advanced education systems and public health, the latter presupposes creationist development governed from a single center (“planning”), suppression of forces of economic and social self-organization (“anarchy”), maintenance of the values of *Sobornost* (group decision-making that has an impelling moral and binding legal force), paternalism, etc. This type of modernization could well be labeled as conservative, instrumental or paternalistic.

This combination was a forced one and showed relative efficiency over a period of time. But as instrumental modernization became more successful, the old picture of the world and all of its assets eventually came into conflict with the novelty of material life, which slowed the spread of modernization throughout society. Conservative modernization can be accomplished, but only if it gives up its archaic vision of the world, as well as philosophy, morals, political ideals and social practices consonant with it — everything associated with the Communist idea in the 20th-century Russia.

ECONOMIC MODERNIZATION

The Bolsheviks were quick to discard the attributes of modernization, like economic and political liberalism, but they were consistently declaring a commitment to industrial and military might, as well as developing urban areas and the urban way of life, promoting education, improving public health, decreasing mortality rates, etc. None of these goals, however, contained anything specifically Communist, as they only reiterated the results already attained in earlier modernized countries. Yet the Soviet authorities interpreted any achievement along that pathway as a product of socialism. The main problem was that these achievements were few and becoming increasingly scarce. The mechanisms of conservative modernization wore out rapidly and turned into hindrances to modernization, above all in economy.

Lenin took over from Marxism its ideas of nationalizing capital goods and replacing “industrial anarchy” with publicly regulated production processes.

After the Bolsheviks seized power, he reiterated these ideas with special vigor, endlessly citing the fruitful – as he believed – experience with regulation of the economy based on government monopoly in Germany during World War I.

The stringent monopolization of the economy by the central government, aimed at limiting so-called industrial anarchy, actually turned into a tool for slashing “the anarchy of consumption.” This was done in the name of resource mobilization for a breakthrough in industrial development, viewed as the cornerstone of modernization. Yet this monopoly never released its grip even when the country was past the early phase of industrial development, when it had built the basic branches of industry and major elements of the industrial infrastructure, and when the economic system had become much more ramified and sophisticated than before the Bolshevik revolution.

Theoreticians of Socialism could never adequately answer what were the incentives of a planned economy. All of their explanations would boil down to subjective, political assessments of the requirements. Meanwhile, the more complicated the economic system became, the more it showed a need for objective criteria of its functioning, efficient means of self-organization and embedded mechanisms of goal projection that only a market system can create.

On the face of it, Soviet leaders continued strengthening a non-market economy, which they called “socialist.” This in turn made the completion of economic modernization in the Soviet Union and Russia impossible and finally drove the whole system into stagnation.

URBANIZATION
AND RISE OF CITY DWELLER CLASSES

“Socialist industrialization,” a term that remained on everyone’s lips in the Soviet Union for decades, meant the transformation of the predominantly agrarian country into a country of cities.

Although urbanization advanced significantly in Russia, the final outcome was debatable by the end of the 1980s; it is still a source of conjecture now. This fact, however, says nothing about the character of modernization. Yet it proves that there are objective limits to any unnatural acceleration of social processes, including natural pace of replacement of generations.

More important is the fact that the growth of new urban areas was simply regarded as an unavoidable functional appendage to industrialization. It was believed that its costs must be minimized. That is why Soviet urbanization did not include the rise of a full-fledged city environment, even if in material terms. Even now, 40 percent of Russian cities and towns have a rural or semi-rural infrastructure. For example, only 143 out of 1,098 cities and towns have sewerage systems serving 95 percent to 100 percent of the population and its urban facilities. In smaller towns, sewer systems are unavailable to about one half of the residents. Meanwhile, 21 percent of residential homes lack sewerage in medium-sized towns with a population of 50,000 people to 100,000 people; in cities with more than one million residents, sewers are unavailable to 10 percent of the population. If we judge the level of Russia's urban development by this most illustrative fixture of urban comforts, then urban population stands at a mere 59 percent of Russia's total, not the 73 percent as suggested in a recent statistic report (T.G. Nefyodova. *Rural Russia at the Crossroads. Geographic Sketches*. Moscow, 2003, p. 21. — Russ. Ed.).

Still more incompatible with the goals of an encompassing modernization project, and indicative of the instrumental nature of the Soviet model, is the underdeveloped social urban environment and medium strata of town dwellers. All the anti-modernization reactions that occurred in post-Soviet Russian society stemmed from the weak evolution of a semi-urban, semi-rural social structure. This scenario prevents Russia from ending its relationship with things that have long become features of the past. Communism in the formal sense of the word no longer exists in Russia, yet its cause lives on. Unless the modernization of the social structure is finalized, Russia's Double-Headed Eagle will

continue to have one head gazing into the future, and the other one still looking toward the past.

DEMOGRAPHIC TRANSITION

Russia's program of industrialization and modernization proved efficient enough in terms of speeding up the demographic transition that had begun before the Bolshevik revolution. It changed the private aspects of people's life and had a profound impact on existential questions of human individuality. The mass demographic and matrimonial behavior of the population evidenced a drastic change, as did family roles and values, the status of women and children, the conditions of family upbringing, and general attitudes toward life, love and death. The close semblance of demographic behavior between the Soviet Union and the Western countries, together with the irreversibility of these changes, are difficult to deny. And for a long time, the successes of demographic modernization in the Soviet Union and Russia looked incontestable, yet they could never be finalized.

This is obvious when we analyze mortality rates. In the beginning of the targeted timeframes, Russia achieved a sizable drop in infant mortality and, as a consequence, an increase of life expectancy. Compared with the turn of the centuries, infant mortality rates in Russia fell sharply by the mid-1960s, while projected life expectancy more than doubled in both men and women (Table 1).

Table 1. Projected Life Expectancy in Russia in 1913, 1964-1965, 1983-1984 and 2002 (years)

Year	Projected life expectancy		Gain against 1896-1897	
	Men	Women	Men	Women
1896-1897*	29.4	31.7	35.2	41.7
1964-1965	64.6	73.4	32.6	41.6
1983-1984	62.0	73.3	29.1	40.3
2002	58.5	72.0		

*European part of Russia

Yet the success appeared to be short-lived. By the mid-1960s, when Russia joined the group of developed nations in terms of its mortality rate, those nations had exhausted the paternalistic strategy of fighting mortality that was consonant with the socialist outlook and which the Soviet Union took so much pride in. These countries approached the second phase of the demographic transition when a new strategy was to be formulated in order to reduce the risk of death from non-infectious diseases (especially cardiovascular types), cancer, as well as death from accidents, violence and other sources.

State paternalism ceased to be a positive asset in that phase. The strategy demanded that each person take a more responsible attitude to his or her own health and that the institutions of civil society exert greater influence on all the decisions concerning the protection of people's health and ecology.

However, the Soviet Union — and consequently Russia — failed to find answers to the new challenges, and the modernization of life expectancy conditions slowed noticeably and remains unfinished. The resultant gap in life expectancy rates between Russia and the advanced countries continued to increase and by 2000 it exceeded the indicators of 1900 (Table 2).

**Table 2. Gap Between Russia and Advanced Countries
in Projected Life Expectancy (years)**

Year	vs the U.S.	vs France	vs Sweden	vs Japan
Men				
1900	15.9	12.7	20.3	14.5
2000	15.2	16.5	18.5	18.7
Women				
1900	16.2	14.1	20.8	13.1
2000	7.5	10.8	9.9	12.4

A general overview of the demographic situation in Russia, together with an analysis of a multitude of indicators, suggests that this country has much demographic archaism. This is manifested in

the insignificant value of life, archaic death factors, a widening gap in life expectancy rates as compared to the West, a huge number of abortions, persisting conservative views on family life and the status of women, etc. All of these factors testify to Russia's unfinished project of demographic modernization.

CULTURAL REVOLUTION

The gradual complication of material and social environment in which the Europeans experiencing first-stage modernization lived was inseparable from change in culture and the structure of human personality. The essence of this change boils down to a transition from *Sobornost* to the principles of individualism and a rise of personality autonomy.

Pre-revolutionary Russia developed an acute awareness of the absence of a new, individualized and independent man. It felt this was a major sign of social retardation and an obstacle to modernization. Consequently, the in-depth task of the entire Russian revolution was to revamp the foundation and contents of culture, as well as its transfer from holism to individualism.

Russia wanted to be just like the rest of the world, yet the complicated urban, market-oriented, monetary environment of the European type, which promised to breed autonomous individuals, never developed here. By the beginning of the 20th century, the country found itself in a deadlock. To unleash the rise of autonomous individuals as a dominant personality type, it needed faster economic and social modernization. However, this cause could be steered only by a new type of people who were scarce in conditions of the prevailing *Sobornost*.

The Bolsheviks ventured to break up that vicious circle. In theory, they realized the imperfections of the human material that was supposed to solve the task, yet they hoped for a cultural revolution. "A political and social upheaval here preceded the cultural upheaval, or the cultural revolution, on the threshold of which we are finally standing," Lenin once commented. For the time being, however, the Bolsheviks had to initiate a speedy modernization, leaning upon the shoulders of unprepared people around them. This dilemma predes-

tined the entire strategy of conservative modernization, which the Soviet Union carried out until the last day of its existence.

The prospect of conservative modernization does not replace the *Sobornost*-minded peasant of the past with an individualistic bourgeois. It replaces him by a “common man,” who is equally *Sobornost*-minded and who differs from his ancestors only superficially, in some instrumental traits. He wears urban clothes and has a modern education, but the in-depth principles of his social existence, his internal world and the mechanisms determining his behavior do not change. He is the same “cog in the machine,” a passive and unpretending one.

It should be noted that the development of trade, industries, and cities in the West provided nothing more but instruments for attaining greater wealth, more comforts of living, new ways of life, and in the final run, for a deep transformation of society and man. Catch-up modernization turns these instruments virtually into goals of development.

The officially proclaimed cultural revolution of the Soviet era aimed to achieve purely instrumental goals, including the growth of education levels, the assimilation of contemporary technological and scientific knowledge. It also included the dissemination of hygiene culture and sports. The authorities had to constantly ensure that the new “educated class,” highly needed to make the axle and wheel of a sophisticated government machinery rotate, did not produce a new people, that is, autonomous personalities.

That was an irresolvable task dogged by internal contradictions, and the attempts to resolve it blocked progress in the instrumental spheres of culture. Attempts at cultural modernization remained half-baked and incomplete. But even if the program had been completed, it would not have been a profound modernization that was capable of changing culture in terms of both instruments and contents, thus replacing the paradigms of holism and *Sobornost*, which were inalienable from the old picture of the world, by individualistic and liberal paradigms.

Over time, the real and imaginary successes of Soviet conservative modernization produced an illusion that the crisis of

Sobornost ideals had been cleared and that those ideals had re-emerged under the banner of Socialist collectivism. Thus was formed a transitional, controversial cultural mix that illustrated an impractical ideal of human personality: a combination of the instrumental virtues of an urban man of the modern age and the collectivist virtues of the *Sobornost*-minded peasant.

It was impossible that such an unnatural amalgam would be long lasting. The instrumental model, undeveloped as it was, altered the social environment where the former peasants, their children and grandchildren had lived. They gradually adapted to the new setting and developed an ever-increasing sensation of being autonomous private individuals who had grown out of the old institutional mantles. Circumstances dictated a transition to the next stage of modernization where the shackles – in the form of old cultural foundations – would be destroyed. But Soviet *Sobornost* was too closely intertwined with the entire totalitarian system, which had no plans to move aside, and was doing everything in its power to fortify the positions of anti-individualism and anti-liberalism. Eventually, it turned into a *counter-modernization* force that slowed down the country's renovation.

RENOVATION OF THE POLITICAL SYSTEM

While cultural modernization of Soviet society, incomplete as it was, advanced to a rather high degree, the political system moved in a totally adverse direction. The Bolsheviks from the very start had rather obscure ideas about the structure of the future political system. On the one hand, they stressed a commitment to upholding the “general democratic tasks,” including many declarations concerning political and civic freedoms, universal franchise, etc. On the other hand, however, they endlessly criticized “bourgeois democracy,” proclaiming the “elimination of the state” as their ultimate goal, which “simultaneously means elimination of democracy.”

Yet there was a third side to that story, the imposition of dictatorship, and it fared badly with the first two conditions. If you factor out the utopian “withering away of the state,” only two possibilities were left: a bourgeois democracy that had marked distinc-

tions from the Russian czarist regime, and dictatorship (and not “of the proletariat”), which had much in common with czarism in terms of the distribution of power. It is of course obvious by now what choice the Bolsheviks made. Soviet totalitarianism drove all the major aspects of Russian authoritarianism to every imaginable and unimaginable extreme, thereby delaying the arrival of a “damned bourgeois democracy,” or at least its semblance, for another 100 years. That is why an assessment of Communism’s contribution to modernization from the perspective of the political system proves that it was absolutely counterproductive.

It could not have been otherwise, however, and not simply because the Soviet political system corresponded with the creationist picture of the world so firmly embedded in the Russian mentality. More importantly, it correlated for many years with Soviet social and economic reality – the economic impoverishment and hierarchical form of the Soviet social pyramid. This system makes the privileges of the handpicked individuals possible only through the suppression of the aspirations of the rest of society.

The changes that occurred within post-revolutionary Russia carried the illusion of democratization of Russian/Soviet society. It grew out of the fact that a mass of people from the grassroots, especially the village-folk, had gained some access to the levers of state power; modernization in Russia opened up new channels of vertical mobility. For the majority of people, it was the first such opportunity. It thrust to power a new political elite, which was democratic in its origin. Yet it is important to note the relative paucity of those mobility channels against the background of sheer survival of the hierarchical social pyramid. The considerable modernization changes made massive horizontal shifts look like vertical ones.

As for the apex of that social pyramid, the power pyramid, it remained lonely at the top as always. In essence, new people filled old positions, but the turnover of the ruling elites does not mean the democratization of the political system, even if most of the new rulers hail from the workers and peasants. The emergence of new elites requires democratically functioning mechanisms, while the limited number of individuals with the social status to support

it makes the advent of such mechanisms impossible. Given this absence, anyone called to replace the old authorities would quickly replicate the behavior of the latter and mutate into caste-like nobility. The demand on social status, political connections and the overall activities of “the new class” raise memories of czarist Russia’s political elite.

But unlike the traditional elite, any new elite must establish itself, fight for high status and master it amid intense struggle; this scenario led to the last drop of blood in an almost literal sense. As a result, the entire society becomes a hostage to that struggle, as happened in the Soviet Union in the 1920s and 1930s. The outcome was that the political system was not modernized, instead it degraded in comparison with the czarist model. State totalitarianism set in as opposed to imperial authoritarianism, and formed a hard shell for a new, medieval-type Soviet system.

That shell was not at all something alien or repressible for Soviet society; in fact, it was its offspring. It contained controversial processes of Soviet social transformation and collisions between the forces of modernization and counter-modernization. It helped maintain balance between them and even facilitated their unnatural symbiosis. And yet it was the most rigid part of the system and eventually proved unable to adapt to the changes that were developing inside the armored egg known as the Soviet Union. And changes did take place. Success did not crown any direction of Soviet modernization efforts, but balance shifted dramatically toward the forces of modernization. The offshoots of economic and political liberalism that had budded in the totalitarian soil were weak, but quite viable. Thus, the political shell of the system shared the same fate as an eggshell after a chicken hatches.

Unfortunately, historical processes move at a much slower pace than the changes that occur on a farm. The political shell has been crushed, but Russia is still wandering around amidst the scattered fragments of that shell, which remain hopeful that they will be put together again some day. They are hoping for a counter-modernization union, albeit with a non-Communist configuration. They are agonizing, and social agony can be a dangerous thing.

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A Historic Chance Missed

Gavriil Popov

Historical events — as well as historical figures — should be assessed in accordance with the primary task of their epoch. This approach is fully applicable to the assessment of the 20th Congress of the Soviet Communist Party, held in February 1956. The main problem that the Soviet Union faced in the mid-1950s was its incessant experimentation with state-led bureaucratic socialism. Instead, it required the launching of reforms that would transform it into a more progressive, post-industrial system.

In my recent book, *The Three Wars of Stalin*, I wrote that Stalin missed a historic chance to start reforming socialism in 1944-45. Only after his death was there an opportunity to launch this reform.

Below I analyze three basic questions:

- 1) What made it possible to begin post-industrial transformations 50 years ago?
- 2) What stood in the way of those reforms?
- 3) What model of reform was implemented and why? What lessons should we learn from the events of 50 years ago?

PREREQUISITES FOR BREAKING AWAY FROM COMMUNISM

In my opinion, there were five factors that made this decision possible.

First, the denunciation by Nikita Khrushchev of Stalin's personality cult. For the first time, the leaders of the Soviet state and

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the Communist Party spoke not just about individual shortcomings or even gross mistakes but about the inadmissibility of the Stalin regime in general. This admission inevitably raised the issue concerning the inadmissibility of “the dictatorship of the proletariat.”

That criticism laid the foundation for the quest to find a new *alternative* to the Communist system. However, in reality it may very well have been the actual starting point of the *renunciation* of that very system.

The second factor that prompted the breakaway from Communism was the presence in the Soviet Union of a large sector of non-Communist forms of farming, as well as groups of the population that were economically independent of Communism.

According to a 1959 census, which collected data for the year 1956 as well, the population of the Soviet Union stood at 208 million people, including 120 million of employable age. Of these 120 million available workers, two million worked in producer cooperative societies and in the handicraft industry. Another 10 million people worked on their home farms. The thirty-two million members of Soviet collective farms spent not less than one-third of their time tilling their personal plots of land. This made an equivalent of another 10 million people. As a result, at least 22 million people were able to produce for themselves.

In 1956, of the 12 million tons of meat produced in the country, collective farms accounted for only four million tons, while state farms added an additional one million tons. Compare these figures with the non-Communist forms of farming that produced over 50 percent of all meat. Of the 50 million tons of milk produced in the same year, private farms accounted for more than 50 percent.

The collective farmers and a majority of workers and employees of the Soviet Union were comprised of former peasants, and under Communism they were terrorized and denied any initiative. Yet they managed to preserve their habits and skills associated with individual private farming. It is a fact that not less than 50 percent of workers and employees lived in private houses and had small plots of land for a kitchen garden.

To sum up, 50 years ago 20 percent of the Soviet population were completely economically independent of the Soviet government, while another 30 percent were independent to a considerable extent. By the time of the 1989-1991 post-industrial reforms launched in the Soviet Union, there was already no trace of that social base left in the country.

Third, the nation as a whole was in a state of historical optimism. The victory in World War II gave strength to the people and faith in their own significance. Additionally, the millions of people who fought in the war got accustomed to not only obeying orders, but making independent decisions as well.

Millions of people were released from prisons and labor camps under a general amnesty issued by Chief Police Officer Lavrenty Beria, while Nikita Khrushchev rehabilitated millions more. Ethnic minorities that had been subjected to Stalin's repressions were acquitted en masse.

In the territories occupied during the war years, millions of Soviet citizens witnessed the complete and rapid disintegration of the Soviet system.

Then there were the millions of Soviet prisoners who were forced by the Nazis to work in Germany, as well as the soldiers of the Red Army who fought Nazi troops in Europe. These groups witnessed for themselves that people lived better without Communism.

On the whole, the Soviet people were ready for change; moreover, they wanted it. But again, this readiness did not automatically predetermine the *type* of change. However, reform initiatives for breaking away from Communism were not ruled out.

The fourth factor involved the Communist Party, bureaucracy, the nomenklatura, and political leaders.

In 1956, the Communist Party was comprised of seven million full and candidate members. In 1941, there were only two million members within its ranks. Since about half of these members died in the war, this means that six out of the seven million members joined the party after 1941. These new members were not involved in the revolutionary terror, the collectivization programs or the reprisals of 1937. They were not responsible for all the crimes of the past if the country decided to create an alternative system to Communism.

The bureaucracy and the nomenklatura wanted changes as well. First of all, they wanted to remove the axe of terror that was hanging over all of them.

But the political leaders turned out to be the most prepared for reforms. They knew the real situation best and understood the need for change better than others. Although they were divided among themselves on other issues, they were unanimous in their wish for reforms. This equally applied to top officials, such as Georgy Malenkov, Lavrenty Beria, and Nikita Khrushchev.

The state of the ruling class could be described by the classical formula: the upper class no longer was able to rule in the old way. It was ready for change.

Fifth, the international situation was favorable for reforms as well. Many people in the West still viewed the Soviet Union as an ally. On the other hand, the Soviet Union's achievements in developing nuclear weapons made fewer people think that a military victory over the Soviet Union was possible. These factors created a prerequisite for large-scale Western help for reforms in this country.

WHAT STOOD IN THE WAY OF POST-INDUSTRIAL REFORMS?

The aforementioned factors suggested that in 1956 there existed the theoretical possibility for breaking away from Communism.

What prevented those efforts? Here again five factors can be singled out.

The first factor was the bureaucracy and the nomenklatura. By 1956, the Soviet bureaucracy had developed a taste for material benefits. It actively sought material wellbeing and removed anything that stood in its way. So it could accept only those reforms that would guarantee that the bureaucracy would remain the master of the country and that its positions would only strengthen.

On the other hand, there were differences as to which reforms to implement, depending on the particular position of various groups inside the bureaucracy.

Second, the Soviet bureaucracy included people who either were directly involved in Stalin's repressions or played an active

part in them. The higher the level of the bureaucracy the greater the number of people involved in such actions. Criticism against Stalinism demoralized and instilled fear in the main strike forces of Stalin's dictatorship, namely the People's Commissariats of Internal Affairs (NKVD) and State Security (NKGB), courts and the Prosecutor's Office. However, this criticism failed to eliminate those forces. Therefore, it was necessary to refute any reforms that would make the past record of these forces a stone on their neck.

The only criticism of Communism they would accept was criticism against Stalin alone, thereby blaming him and his personality cult for all the mistakes of that era.

A large part of the Soviet bureaucracy comprised that of the army and military-industrial complex that had already been formed by 1956.

The development of nuclear weapons and the missile strike force, for example, required immense resources, while the management of these resources and their uncontrolled use was critical for that part of the Soviet bureaucracy. Thus, it could not allow reforms that would threaten its very existence. The threat originated from the idea of peace, while the chances for peace depended upon the removal of the irreconcilable opponents: Capitalism and Communism.

To continue prospering, the bureaucracy needed an orientation to war and, consequently, *the preservation of Communism as a justification of that war*. Any other types of reforms were considered fatal.

The most conservative part of the Soviet bureaucracy, however, involved regional bureaucracy and the bureaucracy of ethnic autonomies. That bureaucracy specialized in squeezing the last ounce of effort out of people; it had a very narrow idea of the country and the world, was obsessed with career making, had constant fear of higher-placed officials, and was always short of funds. Therefore, most of all it hated the central power and the very idea of centralization.

Obviously, this part of the Soviet bureaucracy would be willing to accept any reforms that would limit the center – but not more. It was this kind of bureaucracy that prevented the true rehabilitation of political prisoners and the reinstatement to their posts.

Incidentally, of all the sections of bureaucracy, the ethnic bureaucracy was the strongest part of the Soviet bureaucracy, especially at the level of the Union republics.

The third factor preventing post-industrial reforms was the people themselves. I mentioned above that millions of people were independent of the government. Yet it was a fact that not less than half of all the workers had a constantly improving economic status under Communism. Millions of people moved from rural areas into the towns, thus escaping from the medieval standards of rural life in favor of electricity, shops, cinemas, warm toilets and overall better living conditions (after all, even a barracks is better than a log hut).

Stalin constantly took pains to maintain people's confidence that tomorrow would be even better than today — largely with the help of reparations paid by Germany. Suffice it to recall annual consumer price cuts under Stalin. Therefore, a large part of the population had a strong belief that Communism had enough resources and only some shortcomings that must be eliminated. This confidence, however, was also supported by continuous large-scale political and ideological terror. There was no opposition to criticize the regime.

At the same time, the nation was tired of the bloodshed of revolution, collectivization, terror and war and did not want changes that could bring more upheavals.

The fourth factor was the intelligentsia. A very large part of the Soviet intelligentsia was comprised of men of the common people. They had enough knowledge from their education, but they did not experience the “complex of the intelligentsia.” Russian author Fyodor Dostoyevsky, analyzing the reforms initiated by Peter the Great, described such educated people as “technicians,” while Alexander Solzhenitsyn coined the term “obrazovantsy” [derived from the Russian word *obrazovaniye* — “education”] to describe people who have a higher education, but are void of the traditions of genuine intellectualism.

After Lenin's and Stalin's purges, there was little left of the genuine intelligentsia, which was the brain and soul of the people and its supreme moral and spiritual authority. This referred particularly to the intelligentsia that worked in the humanities.

The most the Soviet intelligentsia was able to do was bring about a period of “thaw” in Soviet life and literature – but not more. The intelligentsia failed to create, discuss and put forward the idea of breaking away from Communism and, moreover, disseminate this idea among the broad masses.

The fifth factor was the Communist leader, Nikita Khrushchev, who was the main obstacle to post-industrial reforms. Although he was the most radical of three contenders for leadership – Malenkov, Beria and Khrushchev – he emerged victorious not owing to a radical approach to reforms but to his connections in the regional party and state bureaucracy, which was particularly “pro-Soviet.” It was that bureaucracy that controlled the votes of the party members. This victory, which depended upon many allies, bound Khrushchev hand and foot.

Besides, Khrushchev found it impossible to renounce the system that had elevated him – a man of the lower classes – to the nation’s helm. He was ready for the most radical reforms, but only within the framework of the Communist system and Communist ideology. Also, like the entire top of the Soviet pyramid, he had a great fear that he would be made personally responsible for what had taken place in the country during the Stalin years.

Khrushchev was unable to find forms and methods for building bridges to other parts of the party, including the people, which were ready for reforms; he also failed to reach the liberal intelligentsia. He was obsessed with what he knew and what he was accustomed to – the Party apparatus. He failed to see other forces.

Realizing that the bureaucracy stood in his way, Khrushchev tried to weaken it by dividing it into industrial and agrarian bureaucracy, thus creating a prototype of a two-party system. But even this project, which eventually cost him his post, remained within the bureaucracy’s framework.

In pyramidal structures, only the leader can be the final author of reforms. The czar was the main moving force of the transformations in Russia under Peter the Great, and of the reforms for abolishing serfdom in this country in the 19th century. In the Soviet Union, however, the leader was only ready for radical but not revolutionary reforms.

The historical chance to launch post-industrial reforms in the middle of the 20th century was missed. Khrushchev never became a Soviet Deng Xiaoping.

THE IMPLEMENTED REFORMS
AND THE LESSONS OF THE PAST

At first, the bureaucracy disciplined by Stalin was obedient to Khrushchev and tolerated various kinds of radical transformations. But Khrushchev's reforms were of two colors. Some of his reforms, such as large-scale housing construction that provided millions of people with apartments of their own, the renunciation of reprisals, and the "thaw," led to a post-industrial society. Other moves, however, only consolidated the positions of the Soviet bureaucracy as the ruling class. These moves included the expropriation of the retail cooperative societies and the larger part of home farms, the proclamation of the program for achieving the final stage of Communism in the lifetime of the current generation, and the abolition of democracy within the Communist Party. Finally, a demonstration of workers in Novocherkassk was ruthlessly squashed, while fierce attacks continued against artists and authors.

Khrushchev's reforms called into question the Marxist model of the future. But at the same time they let the bureaucracy retain its power and become stronger. So the radical reforms launched by Khrushchev worked for the country's post-industrial future, while, at the same time, removed it from that goal.

What lessons can be learned from the epoch of reforms that were symbolized by the 20th Congress?

Lesson one. The variant of reforms, under which these ideas are authored and organized by the country's leader (as was the case under Peter the Great and Alexander II, for example), did not work in the 20th century — either under Khrushchev, Mikhail Gorbachev, or Boris Yeltsin.

The country's leaders should, perhaps, consider a different model of reform that could lead to the revision of the present Constitution.

Lesson two. The bureaucracy should not be the primary, as well as the only, basis of reforms. History shows us that when the bureaucracy united, it deposed Khrushchev. Unification of the bureaucracy strengthens its general conservatism and weakens the small reform-minded groups within itself.

Furthermore, unification of the bureaucracy, especially into one body, liquidates one of the fundamental principles of democracy and post-industrialism – the division of powers. A division of bureaucracy into rival groups opens up great opportunities for reforms.

Therefore, it is important that we reject the notion that unification of the bureaucracy is a positive thing.

Lesson three. There are two true bases for reform – civil society and the independent intelligentsia. Building both is a particularly important task today.

Lesson four. The transformation of radical reforms into moderate reforms leads to stagnation within the country.

Moderate reforms increasingly worsen the situation and give rise to growing opposition. As the government suppresses the opposition, the result is stagnation.

Thus, it is important to be aware of the dangers posed by a policy of moderate reforms and make it clear that this policy has no future.

Lesson five. The bureaucratic policy must be opposed with an alternative project for radical reforms. This concept must be widely discussed by the intelligentsia and then agreed upon by the whole nation.

Nature abhors a vacuum. If there is no project for radical transformations, sooner or later there will emerge a program for building Communism, or some sort of a bureaucratic national idea. Unfortunately, no conclusions were drawn from the 20th Congress, thus, when breaking away from Communism, we fell into the same trap that Khrushchev had fallen into before.

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Back into the Future, Or Cold War Lessons for Russia

Vitaly Shlykov

Sixty years ago, on March 5, 1946, Winston Churchill, at that time the former U.K. prime minister, gave his famous Fulton speech that is generally seen as the formal declaration of the Cold War. Churchill described the ideological division of Europe as an “Iron Curtain,” urging consolidation in the face of the Communist threat.

Unlike the 1941 Nazi attack, Churchill’s comments did not catch Joseph Stalin unawares. Just one month before Churchill’s speech, Stalin had told his country to prepare for a new war. In his no less famous speech to the electorate on February 9, 1946, he said: “We need to ensure that our industry produce up to 50 mln tons of cast iron, up to 60 mln tons of steel, up to 500 mln tons of coal, and up to 60 mln tons of oil. Only this can safeguard our Motherland and prevent contingencies.”

Churchill of course realized that Stalin needed such amounts of steel, oil and gas not for peaceful competition with capitalism. From his previous war experience, he knew that arms production hinged primarily on the availability of metal and fuel. The Soviet leader probably knew this even better than Churchill.

Stalin could not have easily forgotten that even the superiority the Soviet Union had over the enemy in tanks and aircraft at the beginning of the war could not save the Red Army from

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devastating defeats: almost all of the military hardware that the Soviet Union had accumulated in the prewar years was destroyed within the first several months of the war. Nonetheless, despite colossal losses caused by the Nazi invasion, Soviet industry eventually produced far more weapons than Germany. Even in the difficult conditions of 1942, the Soviet Union managed to produce six times more tanks than Germany (24,700 compared with 4,100) and 10,000 more combat aircraft, although Soviet industry produced 8.5 mln tons of steel compared with Germany's 35 mln tons.

The Soviet Union's more productive industry in comparison with German industry was due to a more effective mobilization system that was adopted in the U.S.S.R. in the late 1920s. It was based on the U.S. mobilization model that prioritized dual-use technology in arms production and supplies. The Soviet Union built, with U.S. assistance, huge state-of-the-art tractor and motor plants, while the tractors and motor vehicles were so designed that their key parts and components could be used in the production of battle tanks and aircraft. The Soviet State Planning Agency (Gosplan) rejected the Nazi approach, which provided for the creation of specialized military production facilities, as extremely labor-intensive and leading to immobilization of resources. The war confirmed the advantages of the U.S.-Soviet mobilization model. Both the United States and the Soviet Union were building 30,000 tanks a year whereas Nazi Germany, despite the priority of tanks in its war strategy, was unable to put out more than 4,000 machines a year (the production of one Tiger tank required about 200,000 man-hours).

In the prewar years, the Soviet leadership did not emphasize boosting military production or increasing the military's numerical strength. Rather, it focused on the development of the basic branches of industry (metallurgy, the fuel and energy complex, etc.) as a basis for the mobilization of production in the event of war. The archives of the State Planning Agency show that before 1939, investment in the basic sectors of the economy and general machine-building was several times higher than investment in mil-

itary production, with the quality of civilian products being every bit as good as those of the military use.

Despite the existence of military threats along the entire perimeter, the Soviet Union maintained a relatively small army until the outbreak of World War II with 500,000 to 800,000 men. Stalin decisively rejected the demands of the military establishment for the creation of a mass army (up to 250 divisions) with tens of thousands of tanks and aircraft, and even called Marshal Mikhail Tukhachevsky a “Red militarist” for making such demands. Instead, he channeled the bulk of the available resources to the development of machine-building and basic sectors of industry.

MOBILIZATION SOVIET STYLE

Not surprisingly, after World War II the prewar mobilization system that had proven so effective was completely restored. The armed forces were downsized from 11 mln to 2.7 mln in 1947, while the military industry was decisively converted to civilian production. The share of military output in gross industrial commodity output shrank to 3.3% from 6.9% in prewar 1940. Capital investment in the military industry in 1946-50 was half of the prewar (1938-41) level.

Investment in raw materials and basic sectors of the national economy was a priority throughout the Soviet era. Furthermore, the list of resources included in the mobilization plan was constantly expanding. The appearance of nuclear weapons and missiles required absolutely new materials, alloys, rare-earth metals and elements, and so forth. Under the plan, in 1960 the country was to increase the output of copper by 60%, aluminum 210%, lead 42%, zinc 77%, nickel 64% and tungsten concentrates 57% on 1955. In 1957-60, twice as many resources were provided to increase the fixed productive capital of the non-ferrous industry as in 1951-55.

Contrary to the Western view, the Soviet top brass did not think that the Soviet Union had military superiority over its possible adversaries. It operated on the assumption that in the event of war, the West would easily compensate for its lack of



"More millions of kilowatts for the Motherland! More oil and gas!"
Soviet posters, the 1940s

available weapon systems with the greater mobilization capacity of its industry. The purportedly huge mobilization resources in the United States and other NATO countries, which were also on an increased state of alert (as the Main Intelligence Directorate of the General Staff regularly reported), were a decisive factor in the constantly growing arms production levels in the U.S.S.R. According to the Pentagon, from 1974 till 1982, the Soviet Union produced 5.9 times as many ICBMs as the United States (2,035 compared with 346, respectively); 2.7 times as many tanks (17,350 and 6,400); 7.6 times as many infantry fighting vehicles and armored personnel carriers (36,650 and 4,800); twice as many tactical aircraft (6,100 and 3,050); 1.2 times as many large surface battleships (85 and 72); 2.3 times as many multirole submarines (61 and 27); 16.5 times as many SSBNs (33 and 2); 1.6 times as many nuclear tactical missiles (5,850 and 3,550); and 38.1 times as many field artillery

pieces and multiple rocket launchers (13,350 and 350) (Annual Report to the Congress. Caspar W. Weinberger, Secretary of Defense. Fiscal Year 1987. P. 24).

Could the United States have overstated Soviet arms output? There are no grounds for this conclusion. Actually, the United States seems to have underestimated the size of the Soviet military arsenals. For example, the Americans believed that the Soviet Union had produced 30,000 nuclear warheads and 500 to 600 tons of highly enriched uranium. As a matter of fact, according to former Soviet Atomic Energy Minister Vladimir Mikhailov, the Soviet Union had produced 45,000 warheads and 1,200 tons of weapons grade uranium (*The New York Times*, September 26, 1993). The U.S. estimate of Soviet tanks at a little over 50,000 was also incorrect; in fact, the Soviets possessed 64,000 (other sources put the number as high as 68,000).

Clearly, the Soviet Union strove not to fall behind the Americans in anything, maintaining its own mobilization capability on the same level.

Pressure by the General Staff to meet the requirements of mobilization plans was especially pronounced in continuous-flow production (aluminum, coke, etc.). A good case in point was in the production of aluminum, of which the Soviet Union produced 4 mln tons annually. Aluminum was not exported since it was considered to be strategic material. According to the State Planning Agency, not more than one-fourth of total rolled aluminum products were used in military production. In the civilian sector, aluminum was used only in the production of kitchen utensils and in the construction industry. Some of it went into the mobilization reserves, but there were simply not enough storage facilities for the aluminum that was produced over the decades, thus a considerable part of aluminum was presumably smelted down again. There is a story attributed to Boris Yeltsin, who said in the 1990s he had witnessed a scene in Sverdlovsk when a brand new tank left the factory where it had just been made, crossed the street, and entered another factory where it was immediately smelted.

To provide fuel for tens of thousands of tanks and aircraft in wartime, many oil refineries were built, thereby producing more fuel than could be consumed in a peacetime economy.

It was an absurd situation. The Soviet economy had long exceeded the targets for steel, coal and oil production that Stalin had set in 1946. Nevertheless, there was a shortage of those products in the real economy that worked frantically to produce even more. At the same time, collective farm fields were littered with millions of tons of parts and components from broken tractors – in effect, disposable, single-use machines – while tractor production was steadily growing. Industrial equipment and machine tools were becoming more and more metal-intensive. Mounds of fertilizers were left sitting along railroad tracks in the open air, rendered useless by the rain and the elements, because the fertilizer-making plants were operated mainly as a resource base for the ammunition industry.

Many economists came to the conclusion that extravagance and waste were inherent features of a planned economy. They figured the only way of ending the madness was through the liberalization of prices and freedom of enterprise. They failed to see, however, that during World War II Soviet industry had been quite effective and probably more cost-effective than the German or even the U.S. economy.

The causes for the incredible imbalances and wastefulness of the Soviet economy in the 1980s become more comprehensible when it is understood that mobilization for war in the Soviet Union was elevated to cult status. That cult was a factor in the policy of Mikhail Gorbachev and even the liberal reformers of the 1990s. On April 18, 1991, when the Soviet economy had hit rock bottom and was on the verge of collapse, Mikhail Gorbachev signed off on presidential Decree No. 1812, *On Urgent Measures to Improve the Country's Mobilization Readiness*, pursuant to which, on June 30, 1991, the government issued a resolution, *On Financial Support for the Mobilization of the National Economy*, thereby providing compensation to industrial enterprises for the costs involved in the maintenance of mobilization capacities. In

early December 1991, the State Committee for Defense of the Russian Federation (RSFSR), where I was deputy chairman (the chairman was Gen. Pavel Grachev), received a draft government resolution, signed by Yegor Gaidar, on financing mobilization activities in the national economy, which repeated word for word the old plans of the Soviet State Planning Agency. The only difference was that the word “U.S.S.R.” was replaced with “RSFSR.”

At a Russian Defense Council session in November 1997, it turned out that the main enforceable legal document on mobilization readiness of the national economy was the 1986 mobilization plan that, among other things, provided for military supplies to the armed forces of the long defunct Warsaw Pact. The government only addressed the mobilization problem when President Vladimir Putin, at a Security Council session on November 27, 2001, observed that “our economy is no longer centrally planned,” while mobilization rules had been in effect since “days of yore,” and that the mobilization structure of the defense-industry complex was bloated.

WRONG DIAGNOSIS

There is a commonly held belief that the Russian leadership inherited a ruined country from the U.S.S.R., with references made to the empty store shelves and depletion of state gold and hard currency reserves which, according to Yegor Gaidar, stood at a mere \$55 mln at the time he came into office. Of course, if only these two indicators are used to assess the state of the economy, today’s abundance of goods and the country’s impressive gold and hard currency reserves favorably contrast with the 1991 situation. However, once the material and technological resources (as opposed to its financial resources) that Russia had at that time are compared with what it has now, the situation will look very different. As a matter of fact, Russia inherited from the Soviet Union material of colossal value that with a certain level of knowledge and effort could be quickly converted both into hard currency and consumer goods. Not everyone realizes that this legacy, as opposed to the energy of the “freed-up market,” produced the state’s hard currency reserves, full store

shelves, multibillion personal fortunes, and even tens of billions of dollars under the mattresses of ordinary Russians.

The main objective of the Soviet mobilization system was to accumulate the maximum possible amount of material resources in the event of world war. This accumulation was secured by several methods.

One primary method was the construction of so-called state reserves in the form of reserves and stocks of foodstuffs, drugs, fuel, metals, timber, equipment, railroad tracks, etc. These stocks were stored at thousands of special facilities dispersed throughout the Soviet Union and strictly monitored and controlled by the state; to that end, there was a special government agency with the status of ministry (Goskomrezerv). These reserves were to be used not only in wartime, but also in various emergencies (natural disasters, severe winters, crop failures, etc.).

Another method of accumulating wartime reserves was the creation of mobilization stocks (e.g., raw materials, equipment, components) designed exclusively for the production of specific types of arms in the event of wartime mobilization. They were stored, as a rule, at the same enterprises where a particular weapon system was to be deployed in case of war.

The main mobilization resources that Russia inherited from the Soviet Union, however, did not come from Goskomrezerv or defense enterprise stocks, but from production capacities that had been created in the raw materials and basic sectors of industry for wartime exigencies. Whereas the Goskomrezerv and defense-enterprise resources were worth tens of billions of dollars together, the raw materials and basic sectors of industries for mobilization were worth hundreds of billions.

Still, the largest share of investment did not go into the defense industry, but rather into the development of basic industrial sectors, the raw materials sector and associated transport services. Furthermore, their share in aggregate investment was constantly growing. Whereas in the 1960s-early 1970s, the share of investment in the fuel and energy complex was 10%, in 1980 it rose to 12%; and between 1986 and 1990 it rose to 14% of the total. By the mid-

1980s, the transport sector accounted for 12.4% of total investment, whereas in the 1960s-early 1970s it stood at only 10%. New industrial facilities were created at higher rates than average for the production of new materials. For example, the Soviet Union was producing more titanium than the rest of the world taken together.

Growth of investment in raw materials and basic sectors of industry was of course secured at the expense of other sectors, primarily the production of consumer goods. As a result, demand for consumer goods, more or less balanced until the 1970s, was no longer met by domestic production alone.

Attempts to compensate for the shortage of consumer goods with imports only further unbalanced the economy since the Soviet wartime economy model was originally developed as a closed and self-sufficient system. It remained as such until the 1970s when grain, followed by consumer goods, began to be imported on a large scale, which in turn pushed up the export of oil and natural gas. Meanwhile, the Soviet wartime economy model was absolutely not designed for such exogenous impacts, which provoked shortages of consumer goods, inflation in place of price stability (and even regular price reductions in the postwar years), money supply growth in place of strict monetarist policy, and the devaluation of the ruble.

Unable to understand the situation at the beginning of the perestroika era, politicians, the majority of economic experts, and the media attributed all economic woes to excessive defense spending. Academicians Yuri Ryzhov and Oleg Bogomolov, followed by Mikhail Gorbachev in April 1990, stated that military spending was at 20% of GDP, while Gen. Vladimir Lobov, chief of the General Staff, stated in late 1991 that military spending was over one-third of GDP. However, even those estimates could not explain the depth of the economic crisis that hit the Soviet Union in the late 1980s-early 1990s.

During World War II, the United States was annually spending up to 45% of its GDP on the war effort, while industrial growth stood at an annual rate of 16.9%. During the war years, its investment in the economy increased 65%, industrial production doubled, while power-generating capacity increased by 75%. None

of that spending, however, was achieved at the expense of the people's living standards. On the contrary, real wages during the war grew 50% amidst almost full employment, while per capita food consumption increased 15% to 25%.

The Soviet Union was also spending more than one-half of its GDP on the armed forces. Despite the tremendous destruction and losses it sustained in the war, it managed to not only achieve prewar production levels soon after the war but also create nuclear weapons and their delivery means within the shortest possible time span. By contrast, Russia, 15 years after the breakup of the Soviet Union, has yet to reach the prewar production level even though military spending (including on arms procurement) has been reduced many times over.

Meanwhile, it is still widely believed that the military-industrial complex brought the U.S.S.R. to economic collapse. Defense Minister Sergei Ivanov once said that in the Soviet era, the military budget was as large as 25% to 30% of GDP, and that "we all know what happened very well." Other politicians suggest that the share of the military-industrial complex was even higher. For instance, Yevgeny Primakov in his book, *Eight Months Plus*, writes that "the defense sectors of industry created up to 70% of GDP," while Gavriil Popov, in a recent TV interview, put the figure at 80%.

None of these estimates are backed up by statistics. Gosplan's official data, for example, show that in the late 1980s, the defense industry employed 9.5 mln people (including 6.5 mln to 7 mln in the Russian Federation) of the total 130 mln workforce, consuming 20% of sheet steel, 9.3% of rolled steel and 23.6% of rolled aluminum products, while the complex's fixed productive capital was 6.4% of the Soviet aggregate.

A wrong diagnosis leads to a wrong course of treatment. Having declared the military-industrial complex guilty of ruining the economy, Mikhail Gorbachev decided to reduce arms procurements (by 10% to 20%) and launch a comprehensive program for converting the defense industry to civilian production. However, he carried out those initiatives in such a manner that made the economic sit-

uation even worse. All production capacities that were freed as a result were immediately transferred to mobilization reserves and thus demobilized. As for the five-year conversion program that was adopted in December 1990, it simply provided for the creation of new capacities to produce civilian goods (40 bln rubles for production and 36 bln rubles for R&D programs). That huge investment was only supposed to double civilian production.

MISSED OPPORTUNITIES

To put the Russian economy on a peacetime footing, Russia could have simply resorted to America's post-WWII experience involving the demilitarization of its economy. That experience was all the more valuable since the Americans dismantled their military industry rapidly, as well as painlessly for their population, without economic recession or soaring inflation. By 1948, U.S. military spending fell to 3.2% of GDP from 43% in 1944, while 12.4 mln people were released from defense production. Employment in the aircraft industry, for example, fell from 2.202 mln in November 1943 to 240,000 in 1947. The figure leveled off at 256,000 in 1950; in the shipbuilding industry, the figure went from 1.778 mln to 138,000, respectively; and in the artillery and small arms production, from 1.436 mln to 24,000. By June 1950 (the beginning of the War in Korea), the number of people employed in the military industry promptly returned to the 1940 level. Unemployment increased from 1.2% in 1944 to 3.9% in 1946-48. That level was much lower than in 1940 (14.6%) or 1941 (9.9%). Although GDP naturally shrank (by 1.9% in 1945, 19% in 1946 and 2.8% in 1947), already in 1948 it began to grow (by 3.9%). FRS interest rates, which had stayed at 1% throughout the war and the first postwar years, rose slightly to 1.34% in 1948. As for inflation, the only surge (2.8%) was registered in 1948, but was brought back to normal the following year.

In the early 1990s, both the U.S.S.R. and Russia seemed to have even more favorable conditions for a transition to a peacetime economy than the United States had in 1945. Even if Gorbachev's estimate (20% of GDP) is taken for granted, the militarization level of the Soviet economy was only half of the

U.S. level (45%). The Soviet military industry employed 9 mln people compared with 13 mln to 14 mln in the United States; the Soviet military had a numerical strength of 5 mln people, whereas the U.S. military was 13 mln. Furthermore, the Americans had to carry out a conversion program single-handedly with no outside assistance – on the contrary, they had to help others. Meanwhile, the Soviet Union was offered substantial assistance from other countries – both in expertise and in financial aid (e.g., many billions of dollars paid by Germany for the withdrawal of Soviet troops).

Why, then, did Soviet GDP halve, and why has Russia still not recovered to its former level 15 years later? Why did inflation in the 1990s jump to over several thousand percent a year and why did unemployment get out of control?

Because we did the exact opposite to what the Americans did in a similar situation.

So what exactly did the Americans do? First, as mentioned earlier, they drastically scaled down their military production, while keeping this transition on extremely generous terms for the arms suppliers. In particular, the U.S. government compensated up to 90% of the losses that companies incurred due to the cancellation of military contracts. The U.S. Congress established an expedited, fast track procedure for financial settlements on cancelled contracts, contrary to protests from the Comptroller General who insisted on a preliminary audit to prevent abuses by contractors. The Congress argued that the procedure proposed by the Comptroller General would have frozen billions of dollars in working capital, especially in small- and medium-sized businesses.

Second, the U.S. government sold, at a fairly moderate price, or leased to private companies the majority of the 1,600 plants that it had built during the war. Many plants, which became unnecessary in peacetime, e.g., 51 synthetic rubber-making plants, were simply closed.

Third, in expanding the civilian production, the government gave priority to stimulating public demand. It not only preserved the huge deferred demand, which by the end of the war stood at

about \$160 billion (equal to annual GDP), by keeping inflation in check, but also implemented measures to increase it. In particular, demobilized servicemen were paid a total \$20 billion from the federal budget in the first three postwar years. Another \$1.5 billion came from state treasuries. That was very big money, even by contemporary standards. To put these expenditures into context, the entire U.S. military budget in 1947 was \$11.7 billion.

This radical scaling down of U.S. military production deprived the majority of arms producers from lucrative defense contracts. This change of events forced them to switch to civilian production, which, combined with popular demand for such products, enabled the United States to move from wartime to a peacetime economy without recession, serious inflation or unemployment, and provided an impetus to business activity. In the 1944-48 period alone, consumer spending on durable goods tripled while the volume of housing construction exceeded by tenfold the prewar level.

The Yeltsin-Gaidar government did exactly the opposite. First, in the absence of any military threat, it preserved an unjustifiably high level of military production. In particular, the 1992 defense production order was huge. It included 110 combat aircraft (without strategic bombers), 30 ICBMs, 28 submarine-launched strategic missiles, and 8 strategic bombers. To understand the burden that this production placed on the Russian economy, it is enough to compare the 1992 defense contract with the current one. In 2006, the Defense Ministry ordered just 6 Topol ICBMs, no submarine-launched strategic missiles, and 8 combat aircraft, including one strategic bomber.

During one Cabinet session (chaired by the RF Secretary of State, Gennady Burbulis) where the 1992 arms production order was the subject of debate, the military, led by the chief of the General Staff, objected to the inclusion of ICBMs and strategic bombers into the defense order, asking instead for more funding for the procurement of spare parts and housing construction programs. However, Deputy Minister of Economy Ivan Materov, the keynote speaker, defended the production of the unnecessary mis-

siles and bombers by arguing that it was necessary to provide employment in the defense sector.

It was with the same rationale that on March 17, 1992, Yegor Gaidar signed off on a state order for the production of \$5.4 billion worth of arms and military equipment for export, which was almost four times as large as Soviet arms exports in 1991 (\$1.55 billion). It turned out later that the Russian defense industry managed to sell abroad only \$1.1 billion worth of arms produced under 1992 contracts, leaving unsold about 400 tanks, 200 self-propelled artillery systems, 16,000 missiles of different types, and many other weapons.

Second, unlike the Americans, neither the Gaidar government, nor the Chernomyrdin government that replaced it, took any steps to close or restructure defense enterprises that were in effect redundant or operating below capacity, or to transfer them to the reserves. Russia inherited from the Soviet Union 1,700 defense industry enterprises; today, Russia's defense industry complex still has 1,700 enterprises even though many of them have long ceased producing military goods. While the Americans, within just a few years, reduced the number of people employed in the aircraft industry almost 10 times (to 240,000 in 1948), in 2000, the Russian aerospace industry had 1.2 mln employees who produced \$2 billion worth of goods, whereas the aerospace industry of entire Europe produced \$72 billion worth of goods with 800,000 employees.

Third, and most importantly, the Gaidar government effectively wiped out the same resource on which the United States had relied in switching to a peacetime economy: specifically, the demand for consumer goods and production facilities. The colossal financial resources on private accounts at the Russian State Savings Bank (Sberbank) were simply frozen. As of January 1, 1992, about 100 mln Russian citizens (i.e., almost the entire adult population) had 400 billion rubles on 140 mln bank accounts. In 2003, Russia's recognized internal state debt resulting from the state's failure to return bank deposits, which were frozen on June 20, 1991, stood at 10.9 trillion rubles (\$343 billion).

Yet the lifting of restrictions on the import of goods irrevocably blocked the path to the demilitarization of the Russian economy. Russian defense industry enterprises, unable to compete in the production of consumer goods with cheap imports, had no option but to hold on to what they knew how to do best – weapons production. This, despite the fact that the production of weapons was no longer as profitable as it had been previously.

The backwardness of the civilian sector was directly proportional to the resources that were denied it in favor of military production, thus the economy could only barter goods through a direct distribution of resources at artificially set prices. If such an economy is abruptly placed on a free market basis with the lifting of price controls, the entire system of technological and financial relations will simply collapse. This was exactly what happened to Russia in the early 1990s.

This skewed economic setup, when the economy does not respond to a fall in arms procurement and prevents the re-funneling of resources from the military to the civilian sector, can be described as *structural militarization*, in contrast to militarization that can be measured through the share of military spending and military production in the national budget, GDP, etc. In a structurally militarized economy, arms procurements can come to a halt (which is what happened in Russia by the mid-1990s), but this will not automatically make the civilian sector more effective. Furthermore, it is possible for the economic situation in such a country to worsen.

Paradoxically, in a structurally militarized economy, resources are mainly wasted not in the defense sector but in the civilian one. Because the economy is in extremely poor shape, even the maintenance of the civilian sector requires a colossal amount of resources: raw materials, energy, machinery and equipment. To support its pathetic agricultural complex, the U.S.S.R. had to produce six or seven times as many tractors and several times as much fertilizer as the United States.

Sooner or later such an economy must collapse, as happened to the Soviet Union in the late 1980s-early 1990s. The Soviet

economy collapsed not due to the overproduction of arms but rather an overproduction in the civilian (above all, raw materials and basic) sectors of industry – similar to how the U.S. economy collapsed during the Great Depression of 1929-33.

This was ignored by our neo-reformers who attacked the military-industrial complex as the root cause of all Soviet economic troubles.

The Soviet economy was a pyramid whose base was comprised of, according to Academician Yuri Yaryomenko's definition, "low-quality resources." In other words, it was an economy built around raw materials, basic industrial products (steel, coal, aluminum, etc.) and an unqualified workforce. At the apex of this pyramid were advanced technologies and specialists, designers, engineers and highly qualified workers, i.e., high-quality resources. Thus, the military-industrial complex was an effective mechanism of transforming low-quality resources into high-quality resources, but for military purposes only.

Almost overnight, the pyramid was turned upside down, which drastically changed the Russian economic environment. Here is an emotional but accurate description of what happened at that time by Lev Makarevich, an observer for *Finansovye Izvestia* and expert with the Association of Russian Banks:

"Raw materials producers replaced the military-industrial complex as the unchallenged masters of the country. The Kremlin and the White House were used as a battering ram to push the military-industrial complex to the political and economic sidelines, as graphically demonstrated by its deplorable financial status and the show trials of its top executives. Today, raw materials tycoons shape policy and control key appointments in the presidential staff, the government, major factions in the State Duma, the Federation Council, many government agencies and departments, and the regions."

The opening of state borders for the export of raw materials and basic goods helped quickly deal with the overproduction problem. Bequeathed by Stalin and intensified by succeeding Soviet rulers, mobilization resources were simply dumped on the world

markets and sold off on the cheap. The price of resolving the over-production crisis in such a manner proved inordinate.

However, it was not just a matter that industrial production halved and living standards plummeted. The Americans also paid for their 1929 crisis with the loss of one-half of industrial capacities and massive unemployment. But they cut production more or less evenly. In Russia, however, the Soviet military-industrial complex was jettisoned, while the raw materials and basic sectors of industry were given a major boost for further development. As a result, what is now proudly called the “Russian defense-industrial complex” is simply a couple thousand enterprises from the Soviet era that have outlived their usefulness. The present success of arms export can only delay but not stop the disintegration of the defense-industrial complex.

Having senselessly destroyed the military-industrial complex, we have lost not simply the opportunities to develop and create new weapons, but also our place in the post-industrial world. After all, the Soviet military-industrial complex had concentrated the basic components of a modern economy: continuous education to high standards of excellence, a well developed applied and fundamental science, powerful transport and energy systems, and major head start and work-in-progress efforts in defense technology.

Why then did Russia’s neo-reformers not use the potential of the military-industrial complex after the Cold War?

Usually, in explaining their reforms of the early 1990s, the reformers say proudly that they adopted methods and approaches that had proven themselves in other countries, that there were no other ideas, and that only they were ready to assume the responsibility for leading the economy out of a crisis. This is not so, to put it mildly. There were alternative proposals, and they were put forward quite openly. Academician Yuri Yaryomenko, an economic adviser to Mikhail Gorbachev from May 1991, proposed one well-known and detailed program. He believed that to break the deadlock, it was necessary to “transform military power into economic power” by funneling high-quality resources gener-

ated by the military-industrial complex to civilian sectors of industry, with the conversion of the defense industry being the main instrument of such transformation. "Conversion," Yaryomenko wrote, "is not about using defense industry enterprises to produce non-military products, but using the resources concentrated in the defense sector for restructuring the entire economy." Yaryomenko stressed that "most of the special equipment and special technology in the defense sectors of industry should be scrapped [that was exactly what the Americans did after the war], since they could not be used for anything but arms production." At the same time, he said it was vital to separate military production from civilian production. "Transition to civilian production," he wrote in August 1990, "should proceed *comprehensively*, not piecemeal. I am sure that if the State could move along these lines, we would soon have major, competitive industrial centers preserving and advancing high technology and driving effective consumer demand." Yaryomenko predicated successful conversion on the abandonment of the mobilization doctrine and the adoption of a policy of economic self-sufficiency in order to protect enterprises implementing conversion programs from external competition.

The present author, who in 1991 was deputy chairman of the RSFSR State Committee for Defense and Security in charge of conversion programs, in an interview with the *Demokraticheskaya Rossia* daily (June 21, 1991), proposed using mobilization reserves for conversion purposes, arguing that the Soviet Union had "ideal conditions for rapid and radical conversion." Robert R. Nathan, who had overseen the mobilization of the U.S. economy during the war and later its re-conversion, noted the interview. During a visit by a Russian military delegation to Washington in early October 1991, Nathan said that conversion of the Soviet military industrial complex would be completed within one and a half to two years, and if invited, he was ready to act as a consultant for the Russian government on conversion matters. He also said that after the war in Korea, he and his consulting agency, Nathan Associates, had for 10 years been helping the economic recon-

struction effort in Korea on behalf of the UN. In comparison with that task, he observed with a smile, conversion of the Soviet defense industry was a piece of cake.

At that time, Deputy Secretary of Defense Donald J. Atwood also volunteered to go to Moscow with a group of experts to share U.S. re-conversion experience. The Russian government, however, ignored the opinion of Atwood when he visited Moscow in late October 1991 with a large team of experts. In an interview with *Kommersant* daily just before departing from Russia, he said that during his visit he had not seen any signs of conversion and that no one either in the Soviet Union or in Russia understood the meaning of conversion.

Russian neo-reformers also ignored the experience of other countries in their attempts to make the transition from a militarized economy to a civilian economy. Between July 16 and 26, 1991, a large delegation of Japanese businessmen (including several experts from the United States) visited the Soviet Union to study the conversion of the Soviet military industrial complex and offer consultation in implementing a conversion program based on the Japanese experience after World War II. The delegation acted on instructions from the London Summit of the G7 in July 1990 when the group of leading industrialized countries decided to provide assistance to the Soviet Union in carrying out conversion programs. The delegation visited a number of defense industry enterprises, meeting with many representatives of the Soviet and the Russian government. In October 1991, a report on the results of the trip was sent to the Russian government. It was an extensive and extremely interesting document. It was drawn up into three parts: an appraisal of the status of Russia's conversion program, a detailed description of Japan's transition from an over-militarized to a market economy after World War II, and recommendations on implementing the conversion of the Russian defense industry and building a market economy. Neither the then Russian government, nor any subsequent Russian governments, followed those recommendations.

TO BEGIN ANEW

On November 3, 1991, I published an article, *On Conversion with Optimism*, in *Demokraticheskaya Rossia* daily, reiterating that the defense industry could be rapidly converted and the economic situation turned around. To that end, it was necessary to do several things:

First, impose a two- to three-year moratorium on arms production during the conversion period. Of course there were certain types of military production facilities that could not be brought to a halt, but they constituted a very small proportion of the total. There were certain arms production sectors that could be simply closed. Such a move would release a colossal amount of equipment, resources, fuel, energy, and so on.

Second, revise the entire system of mobilization readiness, scrapping the mobilization plan. If enterprises wanted to retain reserve capacities, they should spend their own resources for it. The same thing applied to the Defense Ministry. This constituted an indispensable element of radical conversion.

Third, transfer all enterprises from the control and tutelage of ministries, making them economically self-sufficient. Otherwise the process could assume ugly forms, and that kind of conversion “according-to-the-ministry” would be more trouble than it was worth.

Fourth, terminate all defense contracts, paying appropriate compensation to the enterprises and providing them with start-up capital. It was necessary to create a central administration to manage property and equipment released as a result of conversion.

Fifth, declassify defense industry technologies so that they could be used in the civilian sector. This is a colossal reserve that could help quickly advance the country’s industry.

The most important thing was to rectify economic misconceptions. Those who thought that a market economy would automatically lead to the production of the necessary consumer goods failed to face up to reality: enterprises in the civilian sectors of industry could not satiate the market. Russia’s civilian industry was obsolete, weak and unviable. With normal pricing mecha-

nisms those enterprises would not be able to recoup their costs (raw materials, energy, etc.), while the defense sectors of industry with their technology, equipment, and qualified labor were well in a position to meet demand.

Of course, directors of the military-industrial enterprises were concerned above all with their own survival, not the development of the civilian sectors of industry. Therefore, to convince them about the need for full conversion, it was essential to demonstrate beyond any doubt that there would be no return to the old ways. In other words, what was needed was “shock therapy” for the military-industrial complex, not for the population, as proposed by Gaidar. U.S. experience was also helpful in this regard.

Demilitarization of the economy is still a highly relevant issue, especially concerning the recommendation to separate military and civilian production. Meanwhile, military and civilian goods are still produced at the same enterprises. As a result, we still do not know how much is being spent on defense, while taking solace in the fact that the share of the military budget does not exceed 2.7% of GDP. At the same time, real military spending is determined not by its share of GDP, or the state budget, but by the economic development opportunities that have been missed as a result of militarization.

If we look at the past 15 years from this perspective, we will see that our economy has become even more structurally militarized. Meanwhile, the raw materials sector was created strictly for war; there was no consideration for the competitiveness of these resources on world markets. And it is quite possible that with every ton of oil, steel and aluminum exported, the country only became poorer. As a matter of fact, we are now seeing a recurrence of the situation of the late 1980s-early 1990s, when the overproduction of raw materials brought the Soviet economy to collapse. Today, this overproduction has assumed a monetary form, while its real scale is blurred by the phenomenon of capital flight. The Stabilization Fund and gold and currency reserves are steadily growing, but they are not being used to any good effect either at home or abroad, destroying the non-raw material sectors of the

economy and the social fabric of society. Capital flight and foreign debt servicing are the only safeguards against an overproduction crisis (as in 1990-91) and hyperinflation.

However, there is still hope. It must be understood that capital taken out of the country, together with the stabilization fund, oil wells and aluminum plants, are the mobilization reserves that we inherited from the Cold War era, not something that we created, and that these reserves should be put to effective use.

Russia missed its opportunity to use the end of the Cold War era for creating a Russian economic miracle like the American re-conversion of 1945-48. As for the aforementioned recommendations by the Japanese delegation of industrialists to build a high-tech economy in place of an over-militarized economy, they are quite relevant and applicable even now, especially given that the former head of the Japanese delegation has an office in Moscow. The experience of South Korea, the FRG and other countries in the postwar development of a market economy is also very instructive.

It is now time to recognize that the reform of the early 1990s was wrong. Such a complex and unique system as the Soviet militarized economy cannot be restructured by pseudo-market methods. First of all, it should be demilitarized on the administrative level, mobilizing the entire power of the state, and only then can a market economy begin to be built.

The sooner this stage is passed, the sooner Russia will be able to build a free and *bona fide* market economy. Furthermore, it is quite possible that due to endemic corruption and the omnipotence of bureaucracy, Russia will need the most radical methods of economic liberalism that was undeservedly compromised in the 1990s.

Fulton Revisited

Vladimir Pechatnov

It is rather difficult to pinpoint an exact event that triggered the Cold War – a protracted and multidimensional event that evolved in gradual stages. Historians remain divided on whether the signal event was October 1917, World War II, the Truman Doctrine or the Marshal Plan. Exactly 60 years ago, in the spring of 1946, Washington's and London's strategic paradigm shifted drastically away from cooperation with the Soviet Union to tough confrontation with it.

Winston Churchill's Fulton Speech may serve as the best starting point for that showdown. In his famous speech, Churchill provided the basic signposts of an emerging new era that served as a guideline for the architects of the Cold War in the United States and the U.K.: a bipolar division of the world, the central role of the Anglo-American axis in the Western system, ideological confrontation with the Soviet Union, and the pursuit of military supremacy based on nuclear power. This new strategy appeared in sharp contrast with the guidelines that had prevailed in Washington just a year before.

“REFORM” STRATEGY REVISED

Franklin D. Roosevelt's Soviet strategy was based on a perception of the Soviet Union as a problem country, not intrinsically hostile

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to the United States, but whose anti-Western complexes were rooted in its hard historical legacy (and up to a point, the behavior of the West itself was a source of blame). Roosevelt believed that those complexes could eventually be overcome with a correct approach. There seemed to be signs that Stalin's regime was experiencing some degree of normalization, which was perhaps more readily believable considering the Soviet Union's motives and behavior during the war, the positive experience of military cooperation, and the optimism of the U.S. president. He firmly believed that he would be able to "tame" Stalin.

Roosevelt's strategy of "reforming" the Soviet Union through its gradual integration into the Western community, however, was incompatible with Moscow's isolation. On the contrary, it was built on the premise that the West would recognize the legitimate security interests of the Soviet Union as a great power and co-founder of a new world order. Roosevelt and his co-planners hoped the newly acquired habits of cooperation with the West would become permanent and the baby would learn to walk, while friendship through coercion would grow into a permanent friendship.

Of course, Roosevelt's policy included an element of selfishness and self-protection (delaying the opening of the Second Front, for example, or keeping the Manhattan Project a secret from its ally, etc.), but it was centered on wartime aid to the Soviet Union and the hope that cooperation would continue in the postwar reality.

Less than a year after Roosevelt died, however, a very different view of the Soviet Union and prospects for cooperation with it prevailed in Washington, to say nothing about London. The rationale for the turnaround came in the famous Long Telegram by George Kennan, U.S. charge d'affaires in Moscow (February 22, 1946), and memos by his British counterpart, Frank Roberts (March 14 and 17, 1946).

According to Kennan and Roberts, the scale of the "Soviet threat" hinged on Stalin's system and the messianic aspirations of its leaders, which enjoyed great military power, colossal resources, and opportunities for expanding the Kremlin's sphere of influence after World War II. At the same time, the Soviet

Union's legitimate security interests were completely ignored. It was not those interests that were seen as the core motives behind "Soviet behavior" but the insatiable and boundless striving for expansion. Furthermore, what legitimate security interests could a totalitarian state – as the West perceived the Soviet Union at that time – possibly have?

Also, the belief in the inherent weakness of Stalin's system as based on fallacious principles, dooming it to economic ineffectiveness and political fickleness, was unmistakable. "The ruling group in the Kremlin is alienated from its own people," Kennan wrote, adding that "if fortune were really to turn against them – if the belief in the firmness and certainty of their power were to be widely shaken in the minds of their subjects and their enemies – then there would be no extensive reserve of loyalties and interests to which they could make their final appeal." In other words, at a critical moment the people would have no one to rely on, which was amply borne out at the turn of the 1990s.

In the realm of foreign policy, the weakness of the Soviet system arose primarily from its inability to ensure the long-term loyalty of its new allies, both in Europe and in East Asia, through sheer coercion and brute force. It was obvious that Moscow's tough control measures would inevitably come into conflict with local nationalist aspirations, breeding resistance that would sooner or later undermine its foundations and reverse Soviet expansion.

From that perspective, the Soviet challenge had some comparable elements with the Nazi threat, yet there were some essential differences as well. "Soviet power, unlike that of Hitlerite Germany, is neither schematic nor adventuristic," Kennan wrote in the Long Telegram. "It does not work by fixed plans. It does not take unnecessary risks. Impervious to logic of reason, and it is highly sensitive to logic of force. For this reason it can easily withdraw – and usually does when strong resistance is encountered at any point." Roberts added to this cautiousness of the Russian rulers the qualities that characterized common Russian people: benevolent interest in the surrounding

world, openness to external influences, and a “fundamental streak of laziness, indiscipline and inefficiency running through the Russian people, who must be constantly kept up to the mark if they are to preserve their position in the world.” The blend of these qualities made the Russian people unfit for building a world empire: “This is therefore a people very different from the Germans who regarded themselves as a master race, destined to dominate the world and who fully sympathized with the ruthless and ambitious policies of their leaders.”

Their obsession with the “Soviet threat” did not prevent Anglo-American policy makers from taking a realistic view of the lineup of forces in the emerging stand-off: “Gauged against Western World as a whole, Soviets are still by far the weaker force. Thus, their success will really depend on degree of cohesion, firmness and vigor which Western World can muster. And this is a factor which it is within our power to influence,” Kennan wrote. Roberts replied, “The Soviet Union...is nothing like so strong at present as the Western democratic world, and knows it.”

Taking these insights into account, the architects of the “containment” doctrine supposed that if the West chose a correct strategy, it would have long-term advantages in the Cold War. Since the Western capitals rejected the preventive-war scenario as too risky (especially considering the crushing defeat of the German *Wehrmacht*), priority was given to wearing down the enemy. That could be achieved by containing the further expansion of its sphere of influence, combined with intense pressure by all possible means (including psychological warfare and subversive operations).

In short, the Kennan-Roberts concept finalized the antithesis to the Roosevelt approach toward the Soviet Union: the Kremlin’s intrinsic aggressiveness (as opposed to rational behavior), its incorrigibility (as opposed to flexibility), which necessarily led to a strategy of “breaking down” or “softening up” the Soviet system under the impact of superior force (as opposed to its gradual integration into the Western community).

THE PRINCIPLES OF CONTAINMENT

Eventually, the objectives of “containment” (and therefore pre-conditions for victory in the Cold War) were specified in U.S. strategic documents – directives by the National Security Council 20/1 (1948) and 68 (1950) – which sought to reduce Moscow’s strength and influence to a level where it would no longer pose a threat to the peace and stability of the international community, and compel the Russian government to drastically revise its theory and practice of international relations.

The strategy for the “reduction of strength and influence” referred to freeing the East European countries from Soviet control and reducing Soviet influence on other countries through their communist parties. Priority was given to terminating the Soviet presence in the center of Europe, which was regarded as a historical anomaly, caused by World War II and the West’s inability to cope with the *Wehrmacht* single-handedly. As long as the Red Army remained encamped on the Oder and the Elbe, the Soviet Union possessed unchallenged geopolitical trump cards in the Cold War.

A “drastic revision” by the Kremlin of its vision of international relations referred to the abandonment (if not in word, then in deed) of its class-based approach toward the outside world. However, it was not entirely clear how such a revolution in Soviet thinking would happen. Kennan saw the system collapsing as the result of an internal crisis or war, but prioritized its gradual “softening up” as a safer scenario both for the United States and the world as a whole. The idea was to adapt the Soviet leadership to its reduced influence, creeping de-ideologization, and gradual transition to new relations with the outside world.

Neither objective was realistic, however, without a drastic change of the Soviet system. But whereas shrewd Kennan believed in the possibility of peaceful and parallel development of this twofold process (stranger things have happened in history, he said), the NSC-68 proclaimed such a change as an indispensable precondition for the Kremlin’s transition to “new thinking.” It also substantially simplified the understanding of

the tasks and objectives of its Soviet policy: while Kennan and Roberts believed that Moscow did not work by fixed plans, the NSC-68 said the Soviet Union had the “grand design” of achieving world supremacy.

Therefore, the main objective was to thwart that design, which, according to the document’s authors, was to become a major step toward weakening and eroding the entire Soviet system; this would guarantee the irreversibility of those changes. In modern terminology, that objective would probably be referred to as “regime change.” Anyway, “containment” became a huge experiment to “modify” the adversary’s behavior and “reform” it under the pressure of superior force.

The main perceived risk was that in the process of “dosed and gradual coercion” (the essence of the NSC-68 containment doctrine), the Soviet leadership might resort to extreme measures and “bang the door” instead of coming to terms with defeat and retreating to the scrap heap of history. The hopes for minimizing that risk were pinned on the careful application of coercion (so as not to drive the adversary into a corner), as well as on the pragmatic behavior of the Soviet leadership, which had been often demonstrated during the war, as well as in the first postwar years.

Kennan and other architects of “containment” should be given their due: their scenario was based on a thorough analysis of the vulnerabilities of the Soviet system, offering the United States a long-term vision and becoming its strategic compass in the Cold War. The Soviet leadership had no such long-term guidelines, and several Soviet diplomats who were closely involved in those events share this view. Furthermore, all attempts to find any programmatic, “grand strategy” documents in the domestic archives have come up empty. However, this was not due to the lack of an appropriate culture of thinking and planning mechanisms – the Kremlin simply did not set itself such ambitious and far-reaching aims.

Stalin’s perception of the adversary was up to a certain extent quite similar to the U.S. perception of the Soviet Union: inherently hostile and expansionist, but internally weak. Stalin believed

he could emerge victorious by containing and wearing down the adversary. Plus, he placed the same hope for new shifts in the balance of force under the impact of crises and wars. Yet, despite their hatred for imperialism, the Bolsheviks apparently had no plans for “regime change” in the United States or modifying U.S. behavior. If there was a “grand design,” it existed in Washington rather than in Moscow.

GLOBAL SECURITY

A legitimate question at this point is: What were the causes of the turnaround in U.S. strategy, aimed to undermine (“reform”) the erstwhile ally? According to official theory, it was a natural reaction to the Soviet Union’s refusal to cooperate with the West, and its return to “Communist expansion.”

As a matter of fact, Soviet policy in the 1940s had not undergone any radical change and was largely defensive, although obviously tough. Based on its experience in the prewar period and World War II, the Soviet Union aimed to create a defense belt of pro-Soviet states along its western borders, secure an outlet to the oceans, and ensure the maximum degree of defense along the entire perimeter of its state borders. Stalin strove to achieve such a strategy first with Hitler, and then, when this had failed, with his Western allies beginning in December 1941 when he opened negotiations with Anthony Eden. The Kremlin believed that through its decisive contribution to victory over a common enemy, the Soviet Union had acquired the right to equal security, the recognition of its interests, and a fair share of geopolitical “trophies.” It is true that by the end of the war, the Kremlin’s geopolitical appetite had grown somewhat, while Stalin’s strong (although futile) pressure on Turkey and Iran gave cause for accusations of “expansion.” Still, by the spring of 1946, Soviet policy had changed far less than had the policy of its Western allies.

During the war, the United States and Great Britain, who needed the Soviet Union to rout Nazism, were tolerant toward its geopolitical aspirations. As during World War I, they made lavish promises on the sea straits and even the Mediterranean, pledging

to provide assistance in the postwar reconstruction effort. But with the end of the war, and a changing of guard at the White House, most of the wartime promises were retracted. The Russians, President Truman told his aides in April 1945, need us more than we need them; so on important issues, Truman believed, the United States should be able to get most of what it wanted.

The U.S. military command, worried by the prospect of complete demobilization and the dismantling of its military machine after the routing of Japan, saw the preservation of its global presence and superior military power as the only way of avoiding a repetition of its strategic failures of World War I and World War II. The Soviet Union, with its huge military resources and alien ideology, was seen as the ideal equivalent of an external threat, thereby giving the United States probably the only justification for its continued military build-up. The United States, according to experts at the Office of Strategic Services in April 1945, could not possibly wait for Russian policy to assert itself worldwide. They believed that Russia's *future* military potential and the grave threat it would pose to the U.S. if it succeeded in pooling European and Asian resources under its control, was an "overwhelming imperative" of the situation.

Brigadier General George Lincoln, chief of army operations, wrote to his commanders: "To justify huge financial, human and industrial resources for preparation of the U.S. for a war soon after we have defeated the two great powers would be realistic only if we could name a specific state — powerful and potentially hostile with which we have a tangible conflict capable of leading to a war in a near future." Barely two weeks after Japan surrendered, the Joint Chiefs of Staff began to develop a new strategic concept based on the assumption that the Soviet Union was the only major power with which the United States could have a conflict that had no chance of being resolved at the UN.

The spring of 1946 became a landmark period in reforming U.S. military-political planning. Once they had identified the nature and objectives of the "Soviet threat," Pentagon planners began working on the military component of the "containment"

doctrine. The principal strategic task was to prevent the physical expansion of the Soviet power. One way of achieving this goal was by creating a military bloc in Western Europe; U.S. security doctrine was becoming increasingly global.

In pursuit of absolute security, the U.S. planners did not even bother to think about how the Soviet side would perceive their actions or what the Soviet security concerns were in the first place. “We were perhaps less conscious of Soviet concerns stemming from experience of WWII than we should have been,” Henry Kissinger admitted later in his memorandum to Richard Nixon (during the preparations for a Soviet-U.S. summit in 1972). “We were perhaps insufficiently conscious that security requirements of a continental power differed from one, like ourselves, surrounded by oceans. Our history of no foreign invasions since 1812 made us less sensitive to problems of the nation invaded many times in the same time span.”

Amidst the vacuum of force that had transpired as a result of the war, together with the polarization of power between the Soviet Union and the United States, and their fundamentally different approaches toward building a postwar world order, U.S.-Soviet rivalry for global influence was probably inevitable. However, it could have assumed other, less dangerous and confrontational forms. A considerable share of responsibility for such a scenario lay with the United States, which was in a far more favorable situation than the Soviet Union. Higher standards should be applied to a country with unsurpassed power, a greater freedom of choice, confident of its political, intellectual, and moral responsibility, not to mention its maturity and leadership abilities, than to an erstwhile pariah and new player in international politics. It would seem that with such a margin of strength the United States could have afforded a far more moderate and generous policy toward its former ally. Even Secretary of State Dean Acheson subsequently admitted: “A school of academic criticism has concluded that we overreacted to Stalin, which in turn caused him to overreact to policies of the United States. This may be true.” Instead of at least a partial political settle-

ment of differences, the West demanded an “unconditional surrender that the Soviet Union was too strong to accept,” as Kennan admitted years later.

WAS THERE AN ALTERNATIVE?

Why did the United States, at the beginning of the Cold War, refuse to open a serious dialog with the Soviet Union and fail to “even give this notion a close consideration?” This is a question that a representative of the new generation of American Cold War historians, Fredrik Logevall, asked in *Diplomatic History* (September 2004). His main explanation is the moralism inherent in “American exceptionalism” and its messianic superiority complex: “America, that principle taught, represented the ultimate form of civilization, the beacon of hope for humankind. Its policies were uniquely altruistic, its institutions worthy of special emulation. Any hostility to the United States was, by definition, hostility to progress and righteousness, and therefore was, again by definition, illegitimate.”

The ensuing tendency to demonize the enemy was encouraged by the bulky constitutional system of “checks and counterbalances” and the popularity of mass anti-Communism, which inspired in politicians a heightened sense of alarm about the “Soviet threat.” Another important factor, Logevall went on, was that the U.S. political elite lacked the historical experience of equitable political alliances with other nations. From its original state of isolation, the United States jumped to world leadership: “Both before and after attaining great power status, therefore, Americans lacked the necessity to negotiate and compromise continually in order to survive and prosper.”

This is especially important for understanding the U.S. idiosyncrasy toward the Soviet Union’s rise as a world power that also represented an alternative model of development. That combination, according to Russian historian Victor Malkov, confronted the United States with a serious dilemma — “preserve a close partnership with the Soviet Union (thereby recognizing it as a superpower) or, by relying on its economic and military (nuclear) supe-

riority, gradually win back the geopolitical space that had ended up under Soviet control, check its aspiration to become an alternative center of force, and ultimately ensure the liberalization of the Soviet regime and the acceptance of Western values.”

Today, when the United States is going through a new period of “imperial temptation” – this time as the “only superpower” – it is faced with the same dilemma: find a *modus vivendi* with other emerging power houses, sharing with them its rights and responsibilities, or strive to preserve its global hegemony at any cost.

During the New Deal era, and later in the war against Nazism, the United States accumulated a material and intellectual capability to make a second breakthrough toward global leadership in the 20th century. Another impediment to the search for compromise with Moscow was the obsession of the U.S. political elite with anti-Communism, which, according to Henry Morgenthau, a patriarch of the American school of “realism,” was stronger than the Soviet Union’s sense of anti-capitalism. In those conditions, the few advocates of the idea of resolving disagreements with the Soviet Union through compromise had no chances of forcing Washington to revise its policy.

Another question, which requires an in-depth analysis of archival documents that are still not available, is: Was the Soviet leadership ready for dialog with the United States in those years? The nuclear factor remained a serious impediment to such a possibility: the Kremlin was unwilling to negotiate with the United States until an equitable balance of forces was achieved, while the United States strove to use its advantage for exerting pressure on the adversary.

That sharply aggravated the original contradiction inherent in the doctrine of “containment” – i.e., the risk of a self-fulfilling prophecy, which was noted by another American Cold War historian, John Gaddis: “What if constant frustration of Soviet designs were to increase rather than diminish Soviet antagonism toward the West? How could one expect serious negotiations from the position of the U.S. strength if for the Russians that would mean a position of weakness?” Indeed, was the United States not mak-

ing an even bigger enemy for itself, an especially dangerous scenario since it could eventually catch up with the United States militarily and attempt to settle scores with it?

Following the logic of a “self-fulfilling prophecy,” it would be legitimate to pose the following question which has never been raised by U.S. policy planners: Did that policy, by actually strengthening the system (at least in the middle term), not impede the ultimate objective of “containment” — the “softening up” or “breaking down” of the Soviet system? The conditions of a “hostile environment” and constant threat to the country’s security not only provided a reason for “tightening the screws” and justified economic ineffectiveness, but also brought the Soviet power closer to the people. The challenge from the outside further strengthened the huge mobilization capacity of the Soviet system, straining the nation’s resources and providing a rationale for the sacrifices.

The confrontation between the two systems dragged on, becoming an end in itself. “The real détente between East and West would become possible only after a complete transformation of the Soviet system,” chief executives of the U.S. Department of State believed. “The Cold War would be over. All of our concepts of psychological objectives related to the Cold War would become obsolete and mischievous. But it seems to lie far beyond the range of speculation permitted by reality.” The Cold War was becoming a protracted positional warfare. As Kennan summed up melancholically before resigning from the post of the head of the State Department’s policy planning staff, “We both hang on doggedly to the grips we have with our teeth on our respective spheres, that is, the Russians and ourselves, and see whose internal contradictions catch up first with whom.” History provided an answer to this question, but not until after the Cold War was over.

A Silent Cold War

Dmitry Furman

News stories coming out of the Commonwealth of Independent States these days sound like reports from the frontline: Georgia, Ukraine, Moldova and Kyrgyzstan are lost; Adzharia has fallen; Transdnistria is under siege. Enemies have engaged in subversive activities in Uzbekistan and Kazakhstan and are approaching the gates of Belarus. Minsk is standing firm, but if it (God forbids) falls, the road to Moscow will be wide open. What kind of war is going on in the expanses of the CIS? Who are the combatants and what are they fighting for?

This war is a less menacing continuation of the Cold War that was waged by the West and the Soviet Union for almost half a century, and now entails a smaller space and a different alignment of forces. Obviously, the struggle between Russia and the West for Ukraine and Belarus is a direct extension of the struggle between the Soviet Union and the West for Poland, Hungary and Czechoslovakia. The support given by Europe and the United States to the presidents of Ukraine and Georgia, Victor Yushchenko and Mikhail Saakashvili, is the continuation of their support for Alexander Dubcek, a reformist Communist leader of Czechoslovakia, and Lech Walesa, a Polish labor and political leader. Russia's support for Belarusian President Alexander Lukashenko may be explained as the continuation of the Soviet

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Union's support for Communist regimes in Eastern Europe, now described as Central Europe. Why didn't that struggle end together with the collapse of the Communist system and with the declaration of Russia a democratic and market-economy state, which is supposed to espouse the same values as the West?

PERPETUAL ANTAGONISTS

A person's behavior toward other people is determined by what kind of man he or she is. Similarly, the foreign policy of a state is determined by what kind of state it is. The nature of a particular society is manifested in its foreign policy.

The Soviet Union was "the world's first state of victorious Communism," and its foreign policy was determined by this title. Of course, all states seek to create a safe environment around themselves. For the Soviet Union, the creation of such an environment predetermined the victory of Communism in other countries as well. In pursuit of this goal, therefore, Soviet policy can be described as highly cynical ("the end justifies the means") as well as idealistic — billions of dollars were thrown down the drain in a bid to help countries like Angola "embark on the path of non-capitalist development." When it came to the security and survival of the Communist state, the "idealistic" and "egoistic" components of that policy were inseparable.

The policy of the U.S. and other Western countries was also dictated by their own nature. They also sought to create a secure environment for themselves in the world, which would guarantee their survival. For the Western countries — most importantly the U.S., a country whose sense of self-identity is inextricably linked with the system of values proclaimed in the Declaration of Independence and the Constitution — the struggle for national interests is inseparable from the struggle for the "ideals of democracy."

Both sides made compromises with reality, thus supporting nations that were ideologically alien to them yet still "enemies of their enemies." At the same time, the fear of nuclear war forced both sides to be cautious and speak of peaceful coexistence. In its last years, the Soviet Union had lost many of its ideals, was in a state of

decay and did not quite understand what it was fighting for. It had completely forgotten about the “victory of Communism all over the world,” and attempted to protect itself against old age and death, whose coming it felt somewhere in the depth of its consciousness, with missiles. Nevertheless, the Soviet formula about the “uncompromising struggle between the opposite social systems” correctly reflected the reality. The conflict between the Soviet and Western systems was really antagonistic, and peaceful coexistence could only be a “continuation of the class struggle by other means.” The struggle was irreconcilable and would end only if one of the conflicting parties disappeared — exactly as what happened in reality. Today, Russia’s foreign policy is necessarily determined by the nature of post-Soviet Russian society.

Now it is important to ask: What is the nature of post-Soviet society?

DETERMINE MEANS DESTROY

Russian society has nominally broken with its Soviet past and adopted democratic values. There is no serious and real ideological alternative to democracy, and it is doubtful there ever will be. However, this society is unable to live in accordance with democratic values. It is recreating a system of “uncontested power” that is increasingly similar to the Soviet one but void of any ideological foundation. The post-Soviet Russian system is based on a profound contradiction between the formal and informal social arrangement — a contradiction which society has to hide from the world and itself (seemingly democratic and contested elections, the outcomes of which are generally known in advance; seemingly independent courts that pass judgments that serve the interests of the authorities, etc.).

As is the case with the U.S., the Soviet Union or any other country, post-Soviet Russia seeks to create a safe environment around itself, but the highly contradictory nature of Russia’s social arrangement predetermines contradictory requirements to maintain security. If we describe the social system in this country as “managed democracy,” then the dual components of this description dictate a different policy.



Images of the Cold War: Soviet and U.S. cartoons, the early 1950s

This camouflaged democratic system requires partnership with the West; however, its authoritarian and “managed” content makes this difficult. A safe environment for our system is an environment of political systems of managed democracies of the same type, which we actively support in the CIS and elsewhere, such as in Serbia, the Middle East, and even Venezuela.

The past policy of the Soviet Union might be described as quixotic – after all, why spend so much money in the name of “proletarian internationalism?” However, if an empire does not expand, it will dissolve. The same can be said of Russia’s policy toward the Lukashenko regime of Belarus: managed democracy in Russia will cease to exist if Russia is surrounded on all sides by unmanaged democracies. After all, it is again a matter of survival.

The West has to support the establishment of systems similar to its own, thereby expanding the zone of its security. Russia, of course, opposes these moves; therefore, the internal struggle in the CIS countries is turning into a Russia-West confrontation. Any opposition immediately looks to the West. At the same time, presidents do not want to jeopardize their relations with the West, because the West gives their regimes some aspect of legitimacy.

But when there arises a threat of these leaders losing power, presidents like Islam Karimov of Uzbekistan, or Leonid Kuchma of Ukraine, never forget that they have an influential friend that will never betray them in a difficult time — Russia.

The Russia-West struggle in the CIS is a struggle between two irreconcilable systems, as was the struggle between the worlds of Capitalism and Communism. Unlike Communism, however, managed democracy has no ideological foundation. This system is based on a contradiction between the reality and the proclaimed principles. Thus, Russia must conduct this struggle covertly, without declaring its objectives or even admitting them to itself. The Soviet Union had a rich language of rhetoric to describe its policy, such as the “victory of Communism all over the world,” “international solidarity,” “peaceful coexistence of the two systems,” “peaceful competition between the two systems,” etc. Russia, by comparison, does not have, nor can have, such a language. Slogans like “Long live the victory of managed democracy all over the world!” are simply impossible. We cannot admit even to ourselves, or others, that our real goal is to prevent fair and unrigged elections, for example, in the CIS countries. But if there is no language, there cannot be well-articulated thoughts and strategies either.

Some of the reasons for our foreign-policy setbacks, and weakness in general, stem from the contradictory nature of our policy and the impossibility of adequately formulating it in principle (this requires defining our socio-political system, yet this is impossible since the nature of the system remains camouflaged). There is the need, stemming from the nature of our system, to pursue two contradictory goals at once: admittance into Western society, and opposition to the West whenever possible. Yet there are still deeper reasons for our failures.

THE FATAL PERSISTENCE OF LOSERS

President Vladimir Putin once stated that the Soviet Union collapsed because it “proved unviable.” He is absolutely right. Western democratic and market-economy systems, characterized

by a constant struggle between political forces, can adapt to various kinds of challenges presented by a fast-changing world; they stand up to the challenges of this world.

The Communist system was viable at a certain stage of its development and for certain countries, for example, those with a relatively low level of development and cultural type, which prevents the establishment of democracy and the market economy. But this system, based on dogma, was organized in a way that soon made it rigid, closed and unable to adapt to a changing reality. The rapid expansion of Communism stopped at the boundary of the more developed world; its stagnation and decay was not far behind. This process was somewhat delayed by the rigid socio-political system, yet the system grew increasingly squeezed for the irreversible development of Communist societies.

Managed democracies are actually a soft variant of the Soviet system. They are not constrained by dogma, but they also lack free struggle between political forces. Furthermore, their political systems do not have a rotation of power, which would enable their respective societies to better adapt to new challenges. The lack of an ideological basis, and the inherent contradiction between form and content, make these regimes even more fragile and unstable than Communist systems.

Managed democracies are natural regimes in societies that have outgrown Communist systems, yet are unprepared to live in democratic conditions. These are transitional entities based on compromise on the way to real democracies. The development of society corrodes such a system in the same way — only faster — than it corroded the Communist societies. This is the main cause of Russia's present foreign-policy setbacks.

In the 1990s, immediately after the breakup of the Soviet Union, Russia experienced a series of achievements: in Azerbaijan and Georgia, the romantic nationalist and pro-Western regimes fell and these countries eventually became part of the CIS. In Ukraine, the pragmatist Leonid Kuchma replaced the architect of Ukrainian independence, Leonid Kravchuk, while in Belarus, Lukashenko took over the helm of government.

It seemed that Russia was once again beginning to “gather lands together,” creating in its periphery a convenient environment, something of a kind of small-scale variant of the Communist bloc. Those achievements, however, did not result from a smart or far-sighted Russian policy, but rather from natural failures to switch to democracy made by countries that were not ready for it. Those were countries gravitating toward Russia and having regimes established by uncontested presidents. During that period, time was on Russia’s side.

But the next decade was a period of setbacks. And again, those setbacks did not stem from mistakes but from natural processes, from the degradation of managed democracies. These regimes were plunging into corruption, losing contact with society, resorting to overt reprisals and assassinations of opponents, and generally losing the legitimacy to govern. The regimes continued to degrade while the normal societies were developing. Today, Ukraine, Belarus and Kazakhstan are much more ready for democracy than they were in the early 1990s. The wave of ‘colored revolutions’ has stopped, having covered the more developed societies and cleared the weaker regimes of managed democracy. The fall of the remaining regimes of this type, however, is only a matter of time.

It seems that Russia is doomed to failure because it seeks to check inevitable and irreversible processes; this behavior seems to stem from its nature.

The Cold War, which continues in disguised form, will stop only when Russia moves from managed democracy to democracy proper. If the structure of our society changes, then the entire system of our national interests will change as well. Russia’s lingering problems will disappear by themselves, just as the victory of democracy in Europe removed many seemingly eternal problems. Of course, new problems will arise but we will be better prepared to handle them. But before Russia can proclaim any sort of a victory, new battles and new defeats are in store for us.

Russia and Beyond



“No to Star Wars!”
Soviet poster, 1985

“ We are being pressured, both at home and abroad, to return to the prehistoric era of the Cold War or “peaceful coexistence.” We must not yield to this pressure either politically or intellectually. We have gone through the tragedy of confrontation. We should not get ourselves involved in a farce as well. ”

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Dangerous Relapses

Sergei Karaganov

Recently, two remarkable foreign policy papers were released in the United States. One is the president's report, *The National Security Strategy of the United States of America*, which is the first such document to be issued since 2003. The Council on Foreign Relations, America's most prominent foreign policy organization, prepared the other, entitled, *Russia's Wrong Direction: What the United States Can and Should Do*. The two documents of course differ in scope, but are crucial for understanding where U.S. foreign policy thought is directed, where the White House is heading, and in what direction the different groups of the policy-making elite are attempting to push U.S. policy toward Russia.

DEMOCRATIC MESSIANISM AND MONOPOLY ON WAR

The first thing that strikes the eye from reading the documents, especially in the presidential report, is democratic Messianism as a keynote of U.S. foreign policy. The words "democracy" and "freedom" occur several times literally on every page. The spread of these ideals is declared not only as the principal goal of U.S. foreign policy, but also a cure-all for the world's misfortunes: poverty, tyranny, diseases, and terrorism, as well as the main

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instrument of ensuring U.S. security. Elements of political realism, the understanding that America cannot always be guided by high-minded ideals in its policy, do exist but somewhere in the background.

One could cynically dismiss the calls for the spread of freedom, democracy and human rights as traditional election campaigning by the Democrats (after all, it has traditionally been the Republicans who have been more pragmatic, appealing to the realism of force rather than the idealism of freedom and democracy in the world). The description of the triumphant march of democracy in the world, showcasing the democratic “success stories” of Afghanistan, Georgia and Saudi Arabia, where Islamic radicals won the country’s first ever election on the municipal level, or Kyrgyzstan, where the situation is increasingly destabilizing and on the verge of chaos, is bound to raise some eyebrows. Finally, for all the empathy that the world feels for America’s suffering in Iraq and the tragedy of the Iraqi people, it is a bit of a stretch to call civil war-ravaged Iraq a victorious democracy.

It is also somewhat surprising that the list of the most tyrannical regimes, including North Korea, Iran, Syria, Cuba, Zimbabwe, and Belarus, does not include certain notorious regimes, including those in the FSU area, some of which produce oil and natural gas.

Yet, even if we disagree with the U.S. president (due to Russian political experience or cynicism born from seven decades of abortive Communist Messianism, a decade of quasi-democratic revolution chaos and the last few years of “managed democracy” that have been void of ideas or ideals), we cannot but feel respect for the leader of a nation who is attempting to restore Western humanistic ideals in a world that is rapidly losing faith in them. I actually believe that the deeply religious George W. Bush thinks of himself as a democratic messiah and is obsessed with the ideas and slogans that he is proclaiming, while the ruling elite (some of it believing in these ideals, some half believing, and some not believing at all) must adjust to them. In pursuing a specific policy line, George W. Bush and his inner circle deviate from the

proclaimed lofty objectives or use them for very practical purposes — i.e., advancing U.S. interests. Nevertheless, the United States does have ideals, occasionally acting to its own detriment in the name of these ideals, while criticizing its representatives and denying them support. Yet, it still manages to get involved in a war whose catastrophic consequences and implications for American interests were predicted by nine-tenths of experts. Where are those critics now who kept saying at that time that the Americans started the war in Iraq over oil? What have the Americans gained from this operation except the loss of power, prestige and money? Thus far, it has been other oil-producing countries that have gained from it, above all Russia.

American democratic idealism should not be underestimated, nor should we judge American leadership by those who have lost faith. Such a temptation is fraught with costly mistakes.

Another important subject of the president's message is the declaration of war — I believe, for the first time ever — on Islamic radicalism. All the right words about respect for the great and proud Islamic civilization were spoken. But it was also said that the fight against most militant and belligerent form of Islamic radicalism is the greatest ideological conflict at the beginning of the 21st century; that all great powers have joined forces on counterterrorism; and that this situation drastically differs from the 20th century, when the great powers were divided by ideology and national interests.

Bush stated what many were thinking about but did not dare say aloud. Now it will be more difficult for Russia to ignore this reality, especially since we were the first to take up arms and, having paid a terrible price, won the battle — not yet the war — in Chechnya against this most militant and belligerent form of Islamic radicalism and terrorism.

Yet, by their ill-judged intervention in Iraq the Americans have made this struggle far more difficult for everyone.

Russia's unique history and geography, as well as many of its partners, are responsible for pushing it onto the battlefield of this new confrontation. Now we are faced with the extremely difficult task of avoiding this fate to the maximum degree possible.

Predictably, Iran – said to be the evil of all evils, overflowing with tyranny, Muslim radicalism, terrorism, and the proliferation of WMD – was declared America’s number one enemy. It looks like the United States has abandoned its attempts (at least for the next two years) to convince Tehran to mend its ways, and will now rely on mostly coercion to achieve its goals. This will not frighten Iranian radicals, but it will certainly drive Iranian reformers into a corner. It would be wiser to fight Tehran’s attempts to acquire nuclear weapons rather than fight the Iranian leadership.

One provision of the National Security Strategy that has caused the most controversy is the option of preemptive actions to counter a sufficient threat to U.S. national security. This option can be used on any scale against regimes or terrorists who have acquired or seized weapons of mass destruction and are threatening, or have the capability, to use them. I was struck by the unanimously negative reaction to this provision in the Western media. I was even more stunned by the criticism that the doctrine received from Russia. After all, preemptive action to counter an attack is an axiom of military theory and practice. Those who did not follow this theory in the past and built *Maginot lines* invariably suffered severe punishment. In our increasingly dangerous age, the need for preemptive strikes becomes more and more evident.

Does Russian military doctrine not provide for such actions as well? Indeed, if it does not, our strategists must be fired on the spot. But as far as I know, such options have never been precluded, and all our potential adversaries understand this. I am sure that the General Staff knows what it is doing.

It is another matter altogether, however, to argue that the United States is attempting to monopolize the right to preemptive actions, saying that (other) nations should not “use preemption as a pretext for aggression.” Please, let’s be serious. If there is a direct threat to a country’s vital interests and national security, no one will ask Washington what to do.

The presidential report put forward a positive program to control WMD proliferation, and Russia would be ready to subscribe

to it almost without reservations. Indeed, Russia is naturally interested in playing a key role in the implementation of this program, and without Russian participation no such program can be effectively implemented.

A RETURN TO “PEACEFUL COEXISTENCE?”
The presidential report offers a vision of Russia that the White House would like to convey to America, the world, and Russia herself. The report reiterates that there should be no rivalry between the great powers, stressing the importance of Russia for the United States and the world. It expresses a readiness to work closely together in areas where our interests coincide, and take problems in stride where they don’t. These are words from the old “positive” lexicon. But there are also some new notes. For example, it is stated that some recent trends (in Russia) point to a diminishing commitment to democratic freedoms and institutions. Russia is urged to move forward, not backward. The report also contains a veiled warning that relations could worsen should Moscow hinder democratic development not only at home but also in neighboring countries. The presidential report does not proclaim a turnaround in Russian-U.S. relations, yet it definitely implies such a possibility.

By contrast, the report issued by the Council on Foreign Relations puts a much greater thrust on the possibility and even the desirability of a turnaround in Russian-U.S. relations.

I will not provide an overall review of the report out of respect for the Council that I have been cooperating with for 30 years, and out of respect for the experts and politicians who took part in preparing it, for I have been linked with many of them by professional and friendly relations for decades. Briefly, I would hate to think that many of the report’s astounding evaluations were caused by ideological bias. They obviously resulted from simple misunderstanding. I will only say that this particular report highlights the need for a deep and frank dialog between the elites of our countries. Presently, this dialog is practically non-existent, and certainly more lacking than during the Cold War era. Allow me to consider some of the basic points of the report.

The Russian economy is developing very successfully. While this is certainly good news, many people in Russia would not share this degree of optimism. At the same time it is stated that in its domestic policy, Russia is backtracking on the democratic gains of the past. Corruption is growing. Over-centralization of power at the expense of building modern state and public institutions is approaching a critical point indicating the decline in the efficiency of state governance.

These assertions have a substantial element of truth. Actually, if I were to write a report about the development of Russia's domestic policy, I would have thrown in a few more serious critical remarks.

The problem with the report in question, however, is that it presents practically all aspects of Russia's domestic policy in a black light – it's all gloom and doom. Thus, it creates the impression that the 1990s witnessed the thriving of democracy, while the middle of this decade is only characterized by its demise.

The authors refuse to face up to the fact that Russia, which no one has ever really helped to reform, is passing through a natural period of conservative consolidation after the chaos of the 1990s. And it is rather strange to hear criticism from people who publicly approved of the use of tanks and guns against the Russian parliament in 1993, supported the methods by which Boris Yeltsin was elected in 1996, granted loans to his bankrupt government in 1998, and stood by the Kremlin in 1999 when it had virtually lost touch with reality and become ineffective, while the state was visibly disintegrating. I was with or on the side of those who had used tanks and provided that support, but I felt ashamed not only for myself and for my country but also for leaders of the democratic world, including the U.S. president, who had openly backed the execution and methods of governance that were being practiced at that time.

While I may be somewhat dismayed about the backsliding on some democratic principles and in disagreement with many aspects of Russia's domestic policy, I will make a heretical point for a person of democratic and liberal persuasions: When all is said and done, Russia has never been a more thriving or freer country

than it is now. We were only slightly freer in the turbulent 1990s, while just a handful of people enjoyed a normal life, let alone prospered at that time.

The report makes gloomy forecasts, stating that Russia's future is unpredictable. But when was it more predictable than right now? A stagnation/authoritarianism scenario is possible, but it is equally possible that within the next several years, the country could turn to more modern and effective development. On the other hand, we are practically past the Weimar period of our history, while any retreat to a totalitarian or ultranationalist regime is extremely unlikely.

The description of Russia's foreign policy produces an even stranger impression. The authors of the CFR report say that this policy, except perhaps for Russia's cooperation on Iran and WMD nonproliferation as a whole, is becoming almost completely anti-American.

Of course, Russia feels more confident, perhaps even overconfident, and now wishes to protect its own interests, while giving up the servile "what can we do for you" policy of the first half of the 1990s that some Americans must be feeling nostalgic for now.

However, is it realistic to call Russia's present policy anti-American? Here are some of the manifestations of "hostility" mentioned in the report. It turns out that we are pushing China into a confrontation with the United States by selling arms to it or conducting joint military exercises. We support antidemocratic regimes in Central Asia and ousting the United States out of the region. As far as the last-mentioned point is concerned, I believe that the Americans were pleased to leave Uzbekistan, shifting responsibility onto Russia. But then the Russian president supported the deployment of the U.S. and NATO base in Kyrgyzstan. What are we expected to do — overthrow bad or very bad local regimes and pave the way to chaos, radical Islamism and drug barons?

We stand admonished for conducting dialog with Hamas. Personally, I do not believe that a country that has suffered so much from Chechen terrorism should have hastened to open negotiations with a terrorist organization even if it legitimately came to

power. But in his message, the U.S. president told Hamas essentially what the Russian authorities did: recognize Israel's right to exist, conduct a responsible policy, and we will work with you.

Cooperation in the energy sphere, although not very effective but still highly positive, is described as anti-American. Even the delay in the construction of an oil pipeline to Murmansk is seen as an anti-American move.

It is proposed that this narrow level of cooperation be narrowed further, not expanded.

And this is the strangest thing of all. A narrowing and downgrading of cooperation is being proposed at a time when the United States has become considerably weakened because of Iraq, while the new agenda – the Greater Middle East, energy, WMD proliferation, the integration of new giants into the world system and other global challenges – requires closer cooperation than ever before. The United States is obviously not in a position to deal with these problems single-handedly, while its traditional allies cannot or do not want to play a global role.

By far the greatest sin of Russia's foreign policy, however, was the "politically motivated" energy blackmail against Ukraine. I do believe there was a political ingredient in the gas price hike, but there was definitely more bad politics and corruption in the decade-long practice of selling natural gas to Ukraine at below-market prices. For the past few years, we had been subsidizing the Ukrainian ruling class to the tune of more than \$4.5 billion a year – probably 30 times as much as what the United States had provided to Kiev. So, is the transition to market prices, the abandonment of paternalism, and the treatment of Ukraine as a completely sovereign state also anti-American policy?

What is especially striking is that the authors of the report fail to see a number of important spheres where Russia and the United States are closely cooperating. We have consistently supported the U.S. peace operation in Afghanistan, and closely cooperate on the North Korean nuclear problem. During the crisis involving Iraq, unlike many U.S. allies, Russia did nothing to undermine Washington's positions. Moscow warned in advance that it saw

military action as bad judgment, and it proved right. Now, there are very few people who would describe Russia's present policy on Iraq as unconstructive.

The report is not entirely negative. It calls for constructive cooperation in nonproliferation and a number of other spheres, but on the whole both its tonality and recommendations are negative.

However, whereas the report is rich on criticism, it is rather short on advice. It recommends cooperation only in areas that are beneficial for the United States. It also proposes predicating U.S. policy toward Russia on the level of its democratic development. (On this point, however, most Republican authors expressed disagreement, arguing that only anti-American moves should be countered.)

In this context, the report offers a curious list of instruments to pressure Russia.

First, downgrading the level of cooperation within the Russia-NATO Council. Now, we thought that our cooperation with NATO helped the organization by providing it desperately needed legitimization.

Second, restoration of the G7 within the G8 – preliminary consultations without Russia, which somewhat downgrades her status. Well, psychologically, this is not a very nice prospect, but Russia today is little reminiscent of the Soviet Union in the late-Gorbachev era or of Boris Yeltsin's Russia. Moscow is more confident and no longer places much significance on outward signs of respect or disrespect. Furthermore, the G8 remains somewhat weak and not as yet in a position to fill the emerging vacuum in international relations. The group's enlargement to include India, China and possibly Brazil is high on the agenda, so the threat of reviving the G7 within the G8 does not look very credible. Meanwhile, the G7 within the G10, which is bound to come about sooner or later, would look very strange indeed.

So what conclusions should we make from the analysis of these two reports?

First, we have reached a limit in conservative evolution. If we cross this line, we will give the “knights and pages” of the Cold

War in the West an excuse for worsening relations with Russia. These people feel lost; they simply cannot live without an enemy nor are they able to acknowledge past mistakes. However, they will only be playing into the hands of our own “knights and pages” who, driven by their parochial mentality and old stereotypes, would like to fight against America, not fight for Russia, thereby pushing the country into ruinous isolationism.

We cannot allow the creation of an “unholy alliance” of the most backward elements within our policy-making class. They and their predecessors have already caused us colossal damage by playing into each other’s hands during the real Cold War.

Second, Russia should not be too cynical toward the democratic rhetoric of the United States or Europe, as we sometimes are toward such rhetoric in our own country. Many people, including political leaders, believe in what they say, and if we want to be together with the developed and relatively free world, we should start playing according to the common rules of the game not only in word but in deed.

Third, we should not be afraid of criticism. We should not become complacent. Criticism should be heeded; the views of “knights and pages” should be taken into account. But we are now acquiring a sense of our motherland and statehood, and we should go our own way, modernizing, strengthening and democratizing the country for our own benefit and therefore for the benefit of the entire civilized world.

Finally, we are being pressured, both at home and abroad, to return to the prehistoric era of the Cold War or “peaceful coexistence.” We must not yield to this pressure either politically or intellectually. We have gone through the tragedy of confrontation. We should not get ourselves involved in a farce as well.

SCHOOLBOY TRICKS OR PROVOCATIONS?

Unfortunately, however, there are certain people in the West who seem to be itching for a fight with Russia judging by the spate of provocative ramblings lately. *Foreign Affairs*, the world’s most respected and popular American journal on foreign and defense

policy, in its latest issue (March/April 2006) published an article by two young authors – an Assistant Professor and an Associate Professor from good, yet minor, U.S. universities. Having read the article, I smiled and recalled my younger years when, during the Cold War, I spent – or rather wasted – more than a decade studying nuclear theology and writing numerous articles, memorandums and booklets on this issue.

Two things in this article by the American authors struck me most: first, their utter lack of professionalism, not to mention the lack of knowledge of the subject and even its appropriate terminology. This is especially strange as the U.S. has for 60 years, since the end of World War II, been the leader and trendsetter in the theory of nuclear deterrence and has produced many outstanding specialists in this branch of science or theology.

The second thing that struck me was the article's main message: the United States may soon gain a first-strike disarming capability against Russia and China, that is, the capability to deliver a nuclear first strike without suffering any consequences. Such a capability would let the U.S. break out of the restraining and civilizing bounds of the mutual assured destruction (MAD) theory, which thus far has kept countries from using nuclear weapons, while forcing them to exercise military and political caution in all other spheres.

Surprisingly, this article – which, as a university professor, I would certainly reject as a Bachelor's graduation paper or even a third-year student's term paper – has been widely discussed in the Russian press. Serious newspapers and venerable authors published lengthy articles in a bid to disprove the claims.

The main point of the article is that the United States' current modernization programs, which involve “incremental improvements to existing [weapon] systems” rather than their buildup, will enable the U.S. to totally destroy Russia's steadily shrinking and decaying nuclear arsenal by a first strike. The authors place emphasis on the quantitative and qualitative decline of Russia's strategic nuclear arsenal. In doing so, they ignore Russia's recent efforts to modernize its nuclear forces, and argue that the U.S.

missile defense system, although relatively ineffective, would vindicate itself in a situation where the United States gains a first-strike capability.

As regards the essence of this subject, it has long been proven that those who will be the first to deliver massive nuclear strikes, will be the second to die — even if because of the ecological consequence of those strikes.

It is even more obvious that no U.S. leader would ever dare deliver a first strike because the theoretical possibility will always exist that several retaliatory missiles might breach missile defenses. One must bear in mind that any retaliatory strike would be launched on warning, and Russia's early-warning system, which is not very reliable today, would only increase the probability of such a strike should a nuclear confrontation ever become a reality. Therefore, from the point of view of established strategic theory, fabrications of this kind are either pure provocation, or sheer nonsense that is occasionally recanted even in the U.S.

As regards the U.S. antimissile defense, as far as I understand from comments by Russian and American experts and from defense publications, even its most zealous supporters admit that this system cannot and will not work even against just several single missiles (that is, of course, if the latter are equipped with systems enabling them to breach missile defenses). Furthermore, after having spent massive funds on its missile defense and related technologies, which must have provided a boost to U.S. technological development, the United States is actually freezing the system's construction. Thus, it remains doubtful that we will ever witness anything close to the realization of the fairy-tales that we were treated to, first by Ronald Reagan and then by other Republicans, before the incumbent Administration came to power and during its first days in office.

Finally, any expert, even with a slightest bit of knowledge, knows that a retaliatory strike — or any strike for that matter against a “potential enemy” — can be delivered without necessarily having to launch the missiles from one's own territory. This is why the United States, Russia and other countries are so con-

cerned about the threat of so-called nuclear terrorism. If nuclear warheads start spreading throughout the world, irreparable damage can be inflicted on any country without a formal declaration of war. This is just one of a dozen ways to prevent a strike against one's territory.

As I mentioned earlier, this article made me recall my younger years. In those days, I wrote policy papers, books and theses and was one of the few people – and, quite possibly, the only Russian – to have access to particular documents of the U.S. National Archives. From this source, I read, for weeks on end, declassified Cold War documents of the National Security Council on strategic planning. I still keep quotes from these sources, so it gave me much pleasure to shake off the dust from these old files and draw my “good old weapon.” These documents all make one absolutely unequivocal conclusion: nuclear war became unacceptable to the United States as far back as the early 1950s, actually since the year 1950 when American strategists concluded that Russian bombers were capable of delivering at least one nuclear bomb to U.S. territory. The rhetoric of threats continued, but the real strategy was soon reoriented toward the prevention of war.

Many renowned official U.S. strategists wrote about this situation, among them Paul Nitze, one of the authors of the nuclear deterrence strategy. In 1954, during discussions on the National Security Direction NSC 5410, President Dwight Eisenhower expressed skepticism as to whether any nation would survive – in any recognizable way – after a nuclear war. He said that every single nation, including the United States, which entered into such a war as a free nation, would emerge from it as a dictatorship. This would be the price of survival. This statement by the U.S. president deserves special attention. Eisenhower meant that the explosion of even one (low-yield by modern standards) nuclear bomb on U.S. territory would shatter the American way of life, as well as its social system, that its leaders loved so much and fought so hard to preserve. National Security Direction NSC 5440 of December 13, 1954, said that U.S. military action against the Soviet Union to reduce the lat-

ter's might should not be a priority either for the U.S. or its allies. Being familiar with this and many other documents, I can say with almost absolute confidence that the United States' political leadership, fearing a retaliatory strike against the U.S., has never planned to use nuclear weapons – even in the event that the Soviet Union attacked its allies in Europe. (One must not be misled by the rhetoric and military plans that the U.S. presented to its allies, who were also increasingly prone to discount America's promises.)

Presidents John Kennedy, Richard Nixon, and I believe all other subsequent presidents, supported Eisenhower's position. The plan known as 'extended containment strategy,' i.e. U.S. readiness to use nuclear weapons in response to a hypothetical threat of Soviet attack against Western Europe, was a bluff. Nevertheless, like the Soviet bluff, it worked. Fearing a U.S. first strike in Europe, Moscow was building armies that were capable of immediately moving warfare to NATO territory. As a result, Russia had more battle tanks than the rest of the world combined. Today, looking back at those policies, it is clear that both sides believed in that phantasmagoric idiocy and spent hundreds of billions of dollars on bluff.

It surprised me that a reputable American magazine published an article on a problem that had long been overcome and shelved by the political leaderships of the two countries, and blatant attempts are once again being made to set our two countries against each other and make them "potential enemies." Indeed, as long as there exist nuclear weapons, there will be deterrence, but this fact has been pushed into the periphery of Russian-U.S. relations.

It is possible, perhaps, that the authors, professors of two American universities, do not know that the U.S. and the Soviet Union, and later the U.S. and Russia, made public declarations not to aim their nuclear weapons against each other. Furthermore, both countries have made unprecedented efforts in cooperation in the nuclear field and have become partners. Yet it is difficult to imagine that the authors can be that ignorant.

What caused the publication of such an article then? Is it explainable by the ordinary enthusiasm of provincial teachers or, perhaps, lack of material for publication? The latter explanation is doubtful. There must be many respectable analysts and policymakers eager to contribute their articles to *Foreign Affairs*.

Another possibility is that someone is hoping to provoke Russia into a harsh political reaction and to aggravate the already fragile relations between the two countries. Several groups inside the American political establishment must fuel the tensions. By way of example, I can refer to the abovementioned report by the Council on Foreign Relations, which is definitely an attempt to revive tensions. There is yet another possibility that such commentary is meant to provoke anti-American, anti-Western and isolationist sentiments throughout Russia, thereby strengthening the positions of groups that already entertain such attitudes in this country. If this is the case, then this move aims to weaken Russia, tie its hands and stop its foreign-policy progress, which is becoming ever more influential on the international stage.

There is another possible explanation. One of the main objectives of the arms race was to bleed the enemy economically. The United States succeeded in these efforts to a much greater extent than the Soviet Union, although it must be said that the latter occasionally launched fake projects, thereby causing the Americans to spend great sums of resources in response to the perceived threat and much more than the systems really cost. One of the main motives for the Star Wars initiative, as well as the idea of a U.S. national missile defense, was the hope that Russia would take the bait and launch a counter-system of its own. Thus, the Star Wars theory was meant to undermine an already ailing Soviet economy. Eventually, that did happen, although on a much smaller scale than the Americans had expected.

Still another possibility is that a certain group of individuals in the U.S. is provoking Russia into spending its petrodollars and funds from the Stabilization Fund — not on the development of cutting-edge technologies, education, the creation of a

multi-vector energy system, and finally, the country's modernization — but on a senseless arms race.

Finally, the article may be intended to instill a sense of fear in China and prevent the natural Russian-Chinese rapprochement by implying that Russia is a weak ally. Meanwhile, at the present time neither Beijing nor Moscow is planning to establish any sort of mutual military-political alliance.

I do not insist on any of the above explanations, but if the latter three explanations are correct, it has been clumsy work.

With that said, it goes without saying that in today's increasingly unpredictable and dangerous world Russia does need to modernize its nuclear potential. But we must do this in an economical and sensible fashion, in accordance with our requirements and capabilities, without reacting to bluff, thereby allowing ourselves to get involved in a new arms race.

A Dictatorship of Incompetence

Konstantin Kosachev

MANY SMALL WARS IN PLACE OF ONE LARGE WAR

It would seem that the end of the global bipolar division has made the world a safer place. Yet, while we have succeeded in eliminating the prospect of an all-out nuclear war (thanks to the common sense of the Cold War opponents), we are now faced with a far less predictable situation: in the past, there was the prospect of one world war threatening nations and states; today, however, local terrorist attacks have become a threat to innocent people in every part of the world. It is enough to reflect on those people who were working in the World Trade Center in New York on September 11, or riding commuter trains in Madrid or in London when tragedy struck. The Russian people watched in horror as a musical at a Moscow theater turned into a tragedy on October 2002, as did the Day of Knowledge on September 1, 2004 at a Beslan school.

These “minor” but very cruel wars are terrible in that they do not require a *casus belli* – such as a serious international incident, an escalation of tensions of international relations or a long-standing confrontation. They can hit anyone anywhere, like a lightning bolt out of the blue.

The reality and palpability of the threat prompts the leaders of the world to find effective means of countering it. The present course of events dictates that Russia and its leading Western partners cast

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aside all of the issues that divide them. There is simply no other solution but to find common approaches, e.g., on the nonproliferation problem. The nuclear programs of North Korea and Iran, for example, are no longer a field for political gamesmanship between the world's leading powers, as was often the case in the past.

Unfortunately, there are those who fail to realize that the proliferation problem directly concerns everyone without exception. There are also those willing to gamble on these increasingly dangerous conflicts: pit the West against the Middle East, for example, and see what happens. As for Russia, nothing good can result from such a showdown: it is naïve and irresponsible to believe that should those countries seeking nuclear weapons finally get them, these weapons will never be aimed against Russia.

A NEW VECTOR OF PARTNERSHIP

Today, the West places special priority on modernizing the Trans-Atlantic partnership between Europe and the United States; much of the present emphasis of the relationship is in countering new threats. This intercontinental partnership looks Trans-Atlantic if the vector continues to move to the *west* of Europe — the favored direction throughout the past century. Yet in the new century, with the growing trend for diversifying partnerships, just one vector of movement is clearly insufficient. Therefore, if the obvious geopolitical reality is accepted — that Russia is a European state, at any rate, no less European than Turkey, an EU candidate member — it will eventually come to light that political Europe is not separated from the United States by the vast Atlantic, but by the narrow passage of the Bering Strait. This is an altogether different geopolitical reality.

To develop such a non-standard vector of rapprochement, the West has until recently lacked the geographic “trifle” known as Russia. Yet, today Russia ranks among the world's democratic and responsible states; it presently holds the rotating presidency of the G8, and is ready to make a decisive contribution to regional and global security. Moreover, now that the factor of a common enemy is gone, Russia could kick-start the floundering Trans-Atlantic integration.

It is true that certain circles want the West to consolidate in the face of a common enemy, with Russia conveniently fitting the bill. This is only natural: after all, the numerous structures, foundations, and institutions that were created to conduct informational warfare against the Soviet Union are still alive and well. Even if these groups and individuals are presented with a different set of tasks, their intellectual inertia and inflexibility will serve as an impediment to any attempt to revise the existing approaches. Furthermore, the lingering idea of the ‘Eastern front’ has been enthusiastically embraced by those who hope – once they are on the “winning side” due to their membership in Euro-Atlantic structures – to settle personal scores with Moscow. Yet, as a matter of fact, Russia is the missing link in the ‘Northern Ring,’ and not only in a purely geographic sense. Its integration into the ‘Greater West’ could make the latter not only more consolidated and better protected, but also self-sufficient in terms of natural resources.

Yet, instead of receiving support for its integration into the international community, Russia is constantly coming up against artificial obstacles. Russia’s ongoing effort to join the World Trade Organization is one fine example. Does Russia’s admission to the WTO benefit only Russia? In reality, Russia’s WTO membership would enable producers from other countries to enter a huge, promising and still unsaturated market that is experiencing a consumption boom. Nonetheless, more and more demands are being placed on Russia that have nothing to do with WTO rules.

It has been argued that Russia’s economy is so weak that it is unworthy of becoming a member of the world’s leading powers. Yet as soon as Russia, in an effort to strengthen its “negligible” economy, raises its natural resource prices for one neighboring state to a level that is used in trade with other states, it is accused of “dictating from the position of strength” and entertaining “neo-imperial ambitions.” Suddenly it surfaces that Russia is too strong and should restrain its power so as to avoid inadvertently smashing the “young democracies,” that is, those that are to a very large degree living off its resources.

When leaders of particular countries endeavor to break free from Russia's influence, even if such a move may harm their nation as a whole, no one has the right to prevent them from making such a decision. Real democracy will put everything in its appropriate place: people are, as a rule, smarter than their rulers, and scare tactics will not work forever. It is far more disappointing, however, that some of these "outside observers," who have never visited Ukraine, Georgia or Moldova, for example, view the "democratic" achievements of these countries as examples for Russia to emulate. They claim that Russia does not have a free press, for example, yet they have never read a single Russian newspaper. They talk about Russia's instability and its appalling investment climate, yet they have never invested a single euro in the Russian economy. They attempt to teach Moscow how to behave in Chechnya, yet they probably would have difficulty locating the republic on a map. They claim that Russia's nuclear weapons are poorly guarded even though they are not experts in this field, and so on.

BREAKING STEREOTYPES

The present banality of thinking, and the proclivity for stereotypes and dogma, are becoming serious impediments to cooperation with the West, as well as for the ability to mount an effective joint response to current challenges. Judgments based on the "democratic versus undemocratic," "freedom versus lack of freedom," "friend versus foe" stereotypes produce skewed decisions that simply do not work in our present world. Unfortunately, experience shows us that the more complex and delicate a problem is the less flexibility is demonstrated by the world's leading powers, above all the United States. There has been a marked increase in the use of ultimatums, threats, blockades, sanctions and other methods involving the usage of massive intimidation. Thus, it often happens that a particular state is driven into a corner and confronted with the dilemma: either submit, or face another Yugoslavia, Iraq, etc.

The loss of flexibility and the ability to make unconventional decisions comes at a heavy cost to the international community.

The entire world was alarmed and outraged by the recent comments made by the new Iranian president. The sentiments of the Iranian people, however, are typical of the region as a whole, which was also reflected by the recent Palestinian elections which saw the militant organization, Hamas, rise to power. Unfortunately, the situation will continue to worsen, especially if the irresponsible practice of insulting the Muslims continues in the media.

The mood of the world's Muslims has also been affected by the war in Iraq, largely because the cause for going to war was essentially plucked out of thin air. And although a ruthless dictator was ousted, bloodshed is escalating. What are we going to tell the Islamic world when the death toll from the *operation to overthrow the regime* becomes comparable with the death toll from the *regime itself*? That the cure proved to be worse than the disease? That the cancer of dictatorship was treated with the lethal (and highly contagious) virus of civil war and terror?

Many other regimes have drawn the same unequivocal conclusion from the Iraq war: Baghdad was attacked simply because it did not have nuclear weapons. This is one of the most dangerous consequences of the campaign, which jeopardizes the entire non-proliferation system. Nevertheless, even those who at first opposed the military campaign in Iraq do not want the U.S. (and its allies) mission to fail. Iraq, as one of the key countries in the Middle East, vitally needs peace and national consensus.

As for Iran, the case calls for even greater flexibility and diplomacy, not pressure and shock tactics. The most horrible scenario would be if the United States allows itself to be drawn into a situation where *attacking* Iran, complete with a large-scale, drawn-out war, proves to be a more preferable option for the U.S. administration than *not attacking* it, which could be construed as weakness, thereby inspiring Iranian radicals.

The aforementioned explains why Russia is searching for options that are not discriminatory against Iran, without bringing the opponents closer to the dangerous point of no return. However, all those who thrive on war are fueling the flames of conflict. They are only waiting for an explosion in order to find a

scapegoat and distract the Islamic youth who are tired of social problems and unemployment.

Those who are talking about the need to democratize particular countries oftentimes bet not so much on democracy but on loyalty (this is how the United States, for example, perceives Saudi Arabia). The ongoing condemnation of disloyal undemocratic regimes, together with the collusion of equally undemocratic but amenable regimes, undermines trust in the idea of democratization as such. Furthermore, it calls into question the sincerity of Euro-Atlantic civilization and its readiness for frank dialog, as opposed to simple intrigue surrounding oil and geopolitical issues.

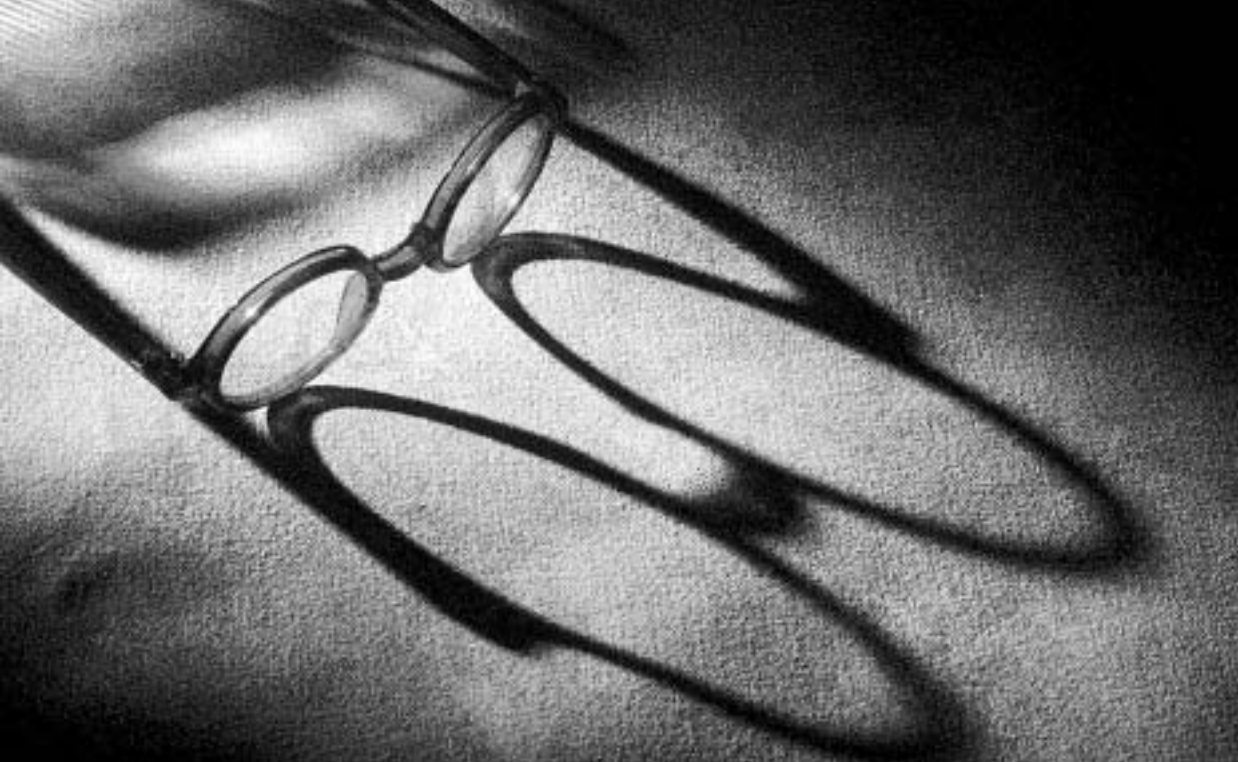
Rational people realize that a repetition of the Iraq scenario in Iran would divide the world along the South-North line. Such a scenario would undermine global security not only in the realm of energy supplies, but also in strategic security, ultimately leading to a global catastrophe. The existing Euro-Atlantic structures, now engrossed in its eastward advance and driven by the inertia of their Cold War-era inferiority complexes, are simply unprepared for such a scenario.

Russia supports close cooperation and wide-ranging exchanges with Europe since such a move can help finally put an end to the *dictatorship of incompetence* in our relations. We are being urged to borrow the centuries-old European and U.S. experiences in building our democratic institutions. But why does Russia (which is seen wanting in democracy) have to persuade its Western partners to simplify visa and travel regulations for its nationals, and stop construction of new Iron Curtains outside their consular offices in Moscow? In the past, the Soviet Union was criticized for denying its citizens an opportunity to study the achievements made by the world's foremost democracies. Thus, the United States passed the notorious Jackson-Vanik amendment that denied Normal Trade Relations to non-market economies that restricted emigration rights, specifically the rights of Soviet Jews who wanted to emigrate. However, although more than 100,000 Jews *have returned* to Russia since the collapse of the Soviet Union, the amendment is still in effect as a monument to eternal 'double standards' (or rather to the immutability of old standards).

If the West would give up its attitude toward Russia, which is based on the “presumption of guilt” principle, this would enable the former to concentrate on truly pressing, relevant problems, such as the blackmail being waged by politically unstable transit states, as well as Europe’s growing dependency on political opportunists. For example, when one party siphons off – actually steals – natural gas from a second party, it would be logical, in accordance with the law and moral principles, to crack down on the thief, not on the aggrieved party, even if the thief may appear to be more popular.

Russia is constantly being pressured to reaffirm its loyalty, while few take the time to consider the effect that the West’s actions – for example, NATO enlargement and the integration of former Warsaw Pact or FSU countries (contrary to the gentleman’s agreement between them and the last Soviet government) into Euro-Atlantic structures – may have on the Russians. Russians are being urged to respect the rights of ethnic minorities, while at the same time ‘Baltic apartheid’ – the outrageous practice of invoking “non-citizenship” and denying basic rights and freedoms on purely ethnic grounds – is being winked at. Even the adaptation of the CFE Treaty – a simple step that can expedite the creation of a new European security system – is being delayed under all sorts of pretexts.

Russia is not a meek applicant standing outside the EU’s closed doors, but a dynamic Eurasian power that is rapidly gaining weight and stature in the world. Furthermore, it is developing without the help of its foreign partners (Western Europe in its time found it necessary to develop through the Marshall Plan), but more and more often *in the face* of pressure and artificial impediments. The habit of relying only on its own resources is certainly useful for every nation, but it weakens both the need for partners and trust in unchallenged authority. If Europe loses Russia to time-serving intrigue and political expediency, it will lose more than just an important partner and a source of raw materials. It will lose a chance to modernize and make a breakthrough into a new dimension of the civilization that it produced.



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Russia-EU Quandary 2007

Nadezhda Arbatova

The Partnership and Cooperation Agreement (PCA), a document underlying the relations between Russia and the European Union, expires on November 30, 2007. The PCA, signed between the Russian Federation and the European Communities and their Member States on June 24, 1994, entered into force on December 1, 1997. Concluded for an initial period of ten years, the Agreement shall be automatically renewed year by year provided that neither party gives the other party written notice of denunciation of the Agreement at least six months before it expires.

The PCA has been a major factor in the establishment, development and expansion of a fundamentally new relationship between Russia and the EU. The present level of cooperation in all fields has amply demonstrated its effectiveness. Nevertheless, it is becoming increasingly obvious that compared with the early 1990s, when the PCA was still on the drafting boards, the situation has changed drastically. Both Russia and the EU have

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Corfu island, the birthplace of post-Soviet Russia's "European choice"

changed, as has the nature of relations between them. The world itself is also a much different place.

Partnership and cooperation between the EU and Russia has become a common, daily practice, while the level of political interaction between the parties has long transcended the boundaries of the Agreement. A joint initiative, known as the Road Maps for the creation of the four Common Spaces, approved at the Russia-EU Summit in May 2005, raises these relations to a fundamentally new strategic level of interaction.

An 'advanced partnership' requires the formalization of a full-fledged, legally binding treaty, as opposed to political accords and joint statements regularly issued at Russia-EU summits. Russian President Vladimir Putin and European Commission President José Manuel Durão Barroso first discussed this possibility in April 2005. The Russian president also stressed the need to upgrade the legal framework at the Russia-EU Summit in London (October 2005).

CONSERVATIVES AND PROGRESSIVES

Different political forces both in the EU and in Russia have a different vision of the way 'Russia-EU Quandary 2007' may be avoided.

European conservatives do not think there is a need to change anything in the PCA. Their traditional position has been to keep Russia at arm's length and not overburden the EU's agenda with extra issues. The number of advocates of this approach has increased considerably with the EU enlargement, most notably after the admission of the Baltic States and several Central and East European countries that continue to be affected by a "victim syndrome" with regard to the Soviet Union and equate the former Soviet Union with the present Russian Federation.

Russia has experienced a recent surge of pro-Asian sentiments (with an especially strong orientation toward China), together with the rise of hard-line nationalists who conceal their inferiority complex over Russia's loss of superpower status with ideas to the effect that the country is "self-sufficient" and should remain an independent "center of force" in international relations.

Of course, Russia is interested in promoting neighborly relations, trade and mutually advantageous cooperation with all of its neighbors. It is not clear, however, how the deepening of contacts with the EU could prevent it from trading with, for example, its partners in Asia. Yet this does not only refer to trade and cooperation, but to the choice of a model for the country's political and socio-economic development in the future.

Russia's experience shows that the Chinese model (i.e. authoritarianism mixed with a 'New Economic Policy') has failed to produce the desired result in a different national environment. Furthermore, an unbalanced, excessive rapprochement with China could lead to a situation in which Russia loses its Far Eastern and Siberian regions to Chinese demographic expansion, thus becoming China's raw-materials adjunct and waste-disposal grounds for its dynamic economy.

As for the belief that Russians are "God's chosen people," this can hardly be taken serious when 70 percent of the Russian popula-

tion is worse off than 10 percent of the neediest Americans, while the self-congratulatory theory that says “We are poor, but we are the most virtuous” holds no water amid the rampant corruption and organized crime that is eroding Russian society.

At the same time, there are forces both in Moscow and in West European capitals that are convinced that the search for a solution to ‘Russia-EU Quandary 2007’ cannot be put off any longer.

There are two main groups in Russia striving to upgrade the level of these relations. These are, first of all, democratic factions within the political elite and the expert community who believe that the European model, adapted according to national differences and specifics but based on general, fundamental principles, can best meet the needs of Russia, which is still in the process of a systemic transformation. The second group is comprised of elements within Russia’s ruling establishment. They argue that upping the level of relations with the EU symbolizes Russia’s importance in the modern world and its status as a “core” state with a special responsibility for international security and stability.

As for the EU, in the wake of the failed referendums on the EU Constitution in France and the Netherlands, many European politicians realized that Brussels’ old strategy, aimed at simultaneously expanding and deepening European integration, had collapsed. Therefore, the elaboration of a new strategy is impossible without ensuring stability along the perimeter of the EU borders, especially in the east. Upgrading the level of Russia-EU relations and rapprochement on the basis of shared interests and values will eliminate, or at least considerably reduce, the possibility of a clash of interests in such CIS countries as Ukraine, Georgia, Moldova and Belarus. In other words, resolution of ‘Russia-EU Quandary 2007’ will be crucial for the stability and development of Greater Europe, as well as for effective multilateral cooperation in countering new threats to international security.

A PARTNERSHIP OR AN ASSOCIATION?

There are three basic options for the formalization of EU-Russia relations after 2007.

1. Renewing the PCA (under the provisions of Article 106) until both sides decide to replace the document.

2. Making amendments and additions to the existing Agreement (taking into account the current level of ‘advanced partnership’ and the prospects for the further development of relations within the next 10 to 15 years), including a provision on forming an association.

3. Creating and ratifying a new agreement (subject to ratification by Russia, the EU and EU Member States) which will supersede the PCA.

The third option is unrealistic since it requires the ratification of a fundamentally new document. This is all but impossible in a situation where the total burden of mutual claims, problems and distrust has been escalated by EU expansion into countries of Central and Eastern Europe.

Furthermore, failure to renew the PCA could cause a temporary legal vacuum that would affect the interests of both individual Russian citizens and the Russian Federation as a whole. Such a scenario could jeopardize PCA-related trade relations (e.g., textile and steel agreements), while undermining the established PCA implementation mechanisms.

This applies in particular to the right of Russian nationals legally employed on the territory of a EU member state. These individuals must be accorded treatment free from any discrimination based on nationality, working conditions, remuneration or dismissal, as compared to its own nationals (Article 23). [A European Court of Justice ruling in the case of Russian footballer Igor Simutenkov set a precedent. On April 12, 2005, the ECJ ruled that the Spanish football association’s refusal to provide Simutenkov a license to play professionally in official Spanish football competition was a form of discrimination. The discrimination was due to the fact that, under the EU-Russia partnership agreement, Russian nationals should be entitled to the same treatment as Community nationals when already employed in that country. – Ed.] The ECJ instructed the courts of the member states to apply PCA provisions in instances when their national laws did not ensure Russian

nationals the same working conditions as compared to their own nationals. Should such rights be eliminated or made subject to formal approval, Russian and EU nationals, including businessmen, will risk losing much of the gains already achieved.

Naturally, similar provisions could be included in a new replacement agreement to the PCA, but then the ECJ would have to reaffirm their direct application. Until that time, Russian nationals would lose their rights.

This leaves only two realistic options: the automatic renewal of the PCA and its modification. If (as in Scenario 1) the Agreement remains unchanged while relations are increasingly built on new parallel rules and regulations, the PCA will eventually become ineffectual. This will become a burden on bilateral relations, causing irritation and disagreement, while pushing the sides back into the past.

Preservation of the PCA in its present form after the 2007 termination date would in effect mean that the partners are not prepared for a closer rapprochement. However, the adoption of a non-binding political declaration on “strategic partnership,” as well as a number of issue-specific agreements that will be signed anyway, could sugarcoat such a possibility. This “cost-effective” option, which will not require a new ratification of the Agreement, is favored by the majority of parties concerned both in Russia and the EU.

Taking into account the course for strategic ‘advanced partnership’ and given that the greater part of the PCA is in need of revision, Scenario 2 appears to be the most expedient and realistic option. Implementing this option, the Agreement can be modernized with amendments modifying its substance and even its name, while still preserving its legal continuity. The goal of a revamped PCA can and should be the formation of an association between Russia and the EU.

There are three known types of association agreements: European Agreements (for Central and East European countries), the Association and Stabilization Agreement (for the Western Balkans), and the European-Mediterranean Agreement (for South Mediterranean states). From a legal perspective, the most advanced form of association is between the EU and the European

Free Trade Association (EFTA), including Iceland, Liechtenstein, Norway, and Switzerland. It is remarkable that proponents of “Russia’s self-sufficiency,” who are greatly concerned about what they see as its excessive dependence on the EU, hold up the Swiss or Norwegian model of relations as worthy of emulation. They are apparently unaware, however, that by so doing, they are promoting the highest and most binding level of association.

There is an erroneous belief that an association agreement, unlike the PCA, ultimately presupposes obligatory EU membership, something that neither Brussels nor Moscow is interested in today. Indeed, both the preambles and the first several articles of the European Agreements mention the prospect of EU membership. At the same time, the first few articles of the Association and Stabilization Agreements with Macedonia and Croatia, for example, say nothing about their possible admission to the EU, although in the preambles they are described as potential candidates. As for association agreements with Mediterranean countries, the prospect of their membership is not mentioned at all.

The PCA’s principal difference from association agreements is that it does not contain provisions about the liberalization of the movement of goods, persons, services and capital. It does not contain any provisions about practical steps, although a free trade zone is mentioned as the partnership’s ultimate goal. Meanwhile, association is predicated on a free trade zone. The current Russian-EU document in the majority of cases provides instead for the Most Favored Nation treatment.

Association agreements, as a rule, have a timeframe for a gradual (over the course of 10 to 12 years) reduction of customs and equivalent duties with their eventual elimination. They also provide for the lifting of import and export quotas, and other equivalent restrictions, as well as the prohibition of discriminatory taxation related to the origin of goods. The absence of such provisions in the PCA creates considerable difficulties for its ultimate implementation. According to officials of the Russian Economic Development and Trade Ministry, Russia is ready to open negotiations on establishing a free trade zone with the EU as soon as it has been admitted to the

WTO. A well-planned procedure for the creation of such a zone would conform to Russia's economic and trade interests.

We do not know what lies in store for us. The opponents of Russia's EU membership, who are in the majority both in Russia and the EU, provide abundant argumentation that can be summed up by the word "never." They argue that Russia, with its vast territorial expanse, will never fit into the EU (although the population factor is more important than the geographic factor). Furthermore, Russia will never cede even a fraction of its sovereignty (but even the Soviet Union managed to do that when it signed wide-ranging strategic arms limitation and control agreements with the United States). Lastly, the EU, so the argument goes, will never want to share borders with China (the EU is prepared to grant Turkey membership, for example, yet this nation borders on the most unstable part of the modern world – the Greater Middle East), and so on and so forth.

The rapid radicalization of the Islamic world amid the proliferation of weapons of mass destruction and the spread of terrorism, however, could lead to a new lineup of forces along the North-South line, to new alliances and coalitions. The danger carried by Islamic radicalism necessitates a strategic alliance between all members of the Euro-Atlantic community and their potential allies outside the region. Therefore, it is not so important whether Russia becomes a member of the EU or whether a real, not symbolic, strategic alliance is formed, based on the protection of shared values and interests. Experience shows that alliances of partners who are equal in all respects prove to be the most viable and effective option. Creation of four common European spaces within a modernized PCA could become a strategic goal.

HOW TO MODIFY THE PCA

A revamped Russia-EU agreement should be signed for an indefinite period. One of the first articles in this future document should contain a provision for changing its official name from the Partnership and Cooperation Agreement to, for example, Advanced Partnership/Association Agreement.

It is essential to revise the preamble so that it state clearly and unambiguously that Russia is a developed country with the basic elements of a market economy and political democracy in place. The preamble should reflect such factors and processes as the high level of existing partnership, the creation of four Common Spaces, and Russia's admission to the WTO. Furthermore, it should also mention new global threats, most notably international terrorism and the proliferation of weapons of mass destruction, as well as the efforts to fight them.

Title I, General Principles, could be modified into General Principles and Objectives, incorporating Article 1 in its present form and complementing it with a number of provisions, taking into account the experience that has been gained and the new tasks and objectives of 'advanced partnership.'

Title II, Political Dialogue, should be transformed into a section on political dialogue and cooperation, incorporating a new article that would record the current level of political interaction. Here, a provision may be added about the "development of new forms of cooperation in the interest of achieving common objectives and countering new threats, in particular the problems of ensuring peace and security, fighting international terrorism and organized crime, and promoting democracy and human rights."

Following this are four sections (titles) on matters relating to the creation of a specific Common Space. Title VII, Economic Cooperation, should be amended and divided into four chapters, one for each Common Space. It is essential to formulate detailed provisions that spell out the "road maps" that were adopted in May 2005. The section on the common economic space should include a provision on the establishment of a timeframe for the full liberalization of trade in goods within 10 to 12 years. The document should clearly spell out the specifics of each of the four spaces — e.g., as follows.

The common economic space.

Objectives:

- the free movement of goods, services, persons, and capital;
- the development of compatible standards and regulations

ensuring the implementation of the four freedoms and the equality of competitive conditions;

– the harmonization of relevant legislation and close cooperation in other spheres of economic and social policy to the extent necessary for the effective functioning of the common economic space.

The common space of freedom, security and justice.

Objectives:

– the freedom of movement, residence and employment, including professional activity, for Russian nationals, entitled to the same treatment as Community nationals;

– equal personal security guarantees for Russian and Community nationals wherever they may reside within the Common Space;

– the harmonization of relevant legislation and judicial procedures in Russia and the EU, as well as close, permanent cooperation between judicial authorities, including the fight against transnational organized crime.

The common space of external security.

Objectives:

– A continuous and regular dialog on all matters of political relations, foreign policy and security (especially in Europe and adjacent regions) coordinated within established mechanisms;

– the convergence of positions and joint actions in foreign policy and security if and when Russia and the EU may deem this expedient or necessary;

– close cooperation in preventing and combating international terrorism;

– cooperation in the military field, especially in conducting joint peacekeeping, rescue or humanitarian operations.

The common space of research and education, including cultural aspects.

Objectives:

– close and continuous cooperation in fundamental and applied sciences based on joint long-term programs and financing, as well as harmonized legislation, in particular guaranteeing intellectual property rights;

– the establishment of a European Higher Education area on the basis of the Bologna Process, including the harmonization of educational systems and broad educational exchanges in which staff and students can move with ease, while receiving fair recognition of their qualifications;

– the creation of favorable conditions for the development of cultural exchanges, the dissemination of art and culture, inter-cultural dialog and knowledge of the history and cultural heritage of the peoples of Europe. This would include the promotion of cultural and linguistic diversity as a basis of vitality of civil society in Europe without dividing lines.

Specific provisions on the four Common Spaces could be spelled out in special protocols to the Agreement, in separate agreements on these spaces, or in some other documents – e.g., annual priority-action programs approved and supervised by the Permanent Partnership Council. It is also important to consider such institutional changes that would facilitate and expedite the creation of the four Common Spaces. Today, Russia-EU interaction in the foreign policy sphere is mainly aimed at bilateral problems, not joint initiatives on current issues of international security.

A separate protocol or declaration in the form of an annex to the modified Agreement could be devoted to a whole array of problems that have emerged around the Kaliningrad Region. Article 55 (Legislative Cooperation) should be amended to include provisions on the gradual (in two stages) approximation of legislation whereby Russia will endeavor to ensure that its legislation will be made compatible with that of the Community based on a jointly elaborated special indicative program. This harmonization mechanism should be enshrined in a special agreement on the implementation of Article 55, the signing of which should be envisioned under the Partnership and Cooperation Agreement.

Substantial modernization of the PCA will require its formal ratification. However, since it will be based on jointly approved initiatives, the chances for its ratification are very good.

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Toward a Strategic Alliance

Timofei Bordachev

The Partnership and Cooperation Agreement (PCA) between Russia and the European Union is due to expire in the autumn of 2007. This deadline presents the parties with a challenge to negotiate a legislative and institutional basis for their future relations.

However, Russia and the EU are approaching this discussion with a noticeable lack of interest toward each other, if not outright irritation. By February 2004, when it became obvious that the socio-political and economic models of the parties had greatly diverged, Moscow and Brussels almost assumed the logic of “peaceful coexistence.” The rapprochement issue is now used only as a pretext for achieving economic concessions that are not related to long-term objectives, while the “strategic partnership” slogan often conceals bitter competition on specific economic issues. Meanwhile, bilateral summits, together with any meaningful documents that these events may produce, have been decreasing. Both Russia and the European Union have displayed their inability to formulate joint strategic objectives and tasks, and to define their common values and even their real interests.

This drop in enthusiasm to engage in debate causes the parties to make “pragmatic and earthly” decisions in the spirit of “obligation-fulfillment” (or, rather, non-fulfillment). The public and

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political atmosphere, every bit as dull as the texts of the Russian-EU joint Road Maps approved in May 2005, does nothing to help find answers to longstanding problems. Adherence to a policy of pragmatism can bring about a situation where breakthrough ideas for the future may become unclaimed.

However, given that Russia and the European Union are already so close, and the real content of their mutual relations is so considerable, the parties require a fundamentally new level of confidence. This will be impossible to accomplish, however, by relying on practices and institutions that were formed in the early 1990s when the situation was quite different. The Russian-EU agenda now includes issues that were impossible to imagine 10 to 15 years ago.

Russia and the European Union – two inseparable parts of the Old World that is presently losing its global influence – must free themselves from the fetters of their bilateral legal and institutional base. Although this base keeps their mutual relations from further degradation, it serves to hinder further progress at the same time. Russia and the EU will be able to formulate a long-term model for their relations only if they overcome stereotypes and recognize the possibility of various variants, including unorthodox ones. Genuine integration wherever possible and necessary is more likely to bring about open markets and the free movement of people, goods, services and capital than the hasty inclusion into grand bureaucratic plans of ever new directions of the “harmonization.” It is also more advantageous than to simply proclaim an association of such diverse actors as a common goal.

The historical division of Europe will not be overcome unless Russia and the EU form an alliance genuinely oriented to the future. The geostrategically ailing European Union has entered a long period of internal transformation; from an objective view, it needs Russia economically and politically to advance its interests on the international stage, although it is not ready yet to admit this officially. Russia, presently involved in a complex geostrategic encirclement and losing its positions in many objec-

tive parameters, needs the European Union, at least in the medium term, as well.

The relative stability of the Russian system of government, which rests on the population's support and the favorable situation on the world energy market, allows Moscow to more actively advance its own vision of strategic objectives and forms of cooperation, while ensuring equal rights for its partners. Therefore, Russia must not be viewed *de facto* as a "younger partner" of the EU. The EU should gradually depart from its present position that its outside partners must adopt "light" versions of EU laws and standards (*acquis communautaire*) in order to bring about progress in their relations with Brussels.

AFTER 2007: THREE VARIANTS

From the legal point of view, there is no "2007 problem" in Russia-EU relations. Article 106 of the Partnership and Cooperation Agreement stipulates that the Agreement shall be automatically renewed year by year provided that neither Party gives the other Party written notice of denunciation of the Agreement at least six months before it expires. Yet the need for a new document is already on the Russia-EU agenda. There are now three ways for the parties to formalize their relations after 2007.

The first way is to provide for the automatic renewal of the PCA on an annual basis, as provided for by Article 106. At this point, the main emphasis of the agreement will be to fill the joint Road Maps on Four Common Spaces with specific content. Some of the PCA provisions may lose their force after a lapse of time. One thing is certain: the PCA will gradually die out without an adequate replacement.

The second way is to add new provisions to the PCA in order to revise the basis for institutional cooperation for the next 10 to 15 years. For example, it may acquire the format of the EU's relations (an association, a free trade zone, etc.) with states located along its periphery and with former colonies of European nations in Africa.

The third way is to draft a new political and legal document (a package of documents) that will completely replace the PCA and that will be ratified, if need be, by Russia, the European Union and its member countries. Ratification may not be required for the general political document (Declaration), but only for individual agreements on specific issues (sectoral agreements).

However, it seems that the less painful method would be to simply extend the PCA, providing it with new articles that would reflect the achievements scored over the last few years, including the Energy Dialogue and the Road Maps on Four Common Spaces. Brussels prefers exactly such a scenario, as it will allow the European Commission to retain the role of leader in relations with Russia, while reducing the influence of individual EU member countries that are more interested in the development of contacts with Moscow. This type of relationship model would suit a significant part of the EU political elite, as it would save the Union the need to work out a clear-cut strategy for developing relations with Russia. Moreover, it would enable Brussels to focus on efforts to overcome its own system crisis.

At the same time, Moscow may find this variant attractive because it would spare it the need to form a strong negotiating team for drafting, together with the European Union, a new document. The catastrophic shortage of qualified experts, in addition to the marked disunity among government agencies, makes it very difficult to form an efficient task force.

However, by agreeing to extend/renew the PCA, or replace it with another document taken from the foreign-policy nomenclature of the European Commission that reflects its terminology, Russia would be voluntarily admitting to its status as a “younger partner,” thus becoming an object for inspection and instruction. The arm-twisting technique frequently used by the European Union in economic issues (witnessed by its position on the Siberian overflight payments charged to European airlines) would become a regular practice.

On the whole, the format of political and legal relations between Russia and the EU does not essentially influence the

development of real integration wherever there is mutual interest. Many countries that have much closer and effective ties with the EU than Russia do not seek to formalize their commitments by ratifying them in parliament and making them part of national law. One of these countries is the United States, which has a visa-free regime and a huge trade turnover with the European Union; yet, it makes do with general political declarations accompanied by a package of bilateral agreements and binding working plans on specific issues.

EMPHASIS ON EQUALITY

The development of a new format for developing political and legal relations between Russia and the European Union requires revising some of the present approaches.

First, the future model of Russia-EU relations must reflect Russia's special role in Europe and the world. This means that the new document (package of documents) cannot fall within the same "system of coordinates" as the EU's present practice of formalizing relations with neighboring states. Thus, any new model should not stem from other generally known formats and titles of EU agreements with other countries, such as Partnership and Cooperation Agreement, Association Agreement, European Agreements, and so on.

Second, the new agreement cannot be an "instruction" for drawing Russia closer to the constantly changing regulatory policies concerning political and economic life in the European Union. In practice, bilateral documents are usually substituted by agreed versions of the EU's internal documents reflecting its vision of what Russia should do. Broadly speaking, it is necessary to avoid excessive emphasis on "harmonization of legislation" as a universal instrument for developing trade, economic and humanitarian ties. Russia's adoption of EU legislation, without raising the issue of obtaining EU membership, would make no sense.

Both parties must be guided by international law, World Trade Organization regulations and other legislative norms. This does

not rule out, however, Russia's adoption of individual norms in cases when it does not involve yielding its state sovereignty. Moreover, in the future, if the parties are prepared to form supra-national forms of cooperation in one or another field, new regulations may be hammered out at that time.

And third, any new document between the parties must avoid evaluative judgments about the state of the Russian economy and its society as a whole. Statements to the effect that the European Union recognizes Russia as a "developed democratic country, possessing the fundamentals of a market economy" look as an attempt to place the EU a step above Russia, thus undermining the principle of equality.

Instead, the parties should consider a document that acknowledges the establishment of a strategic union (community) between Russia and the European Union as a new means for ensuring regional and international security. To this end, Moscow and Brussels must voice their common vision of major issues concerning international life. Despite their tactical disagreement on a majority of pressing issues (such as the role of the United Nations and other international institutions, the supremacy of international law, non-proliferation of weapons of mass destruction, counterterrorism measures, cross-border crime and drug-trafficking, measures to stabilize the Greater Middle East, environmental problems, etc.), the positions of Russia and the European Union are quite close. Therefore, the parties should see to it that their common strategic interests take precedence over individual disagreements or phobias inherited from the past.

A new joint document could cite universally agreed principles, by which Russia and the EU abide in their international affairs and bilateral relations. These principles include the observance of human rights, freedom and equality in international trade, and the organization of the due political process in keeping with the existing norms. The parties should clearly state that they will continue to build their bilateral economic relations on the basis of, and taking into account, the adaptation of Russian legislation to the rules and standards of the WTO,

which Russia seeks to join in the near future. If economic interests demand closer integration in one or another field, the corresponding harmonization of legislation in the given area will be adopted in a separate agreement.

Russia and the European Union should focus on selective integration in economic areas where it can bring them real added value, as well as a long-term instrument for building their economic and geopolitical community. For example, the parties may consider the possibility of setting up supranational associations, like a Russian-European Oil and Gas Association, a Russian-European Transport and Space Association, or a Russian-European Environmental Community. In those areas where the parties are not yet ready for integration, they will retain their full sovereignty and relations in the form of cooperation.

THREE LEVELS OF RELATIONS

The above principles can be translated into life on the basis of a three-level system of political and legal relations between Russia and the European Union. This system will allow the parties to take into account their unique characteristics, interests and international circumstances.

Level one. A strategic framework for Russia-EU relations would be established by a general political document – a Declaration for a Strategic Union Treaty – that would work as a detailed preamble. Its stated goal would be the establishment of a Strategic Union between Russia and the EU, aimed at overcoming the syndrome of enmity, rivalry and psychological consequences of wars and conflicts of the past, and at consolidating truly allied relations that would provide for deeper integration in individual areas. These relations will not be directed against third countries. The relationship will be based on a common vision of challenges and security threats, the interdependence and interoperability between Russia and the European Union in key economic sectors, and their common cultural and scientific heritage. A final key is that both parties recognize the importance of their rapprochement for ensuring their mutual development and security.

The Declaration should state that the common strategic interests of Russia and the European Union have a priority, and specify areas within the realm of international politics where the interests of the two parties objectively coincide. The Declaration should also cover other issues essential to both parties, among them devotion to basic democratic values, such as supremacy of the law, human rights and the rights of minorities, independence of the judicial system, the division of powers, a competitive political environment, independence of the mass media, and the freedom of citizens' movement. Also, it should stress that Russia and the EU will build their mutual relations on the basis of equality, mutual benefit and transparency, and that, while operating within the framework of international and regional organizations, they will seek to take into account each other's positions, coordinate their efforts, and align their approaches as close as possible.

A strategic union between Russia and the European Union would serve as a crucial link between regional security systems in Europe, Asia and North America. To add a systemic nature to the parties' relations in the military and political spheres, the Declaration must name instances when it would be appropriate for mutual cooperation in their foreign policy and military cooperation, as well as in peace-making efforts.

Level two. Russia and the European Union would adopt a strategic agenda that would name specific areas for their cooperation. One would be cooperation in ensuring international and regional security, as well as eliminating 21st century threats and risks, including terrorism, environmental problems, poverty, and others. This section may include a list and description of joint initiatives for resolving specific issues pertaining to international security, military cooperation and peace-making activities, as well as references to specific provisions of international law underlying such joint activities.

Another important area is cooperation in the realm of international trade and the global economy. It would be expedient to specify the parties' plans with regard to issues of mutual interest

in individual sectors of the economy and international trade, provided in detail in the general section of the Declaration.

The third section of this agenda could focus on cooperation in ensuring freedom of people's movement and unimpeded transit. This cooperation must be based on the declared intention of introducing visa-free movement of citizens through a gradual simplification of the visa regime. Also, the agenda should mention the need to simplify, as much as possible, a mechanism of transit through the Kaliningrad Region.

Another section, devoted to cultural and humanitarian cooperation, which is a major area of concern in the debates on rapprochement between Russia and EU, may contain a list of the existing and planned initiatives for the development and strengthening of joint activities. This section should state the plans of the parties to intensify and encourage the exchange of students, teachers and scientists.

Of fundamental importance is a special section that calls for cooperation between businesses and civil societies. The lack of mechanisms and instruments for protecting business interests is now a key problem in Russia-EU relations. This section must contain a list of plans and ideas for advancing dialog inside the business community, as well as between nongovernmental organizations. First, Russian businesspeople, with rare exception, are not ready to invest seriously in the creation of a lobbyist infrastructure. Second, the nature of the relationship between business and government in Russia is not always conducive to protecting the interests of Russian entrepreneurs abroad. The Russia-EU negotiating process remains at a dead end and lacks real transparency for the Russian business community; this is why its interests are not duly taken into consideration.

Considering the unique role the EU plays in Russia's foreign trade (about 50 percent), it would be expedient to raise the issue of expanding the representation of Russian business interests at European supranational institutions, and creating a legal foundation for the integration of Russian businesses into the business community of the United Europe. Russia and the EU may even work out

a separate agreement to support the representation of nongovernmental interests. The main objective of this (sectoral) agreement would be granting Russian and EU businesspeople the right to represent and protect their interests on the territory of their partners.

At the same time, business circles must be obliged to coordinate their approaches to issues of economic relations within the framework of special consultative mechanisms. Associations, companies and their representatives should be guaranteed access to governmental information (this would require, of course, a strictly defined type of documents and could occur only at a certain stage of development between the parties). Also, the parties should submit drafts of the interstate agreements and other documents to Russian and EU councils of entrepreneurs for consideration prior to the decision-making stage.

The last section of the agenda should be devoted to the documents' implementation, including a provision on the creation of a special mechanism for supervising the implementation of the agreed plans between Russia and the European Union.

And finally, **level three**. This includes sectoral agreements of various scales and binding to different degrees. These agreements will serve as a true "motor" and practical instrument for developing Russia-EU relations. They must provide for the functional integration in individual areas between the parties, up to and including the unification of market segments. Years ago, this was the functional approach — the achievement of political integration through in-depth cooperation in purely technical areas — that launched the entire process of European integration. So it would be expedient to apply to Russia-EU relations those practices that formed the European Coal and Steel Community of the early 1950s — the only successful experience of overcoming conflict and contradictions between formerly unfriendly countries, when the participation of France and Germany in the ECSC met their economic interests and also became a decisive factor in their historical reconciliation.

Cooperation on a functional basis makes it possible to reduce discrimination toward one of the partners in the project to the

minimum. At least three of the ECSC founders (France, Germany and Italy) strengthened their shaken positions with the help of the new organization and became leaders of the new historical process. The functional approach enables countries to be more flexible in the adoption of certain norms and values as a mandatory condition for integration. In the Treaty of Rome on the establishment the European Economic Community (EEC), signed in 1957, it occurred to no one to make the participation of France conditional upon the cessation of its military operations in Algeria.

Additionally, the functional rapprochement and direct interaction of the supranational governance bodies, businesses and societal structures of the parties involved will help create what the present relations between Russia and the European Union and, perhaps, between the EU countries themselves, lack most of all, and that is an atmosphere of confidence. However, functional integration can be successful only if the rules of the game are equally advantageous to all the participants. If, on the other hand, integration presupposes or results in the ousting of any of the participants from the market, it will never work.

Obvious potential areas for Russia-EU cooperation include transport, education, space exploration and, possibly, power engineering. Transport – especially air transport – is one of the best areas to launch a Russian-European integration project. Profits in this sphere are minimal, while large airlines, both in Russia and the EU, experience similar difficulties. The scale of state support in this industry, which is necessary even in the United States, is approximately the same in all countries. But most importantly, the potential contribution of Russia and the EU to the “joint stock” can be equal. This factor will let the parties avoid seller-buyer relations, which inevitably transform any dialog into a banal form of bargaining.

Of all the aforementioned documents meeting the new political and legal format of Russia-EU relations, only sectoral agreements require parliamentary ratification. Therefore, the parties will avoid negative consequences that would stem from the need

to push the issue of a Russia-EU strategic union through the legislatures of EU member states, with which Moscow has strained relations due to historical and psychological factors.

This article sets forth major provisions of the Concept of a New Political and Legal Format of Russia-EU Relations, a working document drafted by the Institute of Europe of the Russian Academy of Sciences (the Center for Applied Russia-EU Studies), the Council on Foreign and Defense Policy (SVOP), and *Russia in Global Affairs*. The authors of the project express their gratitude to Sergei Karaganov, Deputy Director of the Institute of Europe, for his constructive criticism and proposals, many of which were taken into account, and to all the participants of the public discussion organized by SVOP and held at the Institute of Europe on November 22, 2005. The authors are grateful to the initiators of the Concept for Modernizing the Russia-EU Partnership and Cooperation Agreement and Concluding an Advanced Partnership Agreement Establishing an Association. Their arguments and conclusions provided a strong stimulus for the attempt, made in this article, to go beyond the frameworks of the official agenda in Russia-EU relations.

Russia, China and India in the World Economy

Vladimir Portyakov

Interaction among Russia, China and India on the international scene largely depends on what place the three countries occupy in the world economy, as well as on the nature and degree of their involvement in the processes of globalization and regionalization. To identify the areas where the interests of these countries may coincide or come into conflict, it is necessary to analyze their development in the context of the global economy. This is also imperative for building mechanisms for tripartite cooperation.

CONVINCING STATISTICS

China's and Russia's shares in the global economy, approximately comparable some 15 years ago, show considerable dissimilarity now due to differences in development dynamics in the 1990s. China's Gross Domestic Product (GDP) grew 9.3 percent on average between 1990 and 2003. In Russia, GDP witnessed some growth between 1999 and 2003, but the GDP level registered in 1990 has not been repeated to date. According to the International Monetary Fund, China's GDP totaled \$1,412.3 billion (at the official rate of 8.28 yuans per 1 U.S. dollar) in 2003. As the dollar fell against the euro, China slid from the world's number six position in 2002 to the seventh position in 2003, with the six top places being occupied by the U.S., Japan, Germany, Britain, France, and Italy. In 2004,

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China's GDP rose 9.5 percent in comparable prices and reached \$1.64 trillion, while its total share in the global economy rose to 4.1 percent. At this time, China's share in global GDP growth stood at 16 percent. Finally, it accounted for about 25 percent of global consumption of steel, 30 percent of coal and 50 percent of cement.



China's status as a leading economy continues through its leadership in the production of a number of manufactured and agricultural commodities: steel, coal, cement, chemical fertilizers, cotton fabrics, TV sets, grain, meat, raw cotton, and peanut. China is the second largest producer of electricity in the world.



Chinese cars changing fast with the times

Due to the country's enormous population, its position in world rankings in terms of per capita GDP ranks 110th (\$1,089 in 2003 against the average global per capita GDP of \$5,080 in 2002).

Russia's GDP was estimated by the IMF at \$432.8 billion (using a ruble to dollar exchange calculation) in 2003, which accounted for 1.19 percent of the global index, while its per capita GDP totaled \$3,020.

Early assessments indicate that Russia's GDP reached \$582.3 billion in 2004, although the steep increase in that parameter, calculated in U.S. dollars, was due to a noticeable rise of the ruble-to-dollar exchange rate.

Russia leads the world in the production of natural gas and rough diamonds and occupies the second position in the production of crude oil, potatoes, construction bricks; it ranks third in the production of iron and milk, and fourth in the production of steel, chemical fertilizers, cotton fabrics, grain, and electricity generation.

India's GDP totaled \$579.7 billion in 2003, or 1.6 percent of the world's total. Against this background, its per capita GDP stood at \$542.5. India has a global reputation as a producer of jewelry, tea, medicines, fabrics, and prêt-à-porter clothes. In recent years, it has moved to the forefront of software production and has gained a leading place on the outsourced information and business services market.

On the basis of the Purchasing Power Parity (PPP), the international GDP ranking of the Chinese, Russian and Indian positions greatly improves.

The IMF says that Russia's GDP, if computed on the PPP basis, totaled \$1.29 trillion, or \$9,000 per capita in 2003, giving Russia the tenth position on the world list. China's GDP reached \$6,353.8 billion (second only to the U.S.) and \$4,890 per capita. India had a GDP amounting to \$2,889.8 billion (the fourth place) and \$2,704 per capita. Additionally, China accounted for 12.58 percent of the global GDP, Russia for 2.55 percent, and India for 5.72 percent.

This means that the three countries have a 20.85 percent share in the global GDP calculated through PPP, as compared to the 6.7 percent computed through the official exchange rate of their national currencies to the U.S. dollar.

The data on China's GDP growth has long been the subject of debate by world economic experts and mass media. GDP/PPP computations have prompted predictions that the Chinese economy will surpass, in absolute parameters, the American economy by 2015 or 2020. The same data also suggests that since the mid-1990s China has had the second largest economy in the world (making up 60 percent of the U.S. economy).

In this context, it is worth noting China's reserved reaction to the IMF's and the World Bank's forecasts in 1992 and 1993,

suggesting that the Chinese were moving to leading positions due to the abovementioned factors. Beijing seemed uncomfortable with the prospect of being the main political opponent of the U.S. on the international stage. Economists criticized the application of the PPP-based methodology to China, arguing that it automatically equates China's entire basket of commodities and services with those commodities and services that have withstood the ordeal of international sales. This methodology leads to overstating the quality and international competitiveness of Chinese products, which for a large part are overexaggerated. Although the situation has improved over the last decade, the argument still remains an issue today.

Compared with India, which flaunts the GDP at purchasing power model to substantiate the thesis that "India has the world's fourth largest economy," China prefers to avoid focusing too much on this parameter. Today, only a handful of Chinese scholars, including macroeconomics expert Hu Angang of Qinghua University, use it in preparing economic development forecasts.

In the global economy, the GPD/PPP versus GDP at official exchange rates shows a much greater volume and share of less developed countries, where people's earnings and purchasing power are modest. This applies to China, Russia and India to practically an equal degree. Russia's and China's GDP indices differed from a ratio of 4.92 to 1 under the GDP/PPP system in 2003, to 3.26 to 1 when converted to U.S. dollars at official exchange rates. For India and Russia, the correlations were 2.24 to 1 and 1.34 to 1, respectively; and for China and India, 2.20 to 1 and 2.43 to 1, respectively.

China outstrips both Russia and India by a large margin in the volume of foreign trade and in terms of its share of global trade. China's policy of economic openness that it proclaimed at the end of the 1970s helped it to build up its trade volume from \$20.6 billion in 1978 to \$851 billion in 2003 (of that amount, exports stood at \$438.23 billion and imports, at \$412.76 billion); eventually it rose to fourth position after the U.S., Germany and Japan. Both exports and imports witnessed an especially dynamic growth after 2001 when China received membership in the World Trade

Organization. Its share in global commodity exports went up to 5.9 percent and in imports, to 5.3 percent. Russia's share in global exports showed about 1.8 percent (\$133.7 billion) and in global imports, around 0.8 percent (\$57.4 billion).

Concerning the global trade of services, China holds somewhat weaker positions: in 2003, it accounted for 2.5 percent of the world's total exports and 3.1 percent of imports. Russia's percentage of global exports was 0.9 percent, while that of global imports reached 1.5 percent.

IMF calculations based on aggregate volumes of commodity and service trade indicate that China accounted for 5.26 percent (\$485 billion) in global exports and 4.91 percent (\$448 billion) in global imports in 2003. Russia's percentage was 1.65 percent (\$152 billion) in exports and 1.12 percent (\$102 billion) in imports.

In 2004, Chinese foreign trade volume grew 35.7 percent and reached \$1,154.79 billion, accounting for \$593.37 billion in exports and \$561.42 billion in imports. With these impressive figures, China became the third largest trading power in the world. Russia's customs department statistics showed that its foreign trade amounted to \$257.1 billion in 2004, accounting for \$181.5 billion in exports and \$75.6 billion in imports.

As regards India, between April 2003 and March 2004 its foreign trade stood at \$142 billion, with exports accounting for \$63.85 billion of this amount and imports adding an additional \$78.15 billion. Indian commodity exports totaled around 0.85 percent of the world's total, while imports made up 1 percent. In terms of the aggregate sales/purchases of commodities and services (the export of services is an economic sphere that India has considerably consolidated of late), India's share amounted to 0.89 percent in global exports (\$82 billion) and 0.92 percent (\$84 billion) in global imports.

ROLE IN THE INTERNATIONAL DIVISION OF LABOR

Each country's specific role in the international division of labor depends on the size as much as the structure of its economy and

availability of industries that have obvious advantages on the world market. Among Chinese industries falling into this category are labor-intensive sectors of the economy: production of clothes, textiles, footwear, toys, household appliances, and electronics.

China's medium-term economic development strategy envisions a dramatic improvement, with heavy emphasis on processing, science-intensive and high-tech industries. One of the nation's goals is to increase its annual growth rate in the processing industries by one percentage point than the GDP growth rate, and the annual growth rate in machine-building industries one percentage point higher than in the processing sector. China contributed 29 percent to the overall increase of the global processing industry in 2002, while its national share in the global processing sector totaled 5 percent. This means that the country's rise to the status of a "worldwide factory" – realistic enough a prospect – will proceed simultaneously with the gaining of new niches in the world economy. The most obvious areas of the "Chinese breakthrough" are in shipbuilding, automobile building, and biotechnologies.

China's development strategy is bolstered by persistently growing allocations for R&D projects. They increased to 1.3 percent of the GDP in 2003 from 0.6 percent in 1995. Meanwhile, the number of researchers and engineers employed in those projects soared to 821,000 from 470,000, illustrated by China's share of high-tech exports that reached 25 percent in 2003.

Another important factor contributing to China's positions in the global economy is the growing demand for oil and various types of raw materials. Chinese experts say the country will possess only 21 out of the 45 most important types of natural resources to meet its demand in 2010, and for only six types in 2020. For example, China was forced to import 122.7 million tons of crude oil, 26.3 million cubic meters of wood, and 208 million tons of iron ore in 2004 alone.

The imminence of these problems has prompted the Chinese government to modify foreign trade strategies in recent years. In 2000, for the first time ever, it promoted the concept of *zouchuqu*

(“exiting the gate of one’s own house”) that calls for the active expansion of Chinese products to foreign markets. In contrast to the twenty years before the enforcement of this new policy, when state corporations specializing in foreign trade drove export-oriented development, factories and companies of various forms of ownership are to become the driving force of export expansionism.

The forms and methods of commodity promotion onto external markets are being variegated, and an increased number of networks and centers for marketing Chinese manufacture are being established abroad. The government encourages the creation of daughter companies abroad, as well as the export of capital – such activities were previously restricted. In 2003 alone, Chinese business investment in projects abroad reached \$2 billion, that is, up 100 percent from 2002. The UN Conference on Trade and Development (UNCTAD) released data that China’s foreign direct investment stood above \$35 billion in 2003.

Taking into account the experience of multinational corporations that have penetrated into the Chinese market, a special role is given to the establishment of enterprises processing customer’s raw materials and to factories engaged in the “screw-driver” assembly of household appliances, which often makes it possible to bypass internal quantitative restrictions and big import fees. China is becoming noticeably more active on the world market of labor, above all in the areas of contractual, engineering and construction work. A total of 489,600 people were employed under such contracts abroad at the end of 2002, versus 380,000 workers in 1999.

The government is considering the construction of new deep-water ports in Shanghai and Shenzhen to host new-generation container ships, a measure destined to make the country more competitive in the field of international transportation. The production of high-demand export commodities (such as ships for transporting liquefied gas) receives strong support in the form of state-controlled Exim Bank loans.

Russia’s position in the international division of labor is currently pegged to the export of natural gas, crude oil and oil prod-

ucts. Their sales brought in more than a half of export revenues in 2003 — \$73.7 billion (\$20 billion, \$39.7 billion and \$14 billion, respectively). In 2004, the total figure jumped to \$94.9 billion, which was accounted for by \$55 billion in crude oil, \$19 billion in oil products, and \$20.9 billion in gas. While the expert community is divided on the prospects for consistent high-level production of crude oil, it unanimously predicts Russia's long-term world leadership on global gas markets.

The list of Russia's other competitive export items includes timber, ferrous and some non-ferrous metals, chemical (mostly potassium-based) fertilizers, and seafood products.

The mass export of machine-building products consists of defense technologies and equipment for nuclear power plants. However, tense competition on the market for weapons and nuclear power equipment, together with the heavy dependence of that trade on political factors, make it doubtful that Russia will keep its present position in that sphere over the long term (although Russia's capabilities make such a possibility quite feasible).

Russia does not have an articulate strategy of improving the structure of its exports. There has been much speculation of late about a possible breakthrough in innovations, yet the situation with Russian research personnel and financing of R&D projects leaves much to be desired. The number of people engaged in research fell from 804,000 in 1992 to 411,000 in 2003. Many researchers have reached retirement age, and government spending for R&D projects has been stuck in the bracket of 0.23 percent to 0.30 percent of the GDP in recent years. Allocations for R&D related to space exploration stand apart (they totaled \$0.53 billion in 2004), yet they do not affect the overall picture dramatically. Not surprising, therefore, that Russia's current share on the global innovations market stands at 0.5 percent versus China's share of 6 percent.

As for India's participation in the international division of labor, this is conditioned by three major factors. First, the country continues to rely on such advantageous factors as a relatively inexpensive workforce, rich deposits of some minerals (iron ore, bauxite, precious stones), and a climate favorable for pro-

duction of many crops – tea, nuts, spices, etc. Second, the growing dependence of India's economy on imports of crude oil (according to some forecasts, 85 percent over the medium term against 70 percent at present) compels it to look for reliable sources of oil and gas, including through extensive investment activity abroad. Third, the Indians have carved a niche for themselves in the global outsourcing of services and business processes based on information technologies. In 2003, India's exports in this sphere stood above \$12 billion.

For the time being, however, experts regard the structure of India's foreign trade far less modernized than China's: machines, equipment and electronics make up less than 10 percent of Indian exports, while in China this figure is above 40 percent. In imports, crude oil and oil products accounted for 28.1 percent between April and December 2004, and this figure was also much greater than machinery and equipment imports (9.78 percent).

INVESTMENT AND FINANCE

In recent years, China has been ahead of Russia in international rankings of competitiveness drawn up by the International Institute for Management Development in Lausanne (Switzerland); out of the 60 countries and territories on the list, China continues to out-rank Russia by fifteen to twenty points. According to a report on global competitiveness in 2004, China ranked in the 24th position, five places up from its 29th position in the previous year.

Concerning its country risk rating, Russia has made some improvements; however, as calculated by *Euromoney* and *Institutional Investor* magazines, it is still behind China. *Euromoney* placed Russia in the 76th position and China in the 56th position in its March 2003 listing. A year later, the two countries rose to the 66th and 45th positions respectively out of 185 rated countries and territories. *Institutional Investor* compiled a rating for 172 countries and territories. It moved Russia from the 64th position to 59th, while China retained its previously held 38th position.

The general conviction that investing in Russia implies heavy risks has rather negative consequences.

First, it denies this country an opportunity to put into force the full extent of its huge transit and transportation potential, especially in the transit of cargoes between Europe and Asia (e.g., along the traditional container corridor provided by the Trans-Siberian railroad, which is certainly not the only option).

Second, it results in a broad gap between volumes of foreign direct investment. In 2003, China had direct foreign investment worth \$53.5 billion, or 8 percent of the world's total direct investment (amounting to \$653 billion). It was second only to the U.S. (\$86.6 billion). In 2004, the country assimilated \$60.6 billion of direct foreign investment. From the start of reforms through to 2004, the Chinese used foreign direct investment amounting to \$562.1 billion and opened 509,000 joint ventures together with foreigners and compatriot investors from Hong Kong, Macao, and Taiwan.

It is noteworthy, however, that in the last few months the Chinese have begun using a new term, "the balance of assimilated foreign direct investment." This term reflects the depreciation of equipment, repatriation of capital, and closure of companies having foreign investors. This balance amounted to \$260 billion at the end of 2003, while there was a total of 230,000 active companies with foreign investment.

Official statistics in Russia shows that its foreign direct investment stood at \$4 billion in 2001 and 2002, and \$6.8 billion in 2003. These figures are inclusive of loans from companies' co-owners (\$2.1 billion in 2001 and 2003, each, and \$1.3 billion in 2002). In 2004, foreign direct investment in Russia rose to \$9.4 billion.

The third consequence of this general negativity involves Russian capital fleeing abroad. China also faces this problem to some degree, although the more apparent underlying reason there is the difficulty of legalizing corrupt or other illicit earnings, as opposed to the risks of investing in the national economy.

In India, foreign investment has not moved to any significant positions thus far. It stands at less than one percent of annual GDP and exerts influence on a handful of sectors only, like the automobile industry or the outsourcing of business services.

Both Russia and China have weak positions in the global financial system. Although a number of leading Chinese companies are represented directly or indirectly on the Hong Kong Stock Exchange, integration of the Chinese financial system with the international stock market is in the early stages. The Russian stock market communicates with international markets through the shares of a select group of big fuel, energy and metallurgy corporations. The insufficient strength of Russian and Chinese corporate business, where only a few companies from both countries are listed among the world's top 500 businesses, is the primary root of this situation.

In recent years, China and Russia alike have been successful in paying back their large foreign debts. China's debt increased considerably following the recalculation of these figures along international standards after the country joined the World Trade Organization. At the end of 2004, China's debt amounted to \$228.6 billion. Of that amount, short-term liabilities subject to repayment over a twelve-month period totaled \$104.3 billion, or 45 percent of the debt load. Russia repaid its sovereign foreign debts intensively and eventually reduced them to \$119.7 billion at the beginning of 2005 from \$143.4 billion at the beginning of 2002.

India's external debt totaled \$120.9 billion at the end of 2004, including short-term debts that made up only 5.7 percent of the total. The World Bank said India's external debt to GDP ratio was 19 percent in 2003, while China's debt to GDP ratio equaled 14 percent.

A steadfast surplus in the balance of payments, together with stringent currency regulation rules (like the demand that exporters sell all of their hard currency revenues to authorized banks) predestined the huge growth of China's foreign exchange reserves. This figure reached \$609.9 billion by the beginning of 2005, second largest only to Japan (in Russia, an influx of oil revenues propelled its foreign exchange reserves to over \$120 billion from around \$40 billion).

China's large foreign exchange reserve (and a number of Chinese economic experts believe \$150 billion to \$180 billion

would suffice) prompts the country to revalue its national currency against leading convertible currencies. The Russian government made a step in that direction, too, deliberately or under the pressure of circumstances. As the U.S. dollar fell against the euro, the internal ruble-to-dollar rate decreased to RUR 29.45: \$1 at the end of 2003 from RUR 31.78: \$1 at the end of the previous year, i.e. the ruble gained 7.3 percent in value. This measure helped avert a further fall of the ruble versus the euro (the ruble lost 25 percent in 2002 and another 11.2 percent in 2003 against the euro), which is significant in a situation where much of Russia's trade and tourism is concentrated in the euro zone.

In 2004, the ruble went on strengthening versus the dollar and hit RUR 27.75 by the yearend. Meanwhile, China kept its yuan tightly pegged to the U.S. dollar despite pressure from the U.S. – until the second half of the year 2005 (starting from July 21, yuan was revalued by 2 percent, to the ratio 8.11 yuan for \$1).

Both China and Russia seek to make their national currencies fully convertible and are gradually moving toward this goal, although neither country has a specific timeframe to meet it. The yuan is gaining grounds as a currency for transborder trade with neighboring countries, primarily in Vietnam, Cambodia, Myanmar, and Russia. Although the Chinese themselves take a cautious stance about the prospects for the yuan's internationalization, this idea is not ruled out in a distant future.

MUTUAL COMPATIBILITY AND COMPETITION

China's banking and insurance sectors were increasingly opened to foreign capitals following its pledges to the WTO, the most authoritative international institution that sets the rules for the world economy. One can expect the same will happen in Russia after it joins the WTO.

Formally, WTO membership gives China indisputable advantages in global trade as compared with Russia, but in reality the conditions under which Beijing joined the WTO were far from ideal (certain political considerations prompted the Chinese to

artificially speed up the final phase of the accession negotiations.) First and foremost, China will be considered as a non-market economy during the first 15 years of its membership. Second, WTO member-states have the power to take protectionist measures against certain Chinese exports during the initial twelve years of its membership, while some member-states will be able to enact such measures against Chinese textiles until 2008. Thus, Chinese experts surmise that the space the WTO offers for China's export expansionism is actually rather limited in reality.

Russia, a member of the Group of Eight Industrialized Nations, does not seem to have any advantages as compared to China either. The Chinese are still sizing up the Group and only in 2004 did they take part for the first time in a conference of G8 finance ministers.

At the same time, Russia's and China's membership in the Asia-Pacific Economic Cooperation forum (APEC) and the Shanghai Cooperation Organization (SCO) enables their leaders to have regular exchanges of information on pressing economic and other issues. Both organizations, and the SCO in particular, offer a solid institutional base for Russian-Chinese collaboration in the phase of developing and implementing regional economic partnership programs.

On the whole, China shows more activity in Asia as it calls for the comprehensive development of regional cooperation, including in the free trade zones.

Asian countries and territories top the list of China's trading partners. They accounted for 57.6 percent of its foreign trade in 2004, or more exactly, for 52.5 percent of its exports and 65.8 percent of imports. Its main partners in the region are Japan (14.5 percent), South Korea (7.8 percent), Taiwan (6.8 percent), Hong Kong (9.8 percent), and ASEAN countries (9.2 percent). The same nations are leading in terms of foreign direct investment in China's economy. Hong Kong's investment stood at 45.73 percent at the end of 2002, Japanese investment, at 8.11 percent, and Taiwanese investment, at 7.39 percent. At the same time, American investment in China amounted to 8.9 percent, while European investment stood at 7.6 percent.

The European Union is gaining ever more importance for China as both an economic and political partner. Beijing appreciates it as a major player in the international arena, especially after the EU's enlargement on May 1, 2004. Chinese-EU trade rose to \$177.28 billion in 2004, making up 15.3 percent of China's foreign trade, which means that it was bigger than trade with Japan (\$167.88 billion) and with the U.S. (\$169.62 billion).

Beijing regards the U.S. as a guideline for and benchmark of economic development, as well as a priority counterpart in international affairs – an opponent in some areas and a partner in others. Washington looks at China very much the same way. After all, the latter's share in U.S. imports stands at 11 percent, compared with Japan's 10 percent and South Korea's 3 percent.

Trade and economic relations between China and its main partners – Japan, the EU and the U.S. – are far from idyllic. The EU has launched a range of anti-dumping investigations against Chinese goods and is putting up technical barriers against some types of Chinese technologies. Furthermore, it is scrapping privileged fees for imports on an increasing number of Chinese goods. The list of American claims against China as a trading partner (for example, the increasing trade imbalance, poor ecological standards of Chinese goods, etc.) is also extensive. Beijing, for its part, initiated similar anti-dumping actions against some U.S. exports.

The zone of competition between China and Japan on the international market is much more narrow than the zone of mutual compatibility. This factor, as some experts in Beijing believe, helps form an East-Asian regional economic coalition that embraces both countries. This fact, however, does not rule out the possibility of competition between the two nations for leadership on the Asian continent.

For Russia, the republics constituting the Commonwealth of Independent States offer the most natural space for integration processes. Their share totaled 17.9 percent in Russia's foreign trade in 2003, or 15.3 percent in exports and 23.7 percent in imports.

Europe (minus Estonia, Latvia and Lithuania) remains the major trading partner for Russia. Russian trade with the Europeans amounted to \$92.9 billion in 2003 (48.6 percent). Russian exports

to Europe stood at 49.7 percent (\$66.5 billion) and imports from Europe, at 46 percent (\$26.4 billion). The Europeans are also leading in terms of investment in Russia. And yet close integration between Russia and the United Europe remains a bit of a fantasy. Europe is unwilling to see Russia become a full-fledged EU member under any circumstances, although some Russian quarters admit to the possibility nevertheless and continue to speak about Russia's belonging to European civilization.

Russian-U.S. trade is stable, with exports staying at about \$4 billion and imports, at \$3 billion. This stability may, among other things, indicate that bilateral relations have attained a maximum level of some kind. This casts doubts over the possibility of expanding them further.

In contrast, Asia – and East Asia in particular – may turn into a priority zone for Russia's participation in regional integration processes. The underlying factors for such a venture are the compatibility of economies and the objective importance for Russia of joining the now forming East-Asian center of global economy, a third after the U.S. and Europe. That region offers considerably more opportunities for Russia than does Europe or North America.

India gives priority in its trade relations to the U.S. (17.5 percent in exports and 6 percent in imports from April through December 2004) and the European Union (21.6 percent in exports and 16.7 percent in imports). Next on the list of partners is the United Arab Emirates (4 percent in imports and 8.7 percent in exports).

Bilateral trade relations between Russia and India, and Russia and China are growing rather steadily. In 2004, Chinese-Russian trade reached \$21.2 billion, while Chinese-Indian trade stood at \$13.6 billion. Trade relations between Russia and India are much weaker, with Russian statistics putting the volume at \$3.3 billion in 2003; Russian exports accounted for \$2.7 billion of the total figure.

A CRUCIAL PARTNERSHIP

The abovementioned statistics and commentary leads us to the following conclusions.

First, China is well ahead of Russia and India as to the degree of its engagement in the global economy, including the realm of trade and investment flows. Thus, it understandably desires to play the role as the engine of the Asian economy, as well as becoming an “active growth factor” in the global economy on the whole. At the same time, however, China may experience problems in the future as it tries to consolidate positions in global economic relations. It has vulnerable areas, like a scanty resource base, together with a lack of affiliation with any integration-minded regional groups. Thus, one may expect to see a marked increase in China’s efforts to eliminate or minimize those problems.

Second, the respectable positions Russia has gained in the global economy largely proceed from its ability to maintain and develop strong elements of its Soviet heritage, which made it possible to engage in the international division of labor. This proved to be profitable in the realm of particular sectors, such as natural gas, crude oil, ferrous and non-ferrous metallurgy, seafood products, defense technologies, atomic energy, and, partly, space technologies and some classes of chemical products. Owing to objective factors, Russia retains a high potential in international transit transportation, while its role on the international oil and gas markets may grow in the future, too. Also, Russia could rejuvenate the still existing Soviet-era intellectual resources (primarily in innovations, atomic energy, defense and space technologies) on the Asian markets, provided the government and private investors support these efforts.

Third, the rapid upgrading of services in software and outsourcing of IT-based business services alters India’s role in the international division of labor, yet the latter’s relative advantages in traditional industries will play a dominant role over the long-term.

Fourth, the zone of the three countries’ overlapping interests and mutual compatibility in terms of the global economy is broader than the zone of their potential conflicting interests. This lays a solid foundation for increasing the scale of trilateral cooperation and ramifying its forms, as well as for working together in the format of Asian integration. However, economic orientation of the

Chinese and Indian markets (and Russian as well, to some degree) to the U.S., European and Asian markets restricts opportunities for trilateral economic cooperation on other markets, and thwarts efforts to improve the terms of international trade.

Finally, although the political and economic foundations of Russian-Chinese-Indian cooperation are strengthening, it would be wrong to overestimate the actual progress. At this point, each of the three countries views relationships within the Moscow-Beijing-New Delhi triangle as a matter of secondary importance, as something hypothetical rather than realistic, or as a future project of the “reserve airport” type – not really necessary. It may become a convenient plan should complications emerge in other directions; otherwise these economic blueprints will continue to gather dust.

But the benefits of more active trilateral cooperation outweigh the possible handicaps. Reinvigorated cooperation will furnish each country with levers for beefing up their individual and collective positions within the global economic system.

Naturally, a Russian-Chinese-Indian partnership will not advance further on its own. Continued efforts on the part of each country are necessary to achieve progress that will serve their individual interests, while consolidating their positions in the world.

Ukrainian Crossroads



Members of Victor Yanukovich's party
as seen by his opponents from Victor Yushchenko's party.
Election campaign cartoon, autumn of 2004

“Russia is no longer a major factor in Ukraine's domestic policy. Moscow still has some influence in the economic and media sphere, but neither the Orange (which was Russia's target in the past), nor the White-and-Blue (which did not benefit from Russia's involvement), perceive it as a critical factor at the present time.”

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Change in the Air in Ukraine

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Ukraine's track record between the time of its presidential elections in 2004 and parliamentary elections in 2006 has been rather inconsistent, while it missed any chances for a rapid breakthrough in the reform sphere. The main pledge delivered on Independence Square – to provide the country with an honest and effective government – failed to materialize. Divisions within the ranks of the erstwhile winners, combined with reciprocal accusations of corruption, romanticism and a lack of direction within the political leadership, as well as visibly declining economic performance, eroded the credibility of the ruling establishment and its popular support. In the foreseeable future, Ukraine is unlikely to have the same favorable conditions for accelerating the reform process that existed in the spring of 2005. As for its foreign policy, Ukraine still has bleak prospects for EU membership and, as shown by the January 2006 natural-gas agreement with Russia, it is unprepared for constructing transparent relations with its eastern neighbor.

Nevertheless, there is a sense of change in Ukraine. According to a poll conducted by the Kiev-based International Institute of Sociology for the first anniversary of the Orange Revolution, over 60 percent of respondents said that the country had changed from the days of President Kuchma's Ukraine. On a national scale, 53.6 percent of respondents in the east, 57

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percent in the south, 57.6 percent in central Ukraine, and 75.6 percent in the west held this view. Only 28.6 percent of the respondents said they saw no difference.

What is more important is that Ukraine's vector has become less uncertain. Whereas under Kuchma it was enough for the local elites to declare, "Ukraine is not Russia," the country's present leaders must overcome its indefinite status and integrate into the Euro-Atlantic community. This implies a far-reaching domestic reform. Such objectives cannot be achieved within the space of a year. Transformations will always be painful and tumultuous, thus *de facto* Ukraine will long remain a "transit European state." This must be considered progress, however, in light of its image as a member in the western sector of the post-Soviet space.

In analyzing the current situation in Ukraine, it is essential to focus not on absolute results but on the shifts that have already occurred; not on the speed of change, but rather on maintaining the course of change. For all the setbacks and failures of the "Orange" authorities, a return to the pre-revolution situation is impossible. So both those who are disappointed with Ukraine and those who are gloating over its problems ("there is no way it can get away from Russia") should simply hold off judgment.

A FACELIFT OF COMPROMISES OR CORE CHANGES?

Ukraine's domestic political map has changed. The multitier system of compromise, checks and balances of today does not resemble what was in place one and a half years ago and is more in sync with the tasks of systemic reform. Although there can be no guarantee of success, things are looking more positive.

First, despite the ideological and political confrontation between the country's western and eastern regions, the contradictions between the "Orange" and the "White-and-Blue" forces have decreased. In the post-Soviet period, the east Ukrainian elites enjoyed sovereignty in upholding their economic interests and acquired a taste for power in an independent state. Yet they

are incapable of developing an ideology of an independent Ukraine and pursuing an appropriate foreign policy (that is, a multilateral foreign policy, which would be unpopular with the eastern electorates), and so now they must rely on national-democrats. The latter, however, are not in a position to ensure normal economic development single-handedly. This realization drives both sides to search for compromise that would guarantee stability in the country.

The nonviolent nature of the Orange Revolution, the preservation of the legal status quo, and the composition of the new ruling establishment, many of whose members had personal connections with the opposing camp, helped to establish a *modus vivendi*. The East Ukrainian opposition abandoned the fight for autonomy (the plan evolved as a means of exerting pressure on the Orange opposition in the fall of 2004) since its interests are better served by using the support of the local electorate to fight for a re-division of power on a nationwide scale. In response, the central authorities halted the persecution of East Ukrainian officials on charges of ballot rigging in the 2004 election and made no attempt to “Ukrainize” the east. The compromise was formalized in September 2005 when the formerly irreconcilable opponents, Victor Yushchenko and Victor Yanukovich, signed a memorandum of accord between the ruling establishment and the opposition. Yushchenko withdrew his signature in January 2006 when the Verkhovna Rada (Ukraine’s parliament) sacked the Yekhanurov Cabinet by a majority of votes, but that move did little to change the overall situation.

Presently, the creation of a “big” coalition between the Party of Regions led by Yanukovich and Yushchenko’s Our Ukraine is a likely post-electoral scenario, which was inconceivable in the fall of 2004. Furthermore, because Our Ukraine has somewhat more freedom in choosing coalition partners and enjoys presidential support, the Party of Regions, despite its success in recent elections, might have to agree to join a new Cabinet as a junior partner.

Second, the oligarchic system was to a very large degree dismantled. Of course, big business retained great lobbying power

and still has broad representation in parliament. But whereas before basic issues were resolved between clans, in which the “state” was represented insofar as the interests of people close to the leadership were concerned, at best playing the role of a counterbalance, today the Yushchenko administration is far more independent of oligarchic support. At the same time, they are not necessarily looking for a confrontation with them. Those once powerful groups, whose political importance previously hinged on access to the administrative resource, failed to effectively advance their political programs. For instance, the Working Ukraine party, which earlier represented the Dnepropetrovsk clan, fell by the wayside, while the United Social Democratic Party, led by Victor Medvedchuk, Kuchma’s last chief of staff, and Ukraine’s first President Leonid Kravchuk, had slim chances of making it into parliament in the run-up to the election. A number of high-profile figures from the era of clan rule (e.g., Victor Pinchuk, the ex-president’s son-in-law; or Alexander Volkov, who once enjoyed great clout) failed to secure seats in the Verkhovna Rada since their inclusion on party lists would have caused more trouble than it solved.

Meanwhile, it seems that the “Orange” establishment is gradually coming to terms with the business community over how to build a new working relationship. The oligarchs recognize the role of the state in setting new rules of the game, while at the same time they receive certain advantages. For example, the ruling authorities have abandoned the idea of mass re-privatization and “revolutionary logic,” limiting their measures to changing owners at a handful of enterprises that have symbolic value. A good example is the Krivorizhstal plant; the re-privatization of this business was part of Yushchenko’s election program. Meanwhile, the re-privatization is transparent, directly benefiting the state: Krivorizhstal was sold in the fall of 2005 at six times its original price. Finally, in order to advance its products on the European market, a substantial part of Ukrainian business needs state support and the administration’s pro-European image. For example, in 2005, the Donbass Industrial Union took control of a steel

making plant in Czestochowa, Poland – something that it was unable to do under President Kuchma.

Today, no new groups of oligarchs are privy to the political establishment. Petro Poroshenko, for example, an individual closely associated with Yushchenko, who allegedly made a major financial contribution to the Orange opposition coming to power, lost his position as secretary of the National Security and Defense Council when he was publicly charged with abuse of office (the charges were never proved in court). Meanwhile, lingering suspicions that the deprivatization of the Nikopol Ferroalloy Plant could have been carried out by Yulia Tymoshenko's Cabinet for its subsequent transfer to the Privat Group was definitely a factor in the prime minister's dismissal.

Third, constitutional reform began in earnest, turning Ukraine into a parliamentary-presidential republic. The president retains sufficient powers (including the power to dissolve the Verkhovna Rada should it fail to form a government within 60 days) and parliamentary leverage through his faction, but with parliament empowered to form the Cabinet of Ministers, the balance of forces between the executive and the legislative is shifting in favor of the latter. Today, parliament and the regional assemblies are formed exclusively on the basis of party lists. In general, these changes strengthen the pluralism of Ukraine's political system, bringing it closer to Central European models. It should be borne in mind, however, that despite his clearly negative attitude toward the reform measures, the president made no attempt to revise the basic compromise agreement that enabled him to come to power. This will prove to be an additional factor in the stabilization of the country's political system in the foreseeable future.

Fourth, under Yushchenko, Ukraine is moving away from 'managed democracy.' The use of the so-called administrative resource in the interest of different political forces is still a viable option, not least because the investigation of the 2004 ballot-rigging allegations has not been completed. Yet it seems that the central authorities are not inclined to use administrative leverage to resolve political struggles. Furthermore, today there is no guaran-

tee that they will be able to mobilize bureaucracy: in this respect, Yushchenko's administration is weaker than Kuchma's since the use of the administrative resource would undermine the legitimacy of the Orange Revolution that began as a protest against ballot rigging, and Yushchenko's chances for re-election in 2009.

The ruling authorities did away with particular media-control devices, such as *temniki* [lists of set topics], which in the last few years of Kuchma's rule were used for shaping the editorial policy of both state and non-state media outlets. In its 2005 list of press freedom, the international organization, Reporters Without Borders, ranked Ukraine 112th, up from its 138th ranking from the year before. The role of the press as "the fourth estate" became obvious during the discussion of the Russian-Ukrainian gas agreements when the media not only divulged particular details, but also compelled the government to provide explanations of certain issues that were rather embarrassing for them.

Fifth, the authorities have reviewed their attitude toward corruption, yet their ability to deal with the problem in a systematic manner remains questionable. The dismissal of Poroshenko, for example, and a number of other top-level officials, is an indirect indication of this problem. According to Transparency International, which publishes an annual Corruption Perception Index, last year Ukraine upgraded its position from 122nd to 107th. By comparison, in the same year, Russia dropped from 90th into the 126th position, marking the first time it ranked below Ukraine.

For Ukraine, time will tell how justified were its compromises with the business community and the opposition; each compromise has a down side. By coming to terms with the political opposition and big business the ruling authorities demonstrate their inability to adhere to their original platform. At the same time, constitutional reform threatens to spark a new series of governmental and political crises. Meanwhile, corruption is still a major impediment to development. These factors call into question the consistency of the reform course, but any other alternative would provoke a general heightening of tensions within the country,

which would make reform impossible in principle. Thus far, this unfavorable scenario has been avoided.

A EURO-ATLANTIC CHOICE
FOR "TRANSIT EUROPE"

Yushchenko's Ukraine has abandoned multilateralism in its foreign policy, which was characteristic of the Kuchma era, while giving top priority to Euro-Atlantic integration. Again, a standard black-and-white appraisal of the administration's performance would differ from a more flexible appraisal, taking all specifics into account.

On the one hand, as the euphoria of those first post-revolution months fades, there has been growing skepticism in Europe concerning the prospects for Ukraine's EU membership. Indeed, the integration of such a large post-Soviet and under-reformed country would require Europe to deploy inordinate efforts. At the same time, Ukrainian integration would push the issue of EU borders to a new level of intensity, something that the EU would like to avoid due to the current difficulties of institutional development. Furthermore, a number of large EU member states are not willing to see new problems emerge in relations with Russia, which would be inevitable in the event of Ukraine's integration. For countries such as France it is important to prevent the EU's further orientation toward the United States, which seems to be growing as the EU takes in former East European countries where pro-Atlantic sentiments are strong. Finally, the "Ukraine advocacy" group within the EU is not as yet sufficiently influential or prepared to push its own agenda.

On the other hand, it would be wrong to say that there is no prospect for Ukraine's EU membership since the quality of Ukrainian-EU relations is changing. For all its vagueness, one could agree with President Yushchenko who, in his inauguration speech, said that Ukraine had become closer to Europe. Under a joint action plan (incidentally, prepared when Yanukovich was prime minister, which further highlights the proximity of the opponents' views on European issues), in addition to a 300-point

“road map,” work has already begun to adapt the Ukrainian political and legal system to EU norms and requirements.

Ukraine *de facto* has already joined the EU’s common foreign and security policy, primarily in the post-Soviet space. In the case of Belarus, for example, Ukraine sided with the EU position concerning the Lukashenko regime, while in the Transdnestr conflict, the Yushchenko administration showed itself as an active player. It was largely due to its efforts as part of the “Yushchenko plan” that the EU joined peace negotiations as an observer and agreed to open an auxiliary mission in Ukraine to monitor the Transdnestr section of the Ukrainian-Moldovan border. The EU made some symbolic moves toward Ukraine, in particular recognizing it as a market economy.

Today, the EU is even more deeply involved in Ukraine and has a great interest in the successful outcome of reform, but most importantly, it feels responsible for Ukraine. Europe pointedly refused to treat the Russian-Ukrainian natural gas conflict in the winter of 2006 as a bilateral dispute, and although it recognized the legitimacy of the Russian position concerning natural-gas price hikes, it limited Russia’s rather than Ukraine’s room to maneuver. This, however, had less to do with Ukrainian policy as with the EU’s resolve to prevent Russia’s monopolization of access to energy sources in Central Asia. In this showdown, Ukraine as a key transit state and the EU oppose Russia.

The idea of Ukraine’s rapprochement with Europe remains popular at home. This is crucial given the general level of disappointment that Ukrainians feel about Brussels’ refusal to negotiate with Kiev on EU membership. According to the Razumkov Polling Center, from December 2004 to June 2005, an absolute majority of Ukraine’s population supported the idea of EU membership; by the fall of 2005, support began to decline, finally stabilizing at 40 percent for membership and about 35 percent against. Furthermore, until June, all age groups without exception supported EU membership (in September, the share of opponents began to increase in the over-50 age category). In November, according to the Kiev-based International Institute of Sociology,

the third most important achievement for the new government, after the increase in social security and welfare benefits and the reduction of compulsory military service from two years to one, was its improvement of relations with European countries. Not surprisingly, during the election campaign, Victor Yanukovich worked hard to prevent Yushchenko's monopoly on European integration rhetoric, and even advocated a pro-European policy.

The Ukrainian elites did not take Brussels' refusal as a final answer. According to the Razumkov Center, 64.6 percent of experts polled said they thought Ukraine could meet the qualifications for EU membership within 10 to 15 years (7.7 percent said within five years, while 6.9 percent said 20 years), while a mere 1.7 percent said they thought Ukraine was in principle unfit to join the EU.

It seems that in the worse case situation, Ukraine's chances for EU membership have not diminished. If Ukraine can show that it measures up to membership standards like the former East European countries, it will be very difficult for Brussels to reject it. Furthermore, the need to ensure stability and economic growth on the eastern periphery could compel the EU to graduate Ukraine from an intermediate transitional status to full membership. Ukraine's European integration could improve further if a decision is made to prevent an increase in the share of Russian fuel in the European energy balance, which is quite possible in the wake of the Russian-Ukrainian gas conflict.

The issue on the agenda now, however, is Ukraine's accession not to the EU but to NATO. Ukraine's NATO membership appears to be a very realistic option as Kiev searches for status that would help to unequivocally bind it to the West and, at the same time, keep it outside the EU; even countries that are the least favorable toward Ukraine could side with the position of the United States and Eastern members of the alliance (the position that is based on geopolitical considerations) and opt for further enlargement. Ukraine would be content with NATO membership as the proverbial bird in the hand that is worth two in the bush. In a more favorable scenario, Kiev hopes to follow the Polish

path and join one organization followed by the other, i.e., the EU. According to the Razumkov Center, almost 80 percent of experts thought that NATO membership would facilitate the country's European integration. It is not ruled out, however, that the situation could turn out completely opposite. By joining NATO and thus gaining a foothold in the Western *security system*, Ukraine could lose its chance of integrating into the European *zone of prosperity and development*, which is hardly in its interests. Nevertheless, there is no doubt that NATO membership for Ukraine today is a shortcut to higher status and away from its "transitional" status. All the indications show that the Ukrainian leadership hopes to do its homework on EU membership as a NATO member, while it does not expect, or is not afraid of, a fundamental worsening of relations with Russia.

In December 2005, a joint statement issued at the end of a session of the Ukraine-NATO Commission highlighted the need for an action initiative that would replace annual cooperation plans inherited from the Kuchma era. According to some experts, the Action Plan could be ready by the fall of 2006, while the decision to send Ukraine a formal invitation to join NATO could be made at the alliance's summit in 2008.

There are no military or economic arguments that could force any Ukrainian leadership to give up the idea of NATO membership, and after 12 years of cooperation, Ukraine's armed forces are largely interoperable with NATO forces. Further military reform is costly, but it is an unquestionable priority for the Ukrainian leadership, while the prospect of NATO membership would provide it with financial assistance. The Ukrainian officer corps is practically devoid of anti-NATO sentiments. The negative fallout for the Ukrainian military-industrial complex from the scaling down of military-technical cooperation with Russia will be minimal. Even in the Russian estimate, total losses will not exceed \$150 million. Not surprisingly, the course toward rapprochement with NATO was consistently pursued under Kuchma, while in May 2002, the National Security and Defense Council made the strategic decision on Ukraine's plan to join the alliance.

The main impediment to NATO membership for Ukraine is anti-NATO public sentiment. According to the Razumkov Center, as of December 2005, even in Western Ukraine, the share of those in favor of NATO membership was about 30 percent, while in the south and east of the country where people fear that Ukraine, as a NATO member, could get involved in a conflict with Russia, the proportion of opponents was close to 80 percent. This public sentiment can hardly be changed quickly by PR activities to improve the bloc's image. On the other hand, anti-NATO sentiments do not directly increase the influence of political forces that have made this a central issue of their political platform. The opposition bloc *Ne Tak!* ('Not This Way!'), formed around the United Social Democratic Party, according to its own estimates garnered nearly 4.7 million votes for a referendum on Ukraine's accession to NATO and the Common Economic Space with Russia, which is 10 percent of Ukraine's total population. At the same time, the political bloc's rating in the run-up to elections varied between one and two percent of the electorate. This gives the executive considerable room to maneuver.

It will be necessary to take into account the lineup of forces within the elites before arriving at a final decision. Given the president's role in shaping the country's foreign and military policy, as well as his powers to appoint the relevant ministers, it is unlikely that the course toward NATO membership will be abandoned after parliamentary elections.

THE END OF THE ERA OF BROTHERHOOD

By far the most serious changes, however, have taken place in Russian-Ukrainian relations, as the Orange Revolution marked the end of the post-Soviet phase in these relations. Ukraine refused to play the role of "junior brother," maintaining a semblance of loyalty as Kuchma was willing to do, while Russia came to the conclusion that it was impossible to continue with the old mechanism of economic subsidies.

For the most part, Russia is no longer a major factor in Ukraine's domestic policy, especially after Moscow's heavy and

ineffective interference in the 2004 presidential elections in Ukraine. Russia still has some influence in the economic and media sphere, but neither the Orange (which was Russia's target in the past), nor the White-and-Blue (which did not benefit from Russia's involvement), perceive it as a critical factor at the present time. Russia's presence as a player in the 2006 election campaign was minimum, and ended up being more of an irritant and a subject of debate.

Eventually, Kiev seized the initiative in bilateral relations. In the past year, Moscow more often than not was forced to react to developments than to raise questions. Kiev's declaration that Euro-Atlantic integration was a priority came as quite a serious challenge to Moscow. That was followed by the creation of the so-called Commonwealth of Democratic Choice – yet another mechanism of tying Ukraine to Europe, while at the same time consolidating those post-Soviet and East European countries whose relations with Russia remain problematic. Even more serious was Kiev's attempt to review the financial agreement of Russia's Black Sea Fleet based in the Crimea. The latest move concerning the rent agreement is hardly justified since such behavior calls into question Ukraine's *pacta sunt servanta*, while Kiev's persistent unwillingness to admit that there are gaps in the legal basis of the agreement – disadvantageous for Ukraine – is quite understandable.

The gas conflict was Russia's attempt to wrest back the initiative from Ukraine. Russian negotiators managed to secure beneficial price agreements, direct access to the Ukrainian market, and control over the supplies of natural gas from Central Asia. The success, however, proved to be only partial and limited. To begin with, the final results concerning both gas prices and pipeline control went far below the initial demands. Furthermore, the viability of the compromise that was reached remains dubious since the lack of transparency of the deal makes it vulnerable both to domestic political opponents of the Ukrainian government and to Ukraine's European partners. During the conflict, Ukraine demonstrated the leverage that the transit state had in relations with the producing country: in the foreseeable future, the latter will not be in a position to cut off

gas supplies at the risk of failing to meet its obligations to end users and due to the lack of gas storage facilities, while the former can still siphon off gas if necessary.

In the long term, the gas conflict has the potential to become a key step toward the reformation of Russian-Ukrainian relations. Instead of the relationship being based simply on relations between the elites, it will evolve to the level of interstate relations. Whatever the new power configuration in Ukraine, Russia can hardly be expected to return to preferential price policy that it abandoned with such difficulties and loss of image. This, in turn, makes it increasingly unlikely that the Ukrainian leadership will review its foreign policy priorities.

On the whole, bilateral relations have become much more conflict-prone than before 2004, although they have not reached the level of intensity that marked the period of negotiations over the withdrawal of nuclear weapons from Ukraine or, more recently, the Black Sea Fleet base in Sevastopol. Initially, both sides sought to play down the conflict. In Moscow, Victor Yushchenko and Yuri Yekhanurov stressed their readiness to search for a new model for bilateral relations, while in March 2005, Vladimir Putin paid a visit to Kiev. Nevertheless, the systemic differences in both countries' vectors of political development prevailed. Ukraine's Euro-Atlantic choice is at odds with Russia's attempts at developing as an independent center of force without formal integration with other countries. Economically, Russia is interested in raising the profitability of energy supplies to the maximum degree possible, while Ukraine would like to preserve low prices. On this issue, East Ukrainian business groups that traditionally are, or considered to be, the base of pro-Russian political movements, especially oppose Russia. Finally, political and personal trust between the partners was undermined by Russia's unsuccessful attempts to prevent Yushchenko's election as president.

On the other hand, even a controlled conflict is detrimental to both sides. For Ukraine (where the eastern regions tend to gravitate toward Russia), that would mean a deepening of inter-regional contradictions, while for Russia, it means the accelera-

tion of Ukraine's movement toward the West. Furthermore, Russia has to bear in mind that any worsening of bilateral relations only consolidates Ukrainian society (suffice it to recall the Tuzla standoff and the rise in the popularity of the pro-presidential party Our Ukraine in the winter of 2006, which not accidentally coincided with the gas conflict). Such a development would allow Kiev to stand up to almost any pressure. Furthermore, the bilateral conflict has a negative impact on the two countries' relations with Europe. Unlike the case with the Baltic States, it will be extremely difficult for Ukraine to gain admission to the EU if it has problems with Russia, unless Moscow subjects it to direct geopolitical pressure first. At the same time, Russia, as a stronger state that is less integrated into Europe and still perceived as a post-imperial force, will be coming under increasing pressure. It is also important to remember mutual economic interests. According to the Ukrainian Economics Ministry, in 2005 Ukrainian exports to Russia grew by 27.3 percent compared with 2004, while imports from Russia grew 5.9 percent.

It seems that in the next few years, Russian-Ukrainian relations will not be easy; the relationship will include turbulent moments of partnership, competition and even conflict. Such relations, however, are not at odds either with Ukraine's present status as a new "transit" state or with its membership in Euro-Atlantic structures — when and if that moment comes. Even so, Ukraine's European integration priorities, regardless of the prospects for its EU membership, will require greater transparency in Russian-Ukrainian relations and, in a broader context, their adaptation to European rules and regulations.

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Ukraine – Growth and Gas

Leonid Grigoriev, Marsel Salikhov

The drama of the New Year's gas conflict between Russia's Gazprom and Ukraine's Naftogaz can be understood only if one takes into consideration the underlying economic causes of the problem. These should be analyzed from the *corporate, economic and political* points of view, while remembering that certain norms, as well as the slant of the global mass media, play a part in the analysis. Leaving aside the political aspects, let us focus on the corporate and economic features of this conflict.

THE DRIVING FORCES OF UKRAINE'S ECONOMY

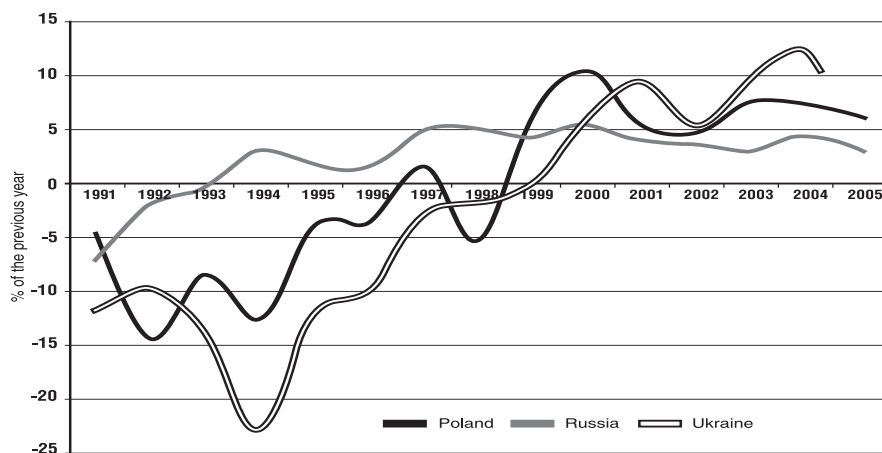
Economic growth in Ukraine in 2000-2005 was so great that it aroused euphoria and influenced the situation in the country, not to mention other members of the Commonwealth of Independent States (see Diagram 1). The Orange Revolution in Ukraine in the autumn of 2004 took place against the background of a considerable increase in the standard of living and macroeconomic stabilization, characterized by a budget surplus and a decrease in inflation to a level below that in Russia. One could expect that after such an improvement in the financial status of Ukrainian citizens, they would begin to demand greater social justice, a more responsible government and the reduction of corruption. The demo-

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cratic component of the Orange Revolution arouses natural sympathy and corresponds to the transition from a protracted crisis to the normalization of economic and political life. At the same time, in the political arena of transitional economies the interests of conflicting financial and industrial groups, for which access to power is a critical factor of existence and development, usually play a major role. These interests certainly played a role during Ukraine's power struggle in the autumn of 2004, and influenced Kiev's policy in 2005.

In order to continue reforms amidst competition between various public forces and financial groups, and to avoid administrative obstacles to reaching decisions, Ukraine needs a sophisticated mechanism for compromise decision-making. The threat from the new government, led by Yulia Tymoshenko, to nationalize and re-privatize 3,000 enterprises in 2005 failed. Only the Krivorozhstal steel company, which was a matter of principle for the government, was re-privatized – and at a very high price. Several controversial (one might add “non-market”) moves by that government proved fatal for it. On January 10, 2006, Verkhovna Rada voted to fire Prime Minister Yuri Yekhanurov,

Diagram 1. Dynamics of the Real GDP of Poland, Russia and Ukraine, 1990-2005



Source: National statistics committees

who had earlier replaced Tymoshenko at the post, and his Cabinet; they were permitted to serve as acting ministers until elections in March. The legislators thus disassociated themselves from the government's unpopular decisions.

In a democratic country, the future of the economy and the investment climate largely depend on the government's predictability, responsibility and consistency of its actions. The transition from a presidential to a parliamentary-presidential republic, and with the potentially more politically versatile composition of Verkhovna Rada after the March 2006 elections, may add to the instability of the future government of Ukraine. It is in Russia's interest to have a stable, compromising neighbor that would not turn economic and, more importantly, corporate relations into issues of domestic and foreign policy.

In the last five years, several factors may explain the economic growth in Ukraine. Some of the explanations were typical of all CIS countries in this period, while others were characteristic of the Ukrainian economy only. Growth in exports to the European Union and Russia, caused by economic growth in these large regions, was a common trend in many CIS and East European countries. The price of Ukraine's traditional exports rose very quickly, so regularly low gas prices only contributed to this growth, reducing costs and improving the positions of Ukrainian manufacturers in comparison with their rivals. A World Bank report of July 5, 2005 on the Ukrainian economy said that Ukraine's recent economic growth rested on the non-diversified yet resilient growth of exports in economic sectors controlled by financial and industrial groups that operate by their informal relations and special privileges.

This growth was based on a certain reserve of production facilities, high global market prices of raw materials, and a low currency exchange rate — exactly as the case was in Russia. At that time, Ukrainian industry, which relied on the same production potential as Russia (ferrous metallurgy, chemical and fertilizer production), received certain advantages. One such advantage involved the export of steel pipes to Russia whose oil industry had

entered a phase of significant growth in output, which required the modernization and development of its infrastructure.

The overall competitiveness of Ukrainian industry was based on several factors, among them a lower wage level (Table 1), a low exchange rate of the Ukrainian hryvnia to the Russian ruble, the mild climate of South Ukraine, and the proximity of convenient ports on the Black Sea – something that Russian industry lacks completely or to a large extent. Wages have been rising fast throughout Eastern Europe. In the Ukrainian economy this growth is faster than in Russia or Poland, but the absolute wage gap (which is important for estimating production costs) is growing as well. In 2003, a Ukrainian worker earned U.S. \$475 less in official wages than a Pole and \$92 less than a Russian. The respective figures for 2005 amounted to \$611 and \$134.

The Russian market plays a major role for the export of Ukrainian industrial products: without considering energy imports from Russia, Ukraine's trade balance with Russia is positive. Vladimir Malinkovich, a Ukrainian political scientist, accurately expressed the logic of the Ukrainian side: "For us it is extremely important to maintain stable relations, especially in the area of energy supply (*at reasonable prices*, of course)... We are not ready to compete in European markets; therefore we are interested in Russia as an extensive market for Ukrainian goods... We are interested in selling more goods to Russians than today – *at advantageous prices*, of course."

For their part, enterprises of the Russian metallurgical industry have been complaining about the level of competition from Ukrainian enterprises, some of which, incidentally, produce more sophisticated and better-quality products, such as large-diameter pipes. This factor, as well as many characteristics of the Russian and Ukrainian economies, is the direct result of the "distribution of productive forces" program developed during the Soviet planned economy. In some cases, Ukraine deliberately resorted to non-market measures to ensure its competitiveness, thereby forcing the Russian government to introduce antidumping duties in late 2005 against Ukrainian industrial pipes of small and medium diameter, for example, for a period of five years.

**Table 1. Average Wages in Ukraine, Russia and Poland
(dollars per month)**

	2000	2001	2002	2003	2004	2005
Ukraine	42	58	71	87	111	162
Russia	79	111	139	179	237	296
Poland	N/A	N/A	464	562	677	773

Source: National statistics committees, estimates by the Institute of Energy and Finance

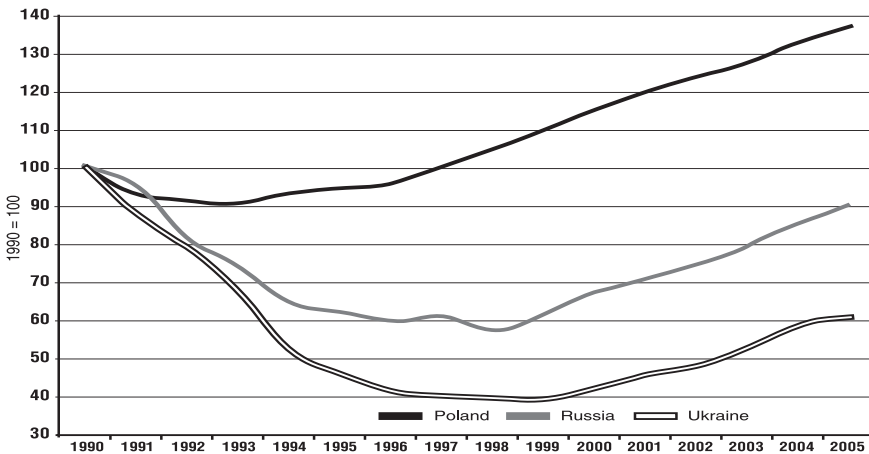
Another factor that has played an enormous and underestimated role in Ukraine's economic growth involves money transfers from labor migrants working abroad; these transfers are estimated at several billion dollars a year. Millions of Ukrainians have for a long time been working in Russia and Eastern Europe. Moreover, since 2004, migration to the EU-15 has sharply increased. Low-paid Ukrainian workers have begun replacing Polish manpower in some member states and economic sectors of Europe. Considering the low hryvnia rate, the contribution of these transfers to the Ukrainian economy has been very high, plus they help to maintain the consumption level and have a positive effect on housing construction. So it must be admitted that Ukrainian citizens working in Ukraine, Russia and the EU have ensured success for their country.

Kiev's successful fiscal policy, as well as in some other areas, has also contributed to the stabilization and growth of the national economy. Ukraine has begun to rise, together with Russia (after the financial crash of 1998) and the EU, and most notably between 2004 and 2005. The transitional crisis in the previous years was very acute, and Ukraine's GDP still remains low against the 1990 level (see Diagram 16). It is closer to the GDP of Georgia and Moldova, which have gone through civil conflicts and still have unsolved territorial problems; these factors have greatly complicated their development in the period between 1990 and 2005. If the Ukrainian economy continues to grow at an average rate of 5.5 percent a year, it can achieve the 1990 level only by 2015, while Russia can achieve this figure by 2007. These estimates do not take into account the shadow sector, which, like in Russia, is a major factor in the incom-

plete collection of taxes; yet it helps to maintain a high level of private consumption and housing construction.

Economic growth in transitional economies is a fragile matter: all factors may promote growth in a country, which may help to normalize the budgetary process, cut inflation, increase consumption and attract more investment. However, if the nature of the effect of external factors suddenly changes, the growth of export markets slows down, the cost of imported energy resources (most importantly, oil) dramatically increases, while the pressure of populists on the budget grows, thereby sparking inflation. A growth in wages starts overtaking labor productivity, thus provoking a decline in profitability and competitiveness of products. Ukraine has found itself exactly in such a situation – and just before elections. More importantly, there has also recently emerged the problem of price hikes on gas that Ukraine buys from Russia. This is a difficult situation even for the political elite of a country that enjoys a very stable democracy and government. In the meantime, in Ukraine there are three leading parties with an electoral ceiling of about 15 to 20 percent each, plus many small parties, lots of interests, and regional imbalance (the politically influential

Diagram 2. The GDP rate of Poland, Russia and Ukraine (the 1990 level equals 100 percent)



Source: National statistics committees, IMF.

Western Ukraine economically depends on the Eastern industrial areas). Given these factors, the politicization of these issues is inevitable, not to mention increased attention on the part of the media and various interested groups.

GAS AND ECONOMIC TIES

From an objective point of view, the rapid increase in the demand for natural gas in Europe is a reflection of its economic and ecological advantages. In the sphere of energy consumption, gas has begun to replace oil and coal, while nuclear power engineering has been in a state of stagnation since 1986. Western Europe has long been pegging the price of its gas to the price of oil and oil products; this explains why the jump in oil prices prompted a rise in gas prices. This principle of price formation is a reality that helps to achieve balance and save energy resources. Against the European Commission's expectations, the formation of a spot gas market in the EU countries has failed to bring down gas prices; on the contrary, it has brought about the opposite result: in late 2005, spot prices soared high above the prices established in long-term contracts.

In the post-Soviet space, gas prices until recently were maintained at a low level for political reasons, although this practice should have been stopped long ago. Naturally, even then a price hike could have been described as a political move. The price level of \$50 per 1,000 cubic meters was set in the second half of the 1990s when export prices in the European gas market stood at about \$70 dollars per 1,000 cubic meters and when relations with East European countries in the gas sphere still preserved vestiges of agreements set down in the days of Comecon. So the gap in prices was quite comparable with transit costs on the way from Ukraine to the EU-15 market, while the growth in gas prices in the EU-25 market in 2004-2005 was so great that it has made the situation dramatic.

The intricate overlapping of economic ties, corporate relations and political problems has made the issue of Gazprom's relations with gas consumers in the CIS countries very difficult, and here we have an interesting case where the Russian side is

objectively interested in depoliticizing economic relations. Thus, Gazprom has finally found it advantageous to introduce more transparent corporate relations and contracts. Nevertheless, economic actors in particular consumer countries (particularly energy companies and gas-consuming industries) have a natural temptation to politicize the problem in a bid to preserve low prices and rents wherever possible.

The circumstances surrounding the 2004 presidential elections in Ukraine, together with the clumsy participation of Russian advisers and politicians in the campaign, give grounds to believe that the recent gas price hike was some sort of revenge on the part of Russian political circles for those events. The opposite cannot be proved, of course, especially when we are speaking about forces that are traditionally suspicious of Russia's actions. Actually, there are many coincidences here. The negotiations on price hikes as of January 1, 2006 were set to begin several months before the year's end. By that time it had become clear that Ukraine was not interested in joining a Common Economic Space (CES) with Russia as previously planned. Thus, there were no grounds left for special economic relations between the two countries, not to mention politically motivated low oil prices.

Purely economic reasoning was strong enough to increase prices for large consumers, which corresponded with the general tendency throughout Europe. This was the "last price shock" in the CIS countries since they had switched to world prices in the early 1990s; it was also the last shock since the 75-percent devaluation of the ruble in 1998. In the autumn of 2005, trade in all raw materials – from bananas to crude oil – was already being conducted at world prices. Gas remained the last vestige of the once-unified Soviet infrastructure that preserved a dubious sort of unity and added an excessive degree of politicization to the pricing issue. The division of the two largest economic entities in the post-Soviet space, that is, Russia and Ukraine, was the longest and most painful. The end of the "political divorce" has freed economic relations from the political component. From the economic point of view, the timing was quite propitious for such an event considering that there had

already been five to six years of economic growth. As for the political circumstances, it is difficult to imagine any “right” time for abolishing cheap gas for some Ukrainian industries, which certainly believed there would never be a right time. The transition to normal relations was delayed for years, which resulted in losses for Russia’s gas sector and in indirect subsidizing of the competitive Ukrainian industry. Tensions over this issue were inevitable, as was its politicization inside and outside Ukraine.

The gas price hikes in the CIS and especially in Ukraine have triggered such a strong reaction because they have affected deep-rooted gas interests and rents. The international mass media describes the role that gas plays in Ukraine’s energy sector and economy as artificially inflated and politicized for several reasons. First, the Ukrainian economy receives gas either directly from Russia or via Russia (excluding Ukraine’s own gas output, which meets 25 to 30 percent of the country’s consumption needs), which makes this situation a bilateral problem. Second, 80 percent of Russian gas transported to Europe passes through pipelines across the Ukrainian territory. These two factors immediately turn a normal item of trade into an issue of bilateral or even international policy.

Naturally, all interested parties receive an excellent opportunity to defend their profits and rents with the help of various political combinations. The competitiveness of some Ukrainian industries (metallurgy, the production of ammonia and nitrogen fertilizers, and others) greatly depends on Russian gas prices. At the same time, the household sector has an immunity to gas price fluctuations for several reasons. First, nuclear power plants produce about half of Ukraine’s electricity supplies (which make up only 20 percent of all electricity-generating facilities), whereas gas, in contrast to Russia, does not dominate in this area. Second, Ukraine extracts about 20 billion cubic meters of natural gas, which meets the requirements of the local population. (Incidentally, since Soviet times Ukrainian rural areas have been better supplied with gas than the Russian provinces.) Now that the Ukrainian economy is on the rise, the price of imported gas influ-

ences the profitability of individual industries only and is not critical for other economic sectors. Also, the growth in oil prices has not produced a strong political reaction from Ukraine's industrial circles, although Ukraine imports oil from Russia at increased prices calculated according to the situation on the global markets.

Naturally, Ukraine's habit of buying gas at prices below those in Europe has created a strong interest in preserving these subsidies for industrial enterprises. There is a well-entrenched suspicion that (politicized) long-term price regimes introduce hidden subsidies, which translate into huge profits for re-wholesalers and those who have access to the gas tap. The aggregate volume of cheap gas bought by Ukraine from Russia and Turkmenistan exceeded the country's domestic requirements and enabled it to resell surplus gas to the West.

GAS HISTORY

The Russian-Ukrainian negotiations held in 2005 and 2006 on new gas prices had a history. For a long time, especially in the 1990s, Gazprom repeatedly had difficulties receiving payment for gas supplied to Ukraine or siphoned off by the Ukrainian side from transit pipelines. From time to time those debts were written off or rescheduled within the frameworks of broader agreements. On the one hand, there was a surprising contrast between the transparency and stability of Gazprom's contracts with Western buyers, while on the other hand there was a surprising lack of transparency of contracts for the delivery of gas to Ukraine, including the terms of its transit to Europe. Assuming that the transparency of contracts and pricing mechanisms are indisputable advantages of market relations, then steps to normalize the system of access to transit flows and pricing can only be welcomed. Yet, in a way, it was the streamlining of the contract system that caused such a conflict.

Technically speaking, Russian gas passes through the gas transport system in Ukraine and, depending on the seasons, travels to underground storage facilities from where it is sent to Europe under special agreement. Ukrainian gas companies are actually the execu-

tors of Gazprom contracts. The entire system was created as a single complex, yet it lacked time-tested mechanisms. There repeatedly emerged conflicts over supplies and “unauthorized siphoning.” Perhaps the gas accounting system was imperfect along this route that is so vital for Europe. Wintertime fluctuations for demand in Ukraine exerted pressure on the system, although the capacities of Ukraine’s storage facilities were constructed to compensate for these fluctuations. In early 2005, there erupted a scandal after several billion cubic meters of gas failed to reach the proper destination in time, as agreed under contracts. Kiev offered several explanations of the situation, which ranged from “we did not have this gas” to “we’ve found it;” eventually the conflict was soon settled. Yet this episode made Gazprom contemplate about the future. Another episode of unauthorized gas siphoning in mid-January 2006 – a mere two weeks after Moscow and Kiev signed an agreement – attested to the gravity of Ukraine’s internal problems with managing the industry and fulfilling its part of the contracts.

As gas prices continued to climb in 2005, the situation became increasingly acute: the gas rent in Ukraine grew, political relations between the two countries were strained, and the economic growth in both countries slowed down (the growth rate in Ukraine fell by about 60 percent). Gazprom extended its long-term investment plans and was interested in additional incomes. Such was the *mise-en-scène* for the brief, nervous and very unpleasant gas conflict, which will have serious consequences for companies, economies and politics of the countries involved.

Gazprom’s move to announce its pricing plans to the business circles of Europe *in advance*, and explain its investment plans and difficulties in relation to the transit of gas, showed the corporate nature of the conflict. According to mass media reports, Gazprom preventively employed a Western auditing firm in order to ensure the transparency of gas accounting. As the conflict was settled out of court, the details of what happened in early 2006 are known only in the form of statements. Gazprom must have thoroughly prepared for legal proceedings, and this factor may have played a role in the drama.

The most important thing was, of course, Gazprom's determination not to back down and raise prices, as well as demand cash payment for transits. In the corporate world, proper settlements and prudent conduct are no less important than in politics; any loss of face may result in huge losses in the future. On the whole, both parties checked the strength of each other's positions: in the absence of a mutual price agreement, Gazprom began to cut gas deliveries only to cover transit supplies to the EU, while Ukraine began to siphon this gas. Naftogaz's actions (considering Gazprom's preparations) cannot be defended in court – one cannot simply take gas without a contract; explaining why a particular amount of gas was taken is impossible. Gazprom's position was vulnerable from a legal point of view for rather strange reasons: How can it fulfill its obligation to supply gas to the EU under long-term contracts, while it does not have a new transit contract? Naftogaz's explanation that it took Turkmen gas from the pipeline (January 1-3, 2006) was unjustified, as it did not have a contract for gas transit via Russia.

The parties finally realized the absurdity and hopelessness of such developments and reached a compromise. Importantly, *this was not a zero-sum game* – many parties have gained. However, in this case there are two monopolies involved – gas and gas transit – and there could not be an easy solution to the problem. (Russia, for its part, has a monopoly on the transit of Central Asian gas.) Ukraine and Russia have found a level of understanding in the new agreement, and the monopolies are not paralyzing each other and not infringing on the interests of third parties. The drama at the beginning of the year would not have occurred had the parties earlier realized the inevitability and normalcy of changes in this area.

Many people in Russia and around the world failed to understand how difficult it was for the Ukrainian side to conduct these negotiations. Until recently, Ukrainian companies experienced difficulties receiving payments for gas and electricity supplies inside the country. It was only recently that this internal problem was solved, although the financial position of the energy companies remains problematic. Thus, the World Bank cited this realm as one of its projects for Ukraine: it will be pushing for transparency, together with

an estimation of the situation in addressing energy sector problems, including old debts and restructuring of property and owner rights necessary for attracting new investments. For those who are familiar with the World Bank's politically correct language, it is obvious that the management and finances of energy companies in Ukraine are in a difficult position, which only impedes the solution of interstate problems when import prices are raised.

We may question how feasible it was for the Ukrainian government, whose powers were set to expire in March, to agree in January to changes in its generous gas contract with Russia, thus endangering rents, hidden subsidies and profits of interested circles. Considering the heavy publicity that the conflict attracted, possible interference by the West, and the growth of nationalistic tendencies in its relations with Russia, it was extremely difficult for Ukraine's economic and political leadership to sign a new agreement. The new agreement requires a revision of the 2006 budget (already approved with a deficit), thereby concluding new internal contracts, as well as the implementation of extensive organizational work that Ukrainian economic agencies should have conducted throughout the autumn of 2005. The developments of mid-January 2006 proved that this work had not been done.

WHO STANDS TO WIN?

The objective results and terms of the contract meet Gazprom's business strategy. The economic aspect of the agreement is very simple:

- Gazprom receives its \$230 per 1,000 cubic meters of gas within the limits of 17 billion cubic meters, although indirectly (actually, this is the cost of gas resale to the West);
- Gazprom pays \$1.6 per 100 km for every 1,000 cubic meters of gas pumped across the Ukrainian territory;
- cheap Central Asian gas and expensive Russian gas are supplied in a package deal through an intermediary legal entity, Rosukrenergo, so Naftogaz pays a weighted price of \$95;
- the resale of Russian gas without participation of the Russian party is ruled out.

The consequences of the new deal require in-depth analysis, so let's consider the gains and losses of the major parties involved.

The main beneficiary of this agreement is the European Union and countries that rank as main gas consumers. They do not need any conflict concerning the basic routes of gas transit to Europe. Besides, the EU has long sought a stable outlet for Central Asian gas into Europe. Now (at least, in 2006) Central Asian gas supplies will flow in maximum volumes through Ukraine, and the released Russian gas will go to the EU. The cost of gas and the cost of transit have been divided. This is a step forward, although this is not quite in line with the wishes of the European Commission, which is interested in the free movement of gas supplies across Russia and other CIS countries. If there arises – in earnest, not just as a subject for discussion in the mass media – the issue of diversifying gas supply sources to the EU, the Russian-Ukrainian conflict may have interesting consequences, such as a renewed search for alternative energy sources and a rethink of the role of coal and nuclear energy in some countries (Germany, Great Britain, etc.).

The second major beneficiaries to the agreement are the Central Asian countries – Kazakhstan, Uzbekistan, and Turkmenistan – which have stable contracts for the export of gas to Ukraine. Naftogaz is now likely to reduce imports of expensive Russian gas in favor of Central Asian gas. Such developments may bring about a situation where Gazprom would only supply gas to countries west of Ukraine, while relations between the Russian and Ukrainian parties would be reduced to issues involved in “mutual transit:” from Russia via Ukraine to the EU, and from Asia via Russia to Ukraine. Such a situation would equally suit both Gazprom and Naftogaz, whose mutual settlements would then be reduced to payments for transit.

The third beneficiary is Gazprom. It has released huge volumes of gas (more than 20 billion cubic meters a year compared to 2005), which previously was used as payment for its gas transit across Ukraine at a cost of one-fifth of the established market price (\$50 as opposed to \$230). Gazprom has cut the actual vol-

ume of payment for transit, if calculated in gas rather than in dollars. Estimations of the aggregate additional income that the agreement provides the Russian party vary, but all of them put it at over \$2 billion. Gazprom has also secured itself against the possible resale of its gas to the EU. At the same time, the deal provides certain benefits for the Ukrainian side since it now has a more convenient mechanism for receiving Central Asian gas supplies; the Russian side has assumed the risk of high payment costs for its gas transit, while ensuring a steady source of income for the Ukrainian party. Also, Gazprom has taken additional measures to improve its gas accounting, thus reducing the probability of unauthorized siphoning of its gas. Yet, Gazprom has losses as well: the image of a huge and merciless company may be rated highly in Eastern Europe or, perhaps, in Asia, but not in Western Europe.

Ukraine has received a complex package, in which its gains or losses are not obvious. In particular, it has settled the conflict with a large gas supplier, which is also a potential investor and partner. Furthermore, Ukraine's Naftogaz has shed its tainted reputation as a company that engages in the unauthorized siphoning of gas (for which it gave vague explanations) and has thus improved the position of its country, especially as the latter has ratified the Energy Charter Treaty. Also, it has ensured the supply of relatively inexpensive gas, the access to which is provided by the same partner.

The growth in gas prices was inevitable, yet it took place amidst economic growth and amounted to about 40 percent of the price paid by the majority of West European countries. The price rise was a shock for some industries, but it was not a tragedy. A gradual price hike is a rational yet belated idea — all reforms of the early 1990s, or adjustments made following the 1998 financial disaster, should have been carried out step by step. This would have made life easier for those citizens living within the post-Soviet space.

The main losers from the New Year gas conflict are those who made profits from the price differences. For example, in 2005 Russia supplied its gas to Ukraine for \$50 per 1,000 cubic meters, whereas prices in the EU exceeded \$200 for the same amount.

Other losers include the chemical and metallurgical enterprises. On the other hand, why should Gazprom subsidize Indian-born British billionaire Lakshmi Mittal, for example, who purchased Ukrainian steel giant, Krivorozhstal? Objectively, economic actors, namely Ukrainian enterprises, must pay an additional three billion dollars for its gas (60 billion cubic meters at \$95 per 1,000 cubic meters, instead of \$40 to \$50).

There is yet important question to this new agreement: How will the gas price hikes affect economic growth in Ukraine? Estimates by the World Bank (October 2005), which predicted that Ukraine would experience a decrease of four percentage points in 2006, stemmed from the supposition that gas prices would be raised to \$115-\$125 per 1,000 cubic meters. The main problem with such estimations involves the quality of the model and its prerequisites, as well as the general dynamics of the economic situation. The growth in gas prices proved to be half the expected figure (in the first six months of 2006; it is still unclear how the situation may develop in the second half-year); economic growth in the world continues, while Ukrainian exports are expected to continue growing. Given these factors, the possible slowdown in Ukrainian economic growth can be estimated at just two percentage points. Determining a reference point from which to calculate a decrease in Ukraine's GDP growth rate, however, is a difficult problem. In 2005, despite low gas prices and the favorable conditions of the global economy, the growth rate of Ukraine's real GDP plummeted from 12 percent to 4.4 percent – entirely due to internal factors. If the main parameters (growth, inflation, and budget) of the national economy remain within reasonable boundaries in 2006, which is quite probable, the shock will be absorbed. But if growth rates fall too sharply, it will take a serious analysis to divide the objective economic processes, the negative influence of internal political processes, and the gas shock from each other in the short and long term.

The savings rate in the Ukrainian economy is higher than the accumulation rate, so at the aggregate level additional payments

must not undermine the balance of payments and financial resources for accumulation. There will be difficulties with administrative problems and the national budget, considering the urgent need to adapt to the new prices. Tariffs inside Ukraine have in the last few years been paid 100 percent, but there may arise problems with the collection of payments, which will present a burden for the next government. So this subject is going to be interesting for the analysts for a long time, it appears. Ukraine has already been recognized as a democratic country; now it arouses sympathy as a “victim.” Any continuation of the conflict would inflict more damage on Ukraine than Gazprom, as businesses in Europe understand the importance of stable gas supplies.

Table 2. Ukraine’s Major Economic Indicators, 2000-2005

	2000	2001	2002	2003	2004	2005
GDP, \$bn	31.3	38.0	42.4	49.5	65.0	82.0
GDP per capita, \$	629	771	867	021	1,340	1,690
Ratio to GDP, %:						
Savings	24.7	23.4	24.6	24.6	28.1	22.7
Capital Formation	19.7	21.8	20.1	22.0	18.7	19.5
Budget revenues	27.3	25.4	27.5	28.5	26.5	32.3
Budget spendings	25.1	27.0	26.7	28.7	29.3	33.6
Budget deficit	2.2	-1.6	0.8	-0.2	-2.9	-1.3
Export, goods and services	62.4	55.5	55.1	58.4	61.1	54.0
Import, goods and services	57.3	53.9	50.7	55.8	53.6	52.8
Inflation, consumer prices or CPI						
Index, %	25.8	6.1	-0.6	8.2	12.3	11.0
Industrial production, %	12.4	14.2	7.0	15.7	12.5	2.9

Source: Statistics Committee of Ukraine, National Bank of Ukraine, estimates by the Institute of Energy and Finance

GLOBALIZATION IS INTERDEPENDENCE

The Russian government managed to depoliticize the negotiations as much as it could. At the same time, it could not avoid accusations that it “punished Ukraine for the so-called Orange Revolution” – the decision to shut off gas supplies as of January 1 had a bad press. One reason for this bad press was the nature of Gazprom’s ‘propaganda’ campaign that was targeted at unbiased, well-informed and rational market-economy experts. But experts and businessmen in Europe understood the economic roots of the conflict even without an explanation; the rest of the story fell into a political context. Overt attempts to reach understanding before the inevitable conflict possibly played a role among experts and businessmen, but failed with regard to politicians and public opinion. Surprisingly, Gazprom may have believed that transparent market relations were the basis that would ensure understanding and support for its decision in Europe. The obvious fact that many mass media and politicians in the world would have been against Gazprom (that is, Russia) irrespective of its actions makes intensive planning, rather than neglect, all the more necessary. The situation is not much different from the inherent bias in figure skating – if you do not trust judges, make a six-turn toe loop jump. But Gazprom, trying to present this conflict as non-political, either pursued a too narrow strategy, or did not want to violate unwritten business ethics and reveal something about its negotiating partners.

It is probable that repeated statements by the presidents of Russia and Ukraine about the “non-political” nature of the conflict helped to reduce the parties’ losses and reach agreement. Some politicians and mass media in Russia, which are now celebrating the “victory,” are wrong in principle. Similar statements by the Ukrainian side about a “victory” are forced for internal political reasons. From our point of view, this is a rare, even unexpected, case of a victory of common sense over conflict, of economics over politics, and of long-term stable relations over short-term rents. Sober-minded observers say “we saw an appropriate shift from political to market pricing, not vice versa as commonly represented.” (White Paper:

Russia-Ukraine Natural Gas Dispute. *PACE Global*, 13 January 2006, p. 12. www.paceglobal.com)

Ukrainian President Victor Yushchenko holds the same point of view: “The gas compromise came unexpected to many in Ukraine. Oligarchs were against it, as it meant an end to the largest bartering scheme in Europe”. But external consequences overshadowed the corporate and rent nature of the conflict. The unauthorized siphoning of gas by Naftogaz in the first few days of 2006, combined with the heavy financial losses suffered by Gazprom, were a violation of contractual principles of the market economy, yet not dramatic enough for politicians and mass media in the rest of the world to feel sympathy for Russia’s gas Leviathan. The essence of economic problems for the European member countries of the CIS has so far remained obscure to Western political circles, mass media and the public. These problems must be delineated in a more delicate and patient way, with more simplicity and clearness. Instead, we shocked Europe with news of an unprecedented reduction of non-contractual gas supplies, thus provoking mass media stories about the “gas threat from the East.” If someone wanted to tarnish Russia’s reputation, he could give the following advice to our negotiating partners: “Price growth is inevitable, but let these Russians show their true colors – let them cut off gas supply at least for one hour, and conclude an agreement with them on January 4.” Noteworthy in this respect was an attempt by some mass media to reduce the conflict either to Russia’s “pressure on Ukraine,” or only reporting on the gas cut-off without mentioning the contractual aspect of the conflict.

It is important to note that there is neither a reasonable purpose nor a reasonable scenario for Russia wielding its energy resources as some kind of a weapon, which began to be widely discussed in the CIS and Europe. Obviously, neither the foreign critics, nor the hotheads in Russia have been able to prove such a scenario. Interestingly, the Soviet Union supplied Western Europe with oil and gas throughout the 1980s, but Europe did not fret much about that.

Russia does not need to use energy resources as a “weapon;” moreover, the very idea is highly disadvantageous to it. Of course, Europe increasingly depends on the Russian economy as regards oil and gas supplies, but Russia also depends on Europe to a high degree: the larger part of Russia’s imports come from Europe. Furthermore, Russia finances its own development with revenues from oil and gas exports. Diversifying sources of energy supply is a good thing, but it takes much money and time. At the global level, everything is mixed together, thus, the world cannot afford to let even one large oil exporter (for example, Iraq) reduce its level of extraction since oil prices would soar immediately. Interdependence is universal; such is the nature of the contemporary world. To put it differently, the world is interested in political and economic stability in Russia, because market regularity largely depends on Russia’s energy exports.

A fundamental issue for Russia is the re-investment of revenues from the export of raw materials and energy resources toward the modernization of the economy. But politics is a tricky thing, and one can always find ways to invent threats from the East. The corporate nature of the Russian-Ukrainian conflict, that is, the energy rent that Ukrainian industrial enterprises received and will continue to partly receive as compared with the rest of Europe, remains on the sideline of the debate for experts and businessmen.

But the more dramatic images of the conflict remain in the memory of the Europeans who tend to view Russia as the cause of that drama. In the European countries, tenants who fail to pay the rent are evicted, but this is done by a court decision and in a humane way. The gas conflict, especially the abrupt halt of gas supplies, is viewed in Europe as a problem of human dimensions; a drama of human relations, which must be treated accordingly. Ultimately, however, it was simply the sad continuation of the fifteen-year history of the breakup of this once single economic space.

Pre-election tensions prevented politicians in Ukraine and many mass media around the world from assessing Russian-Ukrainian relations in an unbiased way. But Russian analysts and mass media must and can be more far-sighted and self-critical so that the coun-

try's long-term interests are not damaged, while ensuring that Russia's methods for solving economic problems are clear to the rest of the world. Civilized market-based economic relations on the post-Soviet space can be beneficial for all, although they should include the interests of Russian enterprises and Russia's national budget. If Russia is to stop playing the role of the Big Brother in the CIS – in line with the wishes of policymakers in other countries, then it is not intended to support (and especially, subsidize) the development of its neighbors to a greater extent than any other country. This is especially fair as the results of the transition crisis are unsatisfactory for us as well; unlike Poland, for example, Russia has not yet achieved the 1990 GDP level.

Finally, there inevitably arises the question as to what effect the gas conflict will have on the Group of Eight summit to be held in Russia's St. Petersburg in July 2006 and that will focus on energy security. Interestingly, the world is divided on the notion of “energy security” and has not agreed on a shared energy policy. The world's reaction to high oil and gas prices shows that all groups of countries interpret energy security in their own way, as part of their own agenda of development and economic growth. Russia has not yet presented, at least publicly, its own concept of this notion or measures to ensure energy security. Therefore, it is difficult to estimate the immediate consequences of the gas conflict for the negotiating process. Of course, the January 2006 developments will influence the negotiations and the St. Petersburg summit. It is important to distinguish objective factors behind tendencies in the energy sphere from their political, propagandistic context.

Russia must present a serious plan on this subject of energy security. The problem remains, however, that the world's energy industry deals not only with objective data pertaining to the extraction, energy infrastructure, prices and energy consumption, but also with billions of people who live in the troubled and unstable 21st century. The world's multilateral energy interdependence makes policymakers particularly responsible for ensuring energy security and inspiring confidence in this security for all nations involved.

Economic Targets



“ To cushion a possible crisis, the government must work out, without delay, a plan of action in case the world economic situation deteriorates. A decrease in oil prices and the government’s reaction to it will be a maturity test for Russia’s political elite and a gauge for determining the country’s real devotion to a responsible economic policy. ”

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Russia's Economic Policy — Setting Priorities

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In the last few years, Russia's economic development has been characterized by two major tendencies: consistently high economic growth rates and the growing involvement of the state in the country's economic life. In 2005, the growth rate reached 6.4 percent of the Gross Domestic Product, against the 5.9 percent that had been predicted before the beginning of the year. Importantly, the growth rate of the Russian economy exceeded growth rates in the most developed nations and in a majority of the post-Communist countries.

The Russian government's policy for achieving high economic growth rates is comprised of different approaches. On the one hand, the government continues to improve the general economic management environment through administrative, tax and budgetary reforms, together with the monetization of social benefits and other moves. On the other hand, it is creating mechanisms for a private-state partnership, which presupposes the emergence of fundamentally new economic instruments that would ensure the direct involvement of the state in developing and implementing specific economic projects.

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ECONOMIC GROWTH AND NATIONAL PRIORITIES

For almost two years prior to December 2005, Russia had no officially approved mid-term program for social and economic development (this is a noticeable difference from the previous post-Soviet years; since 1992, the crisis year, there had been no precedent of a Russian government operating without a program for even a year). The government cited the absence of a clear understanding of the mechanisms for doubling the GDP – the goal set by President Vladimir Putin – as the main reason for the lack of an officially approved program. Prime Minister Mikhail Fradkov justifiably argued that, from a political perspective, the absence of a program was better than a program that did not provide a clear solution to the problem of doubling the GDP. The Ministry for Economic Development and Trade, responsible for the program's development, declined to assume full political responsibility for the economic growth program. That was a natural move, as economic growth is a very complex phenomenon that depends on many economic, political and social factors. Moreover, economic growth in contemporary Russia depends not only (and not so much) on the state of economic institutions as on political and legal factors, such as viable governance, judicial and law-enforcement systems, together with the state's ability (or inability) to ensure execution of its legislation.

For example, the development of business requires the guaranteed execution of contracts. However, if the judicial and law-enforcement systems fail to ensure the necessary conditions, the businesspeople will be burdened by the costs for ensuring the execution of contracts. This factor considerably increases the costs while reducing the competitiveness of doing business. Another important problem concerns the personal safety of businesspeople.

More and more people in Russia understand that the country needs economic growth not per se and not at any cost.

There are several circumstances that the government must take into account when working out a successful economic growth policy. First, high growth rates are needed in the long term, rather

than for the government's reports on its work in the next two to three years. Second, high growth rates are well grounded only when the necessary structural transformations accompany them. These include, most importantly, the diversification of the economy, the reduction of the economy's dependence on the fuel/energy sector, and an accelerated development of post-industrial sectors (high-tech services). Moreover, at certain stages progressive structural transformations may actually be accompanied by a decrease in growth rates. Third, the growth rate must help Russia reduce the gap between itself and the most developed countries of the world, that is, the growth rate of the Russian economy must be higher than the average world rate and the rate in the most developed states. Fourth, this must be real growth, not an artificial growth forged to meet the political situation or to please political leaders. Fifth, there exists the danger of orientating state policy directly to the tasks of economic growth without discussing the economic policy's quality. It must also be acknowledged that economic growth can be achieved not only through natural investment and saving activity, but also through the formation of a mobilization economy similar to the Soviet model based on forced saving and "belt tightening."

This explains why the focus of discussions about economic growth is increasingly shifting to issues pertaining to structure, quality and institutions: it derives from the definition and discussion of strategic priorities for Russia's social and economic policy.

Throughout its post-Communist development, Russian society has demanded that the government set long-term priorities for the country's social and economic development and outline industries that the state would support and stimulate by means of budgetary and tax measures, as well as protect from foreign competition. However, such decisions could not be made simply for political and economic reasons.

Politically, priority setting was impossible given the conditions of the social struggle that accompanied the revolutionary transformation of the 1990s. From an economic point of view, it was impossible for the state to set industrial or other sectoral priorities

since the development of the post-industrial system is incomparably less predictable than the development of the industrial system. The experience of the most developed countries shows that investment in human capital is becoming the key factor in economic growth today. This type of investment creates the conditions for steady and dynamic growth, together with the continuous adaptation of the social and economic structures to new, unpredicted turns in technological progress. Besides, investment in human capital creates demand in numerous related sectors, thus producing significant exponential growth.

Over the last two years, Russia's political leaders and government experts have actively discussed the important role of human capital. The subject was even included in the Russian president's State of the Nation Addresses to the Federal Assembly. Finally, in September 2005, President Putin proposed it as one of his "national projects" – part of the national priorities for the country's development. These include the development of education, public health services, housing construction (the introduction of mortgage lending), and the solution of social problems in rural areas.

The inclusion of these spheres in the national priorities list actually means the beginning of a new stage in Russian economics and politics.

Indeed, during the last 15 years Russia passed through two stages in its development. In the first stage, which comprised the 1990s, the country struggled through a large-scale macroeconomic crisis and created basic economic and political institutions – private property, monetary system, tax and budgetary systems, and federalism. Those efforts were reflected in the Constitution and the Civil Code of the Russian Federation. In the second stage (2000-2003), the emphasis was made on the formation of basic economic institutions – tax, land and bankruptcy legislation, the transformation of natural monopolies, the removal of administrative barriers to business (deregulation), etc. Those decisions only recreated what existed in all countries with a modern structure of society, undistorted by the Communist experiment.

“National priorities” are different in essence. On this point, Russia is not confronted by a crisis related to the Soviet social system, but rather problems that are characteristic of all post-industrial countries. Post-industrial challenges, with their demographic problems, have introduced a crisis of the traditional “welfare state,” which currently presents many countries with the need for an in-depth transformation of their social sphere.

Work on each of the aforementioned national priorities requires two kinds of efforts. On the one hand, it needs the allocation of extra budgetary funds for raising workers’ salaries in corresponding industries and groups of the population; on the other hand, it calls for the implementation of structural reforms in corresponding sectors. These two kinds of efforts are inseparable from each other, and it would be politically dangerous and economically inefficient to address one task while ignoring the other.

Raising salaries for doctors and teachers, investing in new equipment, and similar financial decisions are only prerequisites for solving pressing problems, but not a sufficient condition. The quality of Russia’s educational and medical services depends not only on the level of remuneration and the attraction of qualified personnel into the social sphere, but also on the efficiency of the respective systems.

Moreover, increased funding without structural reforms may produce unwanted results. Higher salaries will not help to rejuvenate personnel but will only conserve them. Thus, many doctors and teachers who have long lost the qualifications to perform their tasks will not start to perform more professionally, even if their salaries are increased one hundred times.

Increased spending on new equipment may result in expenditures at inflated prices, while the purchased equipment may not be what the hospitals and laboratories really need.

In the sphere of housing construction, increased funding, given the present level of monopolization of the market of construction services, can only boost prices and enrich a handful of businessmen who have become local monopolists.

Of major importance is preventing budgetary populism in implementing national projects. The budget must not only remain

well balanced, but it must also be formed on the basis of rather conservative oil price forecasts. Besides, a very short period of time (about two years) must be established for specific projects. During this time, it is possible to predict with high accuracy the incoming of funds required for specific projects.

MECHANISMS FOR ENSURING ECONOMIC GROWTH

High economic growth rates can be ensured by means of the following basic mechanisms: improving institutional conditions for economic development; boosting the state's role in the country's economic life; forming mechanisms for the private-state partnership; and ensuring macroeconomic stability while preventing populism in monetary and budgetary policies.

Economists have become divided between proponents of a dirigiste approach to the consolidation of economic growth and those of an institutional approach. The polarization between the two camps became apparent in 2004 when two other variants for solving the problem of consolidating growth (through development of financial & industrial groups and through resolute liberalization) lost their political importance.

However, the acuteness of the discussions between proponents of the dirigiste and institutional approaches has subsided. The state's direct involvement in the economy has acquired more transparent and institutionalized forms (for example, with the Investment Fund), which have replaced unsystematic attempts to interfere in the economy by means of decisions on individual enterprises or sectors. In 2004, industrial strategies were viewed as a direct alternative to institutional reforms, whereas in 2005 these strategies made up only one (concluding) section in the Mid-Term Program, approved by the government on December 29, 2005.

In the last few years, Russia has continued to improve its economic and social legislation. In particular, it proceeded to reform individual natural-monopoly industries (except the gas industry) and develop natural-monopoly laws. Additionally, it reduced the volume of licensed kinds of activity, adopted important laws on concession

agreements and on special economic zones, and toughened state procurement procedures with a view to introducing maximum transparency. Another important event was the adoption of an amendment to the Civil Code, which has reduced the statute of limitation on privatization transactions from ten years to three. This move has in effect legalized the results of the mass privatizations that took place in the 1990s. This decision can become an important factor for boosting the investment activity of Russian businesses.

At the same time, the government made no radical moves in the institutional sphere, which can be explained by several reasons. First, the government needed a pause after two years of administrative reform that had essentially transformed the entire system of state governance bodies. It needed some time to adjust to the new reforms, especially as the initial results required in-depth analysis. Briefly, the transition to a three-stage system of executive bodies was accompanied by confusion and the loss of the level of governability that had been characteristic of the first few years of Putin's presidency. It was only by the end of 2005 that the new state bodies began to interact more efficiently.

Another circumstance that delayed institutional reform was the shock the government experienced from street protests that broke out in January 2005 following the Kremlin's decision to replace non-monetary social benefits with cash payments. The protests made the government postpone its municipal reform until 2009.

Third, several highly anticipated reforms could not be launched due to the imperfection of law-enforcement practices.

This last factor poses a serious problem for Russia's economic policy. The state of government, judicial and law-enforcement systems is a major obstacle to the improvement of economic legislation. This refers, above all, to antimonopoly regulation, taxation, and customs policy.

The government is now actively working on new antimonopoly legislation, which is of vital importance because the monopoly nature of some areas in the Russian economy has reduced its competitiveness and stands in the way of long-awaited reforms in several sectors (for example, it prevents the development of mort-

gage lending). The Federal Antimonopoly Service (FAS) has come out with a new antimonopoly bill, largely based on European Union standards. If adopted, the bill would serve the important task of harmonizing Russian and EU legislation. However, the bill has come under fierce criticism, and not only from monopolists and certain liberal economists. The main point is that practical implementation of the antimonopoly law is impossible without the active involvement of numerous authorized state employees, not to mention an effective judicial system. In other words, the FAS bill presupposes the introduction of EU procedures for antimonopoly regulation in Russia's law-enforcement environment, which in practice would only discredit the new legislation.

Tax reform faces similar problems. In 2005, the government actively discussed further reductions in taxes, in particular a decrease in the value added tax from 18 to 13 percent. Characteristically, liberals in the government and the expert community opposed this measure, above all. They expressed fears about the budget's stability and pointed to the inefficiency of tax management. In conditions when tax inspections may result in tax charges exceeding the profits of a given enterprise over a corresponding period, the tax rate ceases to play any role in devising business strategies. Many businesspeople drew the government's attention to this problem. The president, too, in his State of the Nation Address to the Federal Assembly in 2005 stated: "Tax agencies have no right to 'terrorize' businesses."

The same refers to taxes covering the extraction of mineral resources. Perhaps the state — as the owner of the natural wealth — could gain more if, when calculating this tax, it took into consideration the variations in natural conditions at different extraction sites. At the same time, a differentiation of the extraction tax rate may become a powerful factor for corruption in those agencies that would set a differentiated tax rate for each specific extraction site.

STATE MANAGEMENT OF THE ECONOMY

The issue of state management in the economy is one of the most difficult and contradictory, yet it is vital for the develop-

ment of the Russian economy. The situation will likely develop along one of two possible avenues: there may be the consolidation of state power institutions, or increased direct interference by the state in economic life. The latter approach is prevailing in Russia as the state is becoming increasingly active in the economic process.

These tendencies are manifest by the state's increased ownership of the largest companies. Events of the last two years have shown that the state is going to consolidate its positions as the primary owner of strategic sectors of the economy, while giving up its holdings in other sectors. The state has demonstrated that it can use two different ways to gain control over property: initiating legal proceedings and purchasing formerly privatized assets. The former variant was used in the YUKOS case, when concerted actions by tax agencies and the Prosecutor's Office ensured the transfer of the private company's best assets into the hands of a government-controlled company. The latter variant was used against Sibneft, which was bought from its proprietor for \$13 billion. Similarly, the state acquired controlling interest in AvtoVAZ (bought by Rosoboronexport), Gута-Bank and Promstroibank (bought by Vneshtorgbank), and several other companies. Moreover, in his 2005 State of the Nation Address, Putin proposed forming a confidential list of industries or facilities that must remain under "predominant control of domestic, including state, capital."

However, it would be wrong to consider the YUKOS model as the least costly option for the state. The "cheap" purchase of Yuganskneftegaz produced a much more negative reaction among investors and the general public than the "expensive" purchase of Sibneft. Considering the blow to Russia's reputation that it produced, losses from that "cheap" purchase may prove very significant.

The main result of this policy is that the owners of some large private firms (as a rule, those that took an active part in shares-for-loans auctions in 1995-1996) seem to have learned the lesson of the YUKOS-Sibneft affair and are beginning to show a readi-

ness to sell their assets if offered the right price. Thus, there emerges a kind of quasi-developer business: businesspeople who are unsure about the legitimacy of their property holdings are prepared to sell their assets to the state for good money.

Simultaneously, within the framework of the administrative reform, the government has over the last few years been reducing its presence in small-scale businesses and institutions, many of which have been either privatized or transferred to sub-federal levels of management.

NEW INSTRUMENTS OF ECONOMIC POLICY
As it pursues the policy of increased participation in the country's economic life, the government has introduced fundamentally new instruments of economic policy that are intended to boost economic growth. These include special economic zones (SEZ), a law on concessions, and an investment fund. All these measures have one thing in common: they presuppose exceptions from the general management rules, and the government's pinpoint influence on economic actors.

The federal law on SEZ, adopted in the summer of 2005, allows for the establishment of two special types of zones, namely, industrial and innovative. The government is ready to offer easy tax and administrative benefits for businesses operating in these zones. Of over 70 proposals for the establishment of SEZ submitted to the government, the latter has chosen two industrial zones (to be established in the Lipetsk Region and Tatarstan's Yelabuga) and four innovative zones (Zelenograd, St. Petersburg, Dubna, and Tomsk). At the end of 2005, a new federal law was adopted on a special economic zone in the Kaliningrad Region, which has introduced substantial corrections into the existing mechanism as it moves away from importer privileges to the stimulation of production.

The new legislation differs from the previous method of creating "free zones" in post-Communist Russia and limits the possibility of abusing this mechanism. First, the new legislation establishes uniform conditions for SEZ, that is, it has ruled out "nego-

tiations” with regional authorities and interested businesses on the special zone mechanism. Second, the law has introduced a procedure of competitive selection of SEZ, while regional and municipal authorities must display their material interest in creating such a zone by allocating financial resources for the development of the necessary infrastructure. Third, the initiative has done away with all other special economic zones; these were established in the 1990s and have not produced the desired effects (except for the zones in the Kaliningrad and Magadan Regions). Fourth, the new zones are oriented to the attraction of investment in new technologies, and to the diversification of the economy, rather than to the solution of the problems of regional inequality or economic backwardness.

Another important decision was the formation of an Investment Fund within the framework of the federal budget (annual and planned for three years and within conditions of high fuel/energy prices). Actually, this is money that under other conditions would go into the Stabilization Fund. Heeding loud demands that petrodollars be used for the national economy, the government had to make a compromise decision and allocate part of the money for increasing state investment. This decision has somewhat increased the macroeconomic vulnerability of the Russian economy should oil prices fall, but it is not fatal provided two conditions are met: first, the size of the Investment Fund remains moderate compared to the Stabilization Fund, and second, money from the Stabilization Fund is used in an effective manner, that is, if it results in higher labor productivity and favorable structural shifts in the Russian economy (read: its reduced dependence on raw materials). The government must realize that if oil prices fall, money from the Stabilization Fund must be used, first of all, to fulfill commitments under investment projects, and only then to ease the reduction of other budget spending items.

State support will be used, above all, for implementing projects aimed at developing infrastructure of national importance, creating and developing elements of the national innovation system and

ensuring institutional transformations. These three areas are vital for the stable development of the Russian economy.

A very important criterion for selecting projects involves guaranteeing equal access to economic agents for receiving state support, as well as the condition that the proposed projects be free from financial risk. Certainly, “equal access” is the most vulnerable point of modern Russian realities.

Other important criteria for selecting investment projects are: the presence of a commercial organization participating in investment; adequacy of a project's objective to priorities of social and economic development and to the government's industrial strategies; positive social effects; substantiation of impossibility of a project's implementation without state participation; the project's estimated cost, which must not be less than five billion rubles; and a favorable overview of the project by an investment adviser with a well established international reputation.

The preservation and consolidation of the Stabilization Fund's role is an exceptionally important factor for ensuring steady growth rates in the long term. The Stabilization Fund is usually viewed as a source of reserve funds for maintaining the necessary level of budget spending in case the global economic situation deteriorates, or as a financial reserve for “future generations.” Meanwhile, the primary role of the Stabilization Fund is to prevent the economy from becoming overly dependent on high oil and gas prices in particular, and the fuel/energy sector in general. The Fund's political role is to prevent Russia from repeating the same fate of the Soviet Union.

In 2005, attempts were made to use the Stabilization Fund for investment financing. Given the present level of Russian export prices, pressure on the government with regard to the use of the Stabilization Fund will continue to grow. In these conditions, the government must take at least two additional steps: establish an “inviolable threshold” for the Fund, not as an absolute value, but as a percentage of the Gross Domestic Product, and second, considerably increase the efficiency of budget spending.

CHALLENGES AND TRENDS
OF SOCIAL AND ECONOMIC DEVELOPMENT
The further development of Russia's economic policy will depend on the following three factors: post-revolutionary stabilization, challenges of post-industrial society, and the price regime that has been established over the last few years with regard to basic Russian exports.

Post-revolutionary stabilization. In the last five years, a high level of macroeconomic and political stability has characterized Russia, which is particularly evident in contrast with the situation of the late 1980s-early 1990s. The full-scale revolution that Russia experienced while implementing the systemic post-Communist transformation is over, and the basic state institutions have been restored. At the same time, the elites have not consolidated much, and a stable national consensus on basic values has not been reached. Solving this problem will take decades. Meanwhile, the lack of consensus on such matters will result in periods of relative stability alternating with sudden political turns.

The reproduction of instability is brought about by the government's constant maneuvering between social groups of varying interests. As a result, there emerges a peculiar system in which stability is ensured by fluctuations inside the government that seeks to create new coalitions.

Challenges of post-industrial society. Russia must solve specific tasks related to "catch-up development" under the new conditions and challenges presented by the post-industrial epoch. The mechanisms for solving these tasks differ essentially from the solution of similar problems in the epoch of industrialization.

Russia requires a deep structural transformation. Meanwhile, as the experience of the most developed countries shows, the period of structural reforms is often accompanied by slower growth rates or even external stagnation (as happened in some Western countries in the 1970s). This is partly because new sectors (especially services) are not adequately covered by traditional statistical methods, and partly because a new technological breakthrough requires the accumulation of resources.

Economic growth without structural shifts can be easily achieved by state administration, but such growth will not make the country richer or the economy more effective.

There are several important principles for achieving economic growth.

First, the government must give up its attempts to set long-term sectoral (industrial) priorities on which it could focus its attention and resources. Practical work on these priorities would only give prominence to those sectors with maximum lobbyist possibilities. Much more effective would be a *strategy of regularly correcting the structure*, under which the government would be ready to protect, flexibly and by political methods, all those who achieve success through competition.

Second, the government must make the economic system flexible and adaptive, while economic agents must be able to react to the present challenges quickly and effectively. Adaptability must replace the concentration of resources as a key benchmark of state policy. The solution of this task is inseparable from the task of building an effective system for the protection of ownership rights.

Third, in the contemporary world a “catching-up” country must have a lower budgetary load on its economy than the most advanced countries in the world.

Fourth, the government and private entrepreneurs must give priority to investment in human capital.

Fifth, the economy must be made sufficiently open. Foreign economic policy must be oriented to the stimulation of the development of new, high-tech sectors, and to the production of high added value products from traditional Russian exports. At the same time, negotiations on Russia's accession to the World Trade Organization must be aimed not at the primitive protection of domestic producers but at a post-industrial breakthrough.

Energy price situation. It is generally believed that high energy prices are exceptionally favorable for the country. However, high energy prices over a long duration may have negative consequences for the stability of the country's economic and political development in the future. This is due to the degradation of the

tax and budgetary systems, in which a high level of revenues that do not stem from growth in labor productivity substantially reduces the effectiveness of decision-making.

The country's political and economic dependence on petrodollars increases annually as the boom in world energy prices continues. Meanwhile, the political and economic risks of a decrease in oil prices continue to grow. A fall in oil prices may provoke an inappropriate reaction from the elite, which has become accustomed to the exceptionally favorable budget situation. As a result, the country may face a budgetary as well as a political crisis characteristic of post-revolutionary development.

To cushion a possible crisis, the government must work out, without delay, a plan of action in case the world economic situation deteriorates. This plan must include various measures concerning monetary, budgetary and tax policies, changes in foreign economic regulation, and other measures that would help alleviate the consequences of a hypothetical crisis. Without such a plan, the likelihood that the situation may get out of control will be very high. On the bright side, a decrease in oil prices and the government's reaction to it will be a maturity test for Russia's political elite and a gauge for determining the country's real devotion to a responsible economic policy.



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Improving Corporate Governance in Russia and the EU

Sergei Porshakov

The advance of modern codes and principles of corporate governance – which involve the system of relations between the shareholders, board of directors, investors and management of a company as defined by the corporate charter, bylaws, formal policy and rule of law – has acquired a global character. Experts of the Organization for Economic Cooperation and Development (OECD), which oversees the promotion of international standards in corporate governance, note that progress has been made by a number of countries in East and Southeast Europe (Hungary, Russia, Croatia and the Czech Republic) and Latin America (Argentina, Brazil, Colombia and Chile). In this sphere, the interests of the state and business coincide: both equally need a favorable and transparent business environment. A well-built corporate governance system is an essential condition for the growth of capitalization, development of the stock market, and creation of an investor-friendly economic environment.

Corporate governance practices in the EU and in Russia differ considerably. There are, however, certain objective and subjective factors that allow for comparisons and analogies to be made. Furthermore, even within the euro zone, corporate governance institutions differ in the levels of their maturity. These differences became especially pronounced in the wake of EU enlargement

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with a number of East European states, although several “old” EU members (e.g., Portugal or Greece) are only slightly ahead of Russia in the development of such institutions.

In Europe, it is the state that calls the shots in reforming corporate governance. The business community – not only in Russia, but also in many European countries – is not yet self-organized and self-sufficient enough to influence the formation of corporate governance principles. The prevalence of concentrated ownership in Russian and the majority of European companies has a substantial impact on such essential aspects of their activity as relations between shareholders and management of a company, transparency, and the status of independent directors.

Comparative analysis of certain corporate governance institutions in Russia and major EU countries also shows that they have much in common. For example, boards of directors in France, Germany or Italy, as in Russia, are not particularly active and are mainly comprised of ‘insiders’ affiliated with the owners and management of the companies. Minority shareholders are clearly in the minority there. In the U.K. and the United States, boards of directors are vigorously active and include mainly independent directors.

MODERNIZATION OF CORPORATE STANDARDS: THE EUROPEAN APPROACH

In recent years, the European Commission (EC) has visibly intensified its efforts of improving corporate legislation and corporate governance practices. EU commissioner for internal market and services, Charlie McCreevy (former Irish finance minister), incumbent since November 2004, consistently supports the initiatives put forward by his predecessor, Frits Bolkestein (former Dutch defense minister).

In the Old World, this problem was given high priority in the wake of a series of corporate scandals (involving Parmalat, Vivendi Universal, Royal Ahold, Skandia Insurance, Adecco, etc.) that made institutional investors and shareholders aware, like never before, that they had to deal with a serious risk factor. The EC’s

efforts to institute an effective corporate governance system are dictated, in equal measure, by the desire to restore trust in the stock market and, most importantly, to stop the decline in EU economic growth rates. Furthermore, European companies whose shares are listed on U.S. stock exchanges must comply with the accounting requirements of the Sarbanes-Oxley Act (2002). Finally, the admission of new members to the EU (Hungary, Poland, the Czech Republic and others) highlighted the need for harmonizing corporate governance models and bringing them in line with EU standards.

Today, work is underway in EU member countries to adapt the existing corporate governance codes to the OECD Corporate Governance Principles revised in 2004. EU officials are increasingly talking about the convergence of legislative and regulatory documents to improve corporate governance practices within the entire European Union. EU officials say that this will not lead to the elimination of country (national) models that evolved under the influence of national political and cultural traditions. Furthermore, they deny the possibility of enacting a European Code of Corporate Governance, along the lines of the European Constitution (which is still under consideration).

According to McCreevy, the role of the EC is to coordinate the efforts of EU members with an aim at improving corporate governance practices by amending national laws and codes of corporate governance. It is important to remember that EU countries have different historical traditions that should be treated with respect. At the same time, it is essential to eliminate divergences in the legislative sphere that hinder the creation of a single financial market and create additional impediments to investors.

The European Corporate Governance Forum, a body designed to set priorities and work out recommendations, was launched in October 2004. It is made up of 15 experts representing a range of stakeholders, issuers, investors, regulators, auditors, and academic circles. Its members include Antonio Borges, the vice chairman of Goldman Sachs International; Alastair Ross-Gooby, who until recently was chairman of the International Corporate Governance

Network; Jaap Winter, professor of Amsterdam University; De Brauw Blackstone Westbroek PC; and others.

The Forum was created as part of the Action Plan on Corporate Law and Corporate Governance, adopted in May 2003. Under the Action Plan, the EC has for the past two years been publishing regulatory documents designed to help national governments lay the groundwork for EU principles in this sphere. Compared with the tough requirements of the Sarbanes-Oxley Act, the proposals by EU regulators appear milder and are mainly of an advisory nature and non-binding.

The Forum's sessions held last year in Brussels (January), Luxembourg (June) and again in Brussels (November) showed that the main problem area in EU corporate governance practices, according to the EU's "committee of wise men," is within the realm of shareholder empowerment. In particular, foreign shareholders are confronted with serious legal impediments in exercising their rights. Meanwhile, according to the EC, public companies in large EU states have 30 to 35 percent of foreign shareholders, while companies in small European countries have between 70 and 80 percent. There is also a pressing need to improve corporate control mechanisms to minimize investment risks.

The EC code of recommendations prioritizes the interests of shareholders. This refers to expanding shareholders' access to information about management and board of directors' activity, their participation in discussions and attendance at voting at general meetings, and giving them a greater role in decision-making on management compensation policy. Top management salaries should be transparent and linked to a company's financial performance. In a special recommendation (December 2004), the EC directed the Spanish government to amend its national legislation to end discrimination against minority shareholders, in particular by issuing additional shares. In the interests of shareholders, the EC Directorate General for Internal Market and Services urged issuing companies to publish special annual reports disclosing in detail corporate governance practices and procedures.

At the same time, European regulators are aware that should shareholders' influence in corporate management move beyond a certain level, this could effectively nullify the role of management, turning it into a purely bureaucratic appendage. The latter, incidentally, is fraught with greater risks, as well as a possible decline in economic effectiveness. Ideally, the regulators believe that the interests of shareholders and management should coincide.

Other EC recommendations include increased representation. This move would include a greater role of independent members in the board of directors, in order to harmonize the relations between management and majority and minority shareholders; a greater priority would be given to their professional qualifications. The advocates of uniform standards also propose improving the level of responsibility toward the investors and shareholders in relation to the decisions made by members of the board of directors – above all in financial matters.

At the same time, certain EC recommendations are failing to secure the understanding and approval of national governments in those European countries where national corporate governance traditions took decades to evolve. Countries of the Old World, where, in contrast to the United States, concentrated rather than “dispersed” ownership structures prevail, do not see much point in a forced expansion in the number of independent board members. For example, Sweden's latest version of the code of corporate governance basically preserves the practice of granting majority seats of the boards of directors to representatives of majority shareholders.

The EC principle of guaranteeing the equality of shareholders is coming up against traditions, especially in medium-sized French companies where the “veteran” shareholders enjoy a privileged position compared with “young” shareholders (e.g., in voting at general meetings). The EC's stringent disclosure recommendations have also stirred heated debate within the business community. For instance, top management at major German concerns is obviously less than enthusiastic about the idea of introducing mandatory disclosure claims of board member compensa-

tion arrangements. Not surprisingly, shareholders, supported by the German Federal Government, insist that this procedure be made into law.

The vector of change outlined by the EC does not mean a move toward the U.S. model, however, with its over-regulation and excessively tough and detailed requirements. Brussels officials prefer a more uniform corporate governance model that would take into account national specifics and be based on a flexible combination of mandatory and non-binding procedures.

CORPORATE LEGISLATION IN RUSSIA

In Russia, as well as in other transitional economies, the state and business community have yet to create an institutional and legal framework for a full-fledged corporate governance system. In the opinion of Russia's more far-seeing business leaders, this sphere of activity is increasingly taking on a financial and economic dimension. Russian business majors are spending more money on improving corporate governance practices. Corporate transparency strengthens a company's reputation, while ultimately yielding more dividends than through the dubious practice of skimming profits into offshore accounts. To foreign investors, this development is just as important as witnessing progress in macroeconomic indicators. Not surprisingly, this aspect is often highlighted by many Russian companies at their road shows (meetings, presentations and conferences with members of the investment community) held in the West.

It is no secret that the level of corporate governance in Russia is still far from European standards. At the same time, a number of Russian companies have been demonstrating good results in this sphere. In general, however, progress remains rather limited. In the past one or two years, the biggest achievements have been made in creating new corporate governance instruments and procedures. The decision-making role of various corporate boards of directors is increasing as the number of major deals subject to their approval is expanding. Companies are streamlining their structure, in particular by setting up specialized committees – on auditing,

human resources and remuneration, strategic planning, relations with investors, etc. Furthermore, the proportion of independent members on boards of directors continues to increase not only at large but also medium sized companies. At some large companies and banks, beneficial owners (real owners of securities not subject to promulgation) are moving from operating control to strategic planning, leaving it for company management to run day-to-day activities (the Magnitogorsk Metallurgical Plant, the Pipe Metallurgical Company, SUAL Holding, MDM Bank).

Another factor involves foreign capital in Russia. The presence of European and U.S. capital in Russian companies (Vympelkom, TNK-BP, Wimm-Bill-Dann, Lukoil) has a positive impact on the state of their corporate governance.

Russia's shortfalls in the realm of corporate governance are typical of transitional economies. At best, corporate governance is oftentimes seen as a mandatory ritual that companies must adhere to; at worst, it represents a free pass to the stock market. Needless to say, the legal framework remains insufficient and lags behind the needs of domestic business.

Corporate legislation in Russia is marked by substantial internal contradictions and outdated norms and regulations. This results in numerous corporate conflicts related to the redistribution of property, while the danger of hostile takeovers and mergers increases investment risks and the concentration of ownership. As a result, the volume of publicly traded shares on the Russian stock market remains insignificant.

In light of the abovementioned situation, there is a pressing need to amend and adjust legislation regulating corporate conflicts, mergers and acquisitions, as well as relations between majority and minority shareholders. Other areas of concern involve dividend policy, the use of insider information, conflicts of interest, and affiliation criteria.

In late 2004 and during 2005, an attempt to achieve a breakthrough in adjusting company law was made. Within the space of a few months, three state regulatory bodies offered their vision on how to develop Russian corporate law. First, the State Duma

Property Committee issued recommendations in November 2004. Then in May 2005, the Expert Council on Corporate Governance of the Economic Development and Trade Ministry (EDTM) put forward for discussion a draft concept of corporate law for a period until 2008. The Council comprises a number of reputable experts on company and finance law representing the Research Center for Private Law (affiliated with the Office of the President of the Russian Federation), the Russian Lawyers' Union, and Baker & McKenzie. The Council is chaired by Deputy Minister Andrei Sharonov. Finally, in June 2005, the Federal Service for Financial Markets came out with a strategy for the development of Russia's financial market that also contains a number of proposals on improving corporate legislation.

It is expected that the key provisions of these documents will be approved at a Cabinet session and integrated in the form of amendments and additions to the federal laws *On Joint-Stock Companies*, *On the Securities Market*, and others.

The EDTM concept contains a number of practical recommendations on improving corporate governance. This refers in particular to further downsizing the number of executive directors on boards of directors with a view to distancing them from managerial structures. One serious shortfall in Russian corporate governance practice is the weakness of the internal control system and its subordination to company management. There are also proposals concerning the formation of control commissions, which would involve various strategies, such as banning all company executives from being elected to control commissions, and introducing cumulative voting in the election of members so as to take into account the opinion of minority shareholders and ensure their representation.

Current legislation lacks provisions about the liability of independent directors who have harmed their company by voting contrary to its interests but in accordance with the wishes of "their" shareholders. To this end, there are plans to amend the federal law *On Joint-Stock Companies*, specifying the duties of board members and laying down action procedures by the board

of directors in the event of a conflict of interests between a company and its shareholders.

Russian corporate legislation has yet to address issues related to insider information. Meanwhile, share prices are being constantly manipulated on the stock market. For example, in April 2003, insiders cashed in on rumors about the YUKOS-Sibneft merger that never materialized. According to the federal law *On the Securities Market*, the circle of individuals privy to insider information is rather narrowly circumscribed and does not include, e.g., members of the board of directors, the audit commission, or major shareholders. Today, a bill *On Insider Information and Market Manipulation* is pending in the State Duma. It provides a clear definition of “insider information,” while giving a list of securities that can be affected by insider trading. The bill would ban the use of such insider information, and expand the scope of insiders to include not only corporate executives, but also state and government officials who have access to an issuing company’s database.

There is also a pressing need to amend the Corporate Code of Conduct that was prepared in keeping with OECD standards. This document was approved by the Russian Government in February 2002, and remains the main guideline for companies seeking to follow modern principles of corporate governance. A *Financial Market Development Strategy*, formulated by the Federal Service for Financial Markets, proposes amendments to the Corporate Code of Conduct, such as the creation of independent boards of directors, preparation and disclosure of consolidated financial statements according to international accounting standards, and the impermissibility of insider trading.

There have been few changes in the status of minority shareholders. Today, Russian business majors have almost 188,000 minority shareholders who own a total of \$3.1 billion worth of stock. Their status remains one of the most serious problems in the field of corporate governance even though many companies are striving to earn credentials as being “minority friendly.” Shortfalls in Russian corporate governance practices include the

infringement of minority shareholders' rights, the insufficient role they have in the decision-making process, and the shortage or complete absence of their representatives on boards of directors.

The EDTM and Duma documents give priority to creating legal mechanisms of protection against hostile takeovers. In particular, proposed amendments to the federal law *On Joint-Stock Companies* prohibit the seizure of the shareholders' shares involving enforcement proceedings, as well as guarantee that decisions by a general shareholders' meeting held without approval from the board of directors will be deemed null and void. The interests of a majority owner can also be secured by squeezing out minority shareholders from a company through a forced buyout. In practice, a considerable part of corporate takeovers is accomplished through an extraordinary general shareholders' meeting conducted by minority shareholders who control a total of not less than 10 percent of stock. In this context, the EDTM Expert Council on Corporate Governance has recommended an amendment whereby an extraordinary shareholders' meeting may only be convened by a group of minority shareholders once a court has ruled that the refusal by the board of directors to hold such a meeting was illegitimate.

The State Duma Property Committee officials believe that minority shareholders have excessive rights that they purposely abuse. According to Committee Chairman Victor Pleskachevsky, there is a pressing need to protect companies and major shareholders against minority shareholders who act in bad faith. Under current Russian legislation, the holders of even one or two shares have the right to file lawsuits to protect their property interests, while courts may impose all sorts of restraints on companies as security for these claims, thus effectively paralyzing their operations. For instance, several years ago, a major LUKOIL deal was scuttled over a groundless lawsuit filed by a single minority shareholder.

In order to eliminate corporate blackmail, amendments have been drafted limiting minority shareholders' rights to file claims on matters concerning the convocation of extraordinary shareholders' meetings, the arrest of blocks of shares, the issue of additional shares, and the reorganization of joint-stock companies. By

way of compensation for these amendments, the Duma Property Committee has proposed a bill making it binding for all open joint-stock companies to distribute and pay dividends. Opponents to the idea believe, however, that such measures could result in company's underreporting their profits as a way of lessening the dividend payout.

In July 2004, the State Duma (on the initiative of the chairmen of four of its key committees: property; credit organizations and financial markets; civil, criminal, arbitral and procedural law; and constitutional law and state building) unanimously passed in the first reading an array of amendments to the federal law *On Joint-Stock Companies*. Under these amendments, the holder of a controlling stake who owns more than 90 percent of company stock has the right to buy out minority shareholders. Later in the year, however, the issue stirred heated controversy, which continues to date. In September 2004, a large group of foreign and Russian investors representing Hermitage Capital Management, Prosperity Capital Management, Firebird Management, Aton, Charlemagne Capital, East Capital, Halcyon Advisors, Morgan Stanley Investment Management, MC Trust, Third Point Management, Troika Dialog, Vostok Nafta, and Alfred Berg Asset Management, asked the Russian president to withdraw the bill. They said that the bill could hurt the interests of investors and minority shareholders in major companies. It should be remembered that in the overwhelming majority of cases, a foreign investor in Russia is a minority shareholder. Thus, the Expert Department of the Administration of the President of the Russian Federation supported the investment community, thereby recommending that the bill be scrapped. As a result, the draft bill providing for a mechanism to squeeze out minority shareholders was sent back to the committee and in the summer of 2005 taken off its agenda.

Disclosure and transparency is an important factor in reducing the level and intensity of corporate conflicts. According to Standard & Poor's, domestic business is becoming increasingly transparent. The corporate transparency index of Russian business majors rose from 40 percent in 2003 to 46 percent in 2004, eventually hitting

50 percent in 2005. The Mechel Steel Group (a leading Russian mining and metals company) made spectacular progress within the space of just one year: initially beginning as an outsider, it quickly rose to become one of the top three leading mining and metals companies in Russia, along with MTS and Rostelecom. It was not the majors, however, but medium-sized companies that were a crucial factor in the index. It is noteworthy that Russian corporations are far more willing to disclose information about their social and charity activities than about the remuneration of their top executives, members of boards of directors, and external auditors. The majority of companies still shun transparency. At the same time, many top executives in Russia are inclined to see “excessive” transparency as a risk factor, contributing to hostile takeovers and administrative pressure by corrupt bureaucracy.

The main priority for Russian lawmakers at this point is to establish a clear legal framework for resolving corporate conflicts, create civilized mechanisms for mergers and reorganizations, define affiliation criteria, and regulate the use of insider information. These moves would signal a clean-up stage for creating a favorable environment, which is critical to a full-fledged corporate governance system in Russia.

Addressing the first international conference *Corporate Governance and Economic Growth in Russia* in June 2004, Ira Millstein, a prominent expert on corporate governance, drew an interesting analogy: “Throughout its history Russia successfully repulsed invasions from foreign powers of all kinds: Germany, France, Turkey, and Sweden. At the same time, however, there is a kind of invasion that remains impossible to resist: corporate governance and the global need to attract capital to secure production growth and enhance competitiveness. This is a universal rule that was not invented in America, Britain, Germany, Canada or anywhere else. It applies to all countries. If Russia wants to become part of the global economy, it should play according to the general rules. If you want to attract capital to Russia, you’ll have to live according to these rules.”

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