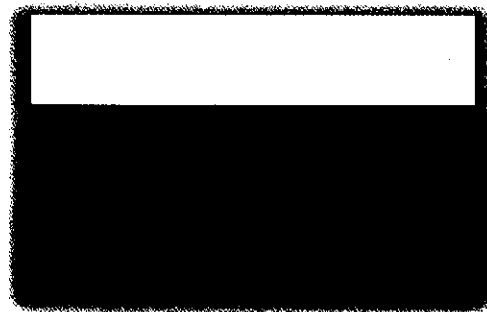


A COUNCIL ON FOREIGN RELATIONS BOOK

TOWARD AN
UNDERSTANDING
OF RUSSIA



NEW EUROPEAN
PERSPECTIVES

EDITED BY JANUSZ BUGAJSKI
WITH MAREK MICHALEWSKI

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Foreword

Over a decade after the end of Cold War and the disintegration of the Soviet empire, the initial optimism on the part of some that Russia would become a responsible, modern state integrated into the "New World Order" has been replaced by a sense of wasted opportunity among some Western as well as some Russian elites. A large number of American scholars and analysts have focused on Russia and accumulated enormous amounts of knowledge. In addition vast resources have been devoted to assisting Russia in its transition to democratic capitalism. But their overall impact on democracy and capitalism in Russia has been discouraging. One should, therefore, ask whether knowledge automatically brings understanding and whether a lack of understanding can be overcome through material help. The answer to both questions is apparently negative.

This project was intended to help understand Russia better by bringing together the perspectives of American analysts with those of scholars who were much closer to Russia due to geography and history. Therefore, we invited 12 analysts from Central and Eastern Europe to share their views on issues ranging from Russia's structure of power and President Vladimir Putin's foreign policy goals to Russia's energy policy. We hoped to learn from the differences between these perspectives.

Several of them are worth mentioning here. American analysts examined Russia's potential to be a global actor that could challenge the United States, while analysts from the former Soviet empire concentrated on Russia as a European actor and its potential to influence that region.

More often than not, the majority of American analysts focused on Russia episodically, rather than systematically. This is the reason why extremely

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Russia's Political Economy

László Csaba

This chapter discusses the sustainability of the Russian economic recovery of 1999–2001 and covers the short-term factors that brought it about: energy prices and the devaluation of the ruble. This chapter also advances the thesis that an activist presidency is not equivalent to the rule of law. The fight against the “oligarchs” implies a restructuring of economic power, but not a change in the modus operandi of Russia’s version of a market economy. While much of the legislation approved after the Strategy of Economic Development of June 2000 points in the right direction, these measures definitely fail to address some key issues that determine economic development in the long run, such as financial intermediation, local power, the ability of corporations to finance their own growth, small business, and foreign direct investment (FDI). Russia’s export performance is likely to diminish, even according to the government’s three-year plan published in July 2001. Thus, Russia’s ability to service debt will depend heavily upon successful agreements with the Paris and London Clubs.

The weak point in the Russian economic success story of 1999–2001 has been its continued reliance on exports of raw materials and the lack of improvement the manufacturing sector’s competitiveness. The government’s strategy for 2002–2004 rightly acknowledges that currency inflows and the inability to centralize them continue to put a severe limit on long-term economic growth. While economic growth in the front-runner transition countries has been export-led and thus sustainable, the Russian economic miracle will easily fall victim to weakening oil prices coupled with the limitations of an import-substitution industrial recovery, which has been the hallmark of the early Vladimir Putin years. Decelerating growth may force the new president to make some hard choices: either to radi-

calize the structural reforms, or to allow for a backtracking, which in turn will further weaken economic performance.

BACKGROUND TO REFORMS

The collapse of the Russian ruble in August 1998 and the subsequent developments following the event have proven that the Russian economy is by no means peculiar. Indeed, it functions according to the logic of standard textbooks. If you liberalize the capital account prematurely, use short-term money to cover structural deficits in the fiscal accounts, and at the same time try to sustain a fixed exchange rate, you are heading for trouble. Only the timing is subject to chance. If you devalue the domestic currency to one-fourth of its original value, you create an enormous impetus for import substitution, protect your markets, and trigger a supply-side response, while the current account is likely to improve tremendously. Add to this oil prices that more than triple, where 53 percent of currency inflows are derived from the exports of fuel and energy. The surplus in the current account is likely to be substantial, and the fiscal account is likely to close with a surplus, while activity indicators will improve. Indeed, Russia's current account surplus of U.S.\$2 billion in 1998 did grow to U.S.\$18 billion by 1999 and U.S.\$41 billion by 2000.¹ General government deficits, consolidated according to government fiscal statistics (GFS) standards, were 8.9 percent of gross domestic product (GDP) in 1997, 3.2 percent in 1998, and 1.0 percent in 1999, giving way to a surplus of 4.6 percent in 2000. Estimates for 2001 call for a surplus ranging from 0.25 percent to 1.5 percent of GDP.² All in all, there is nothing deviant in the way the Russian economy works; there are no grounds for talk about a miracle. Likewise all analysts agree that growth likely decelerated in 2001, from 2 to 4.5 percent on an annualized basis, with the consensus estimate being around or below 2 percent, strongly dependent, of course, on the actual level of world oil market prices. Actually, as econometric evidence suggests, the correlation between Russian industrial output and world oil prices is over 81 percent, allowing for a mere 1 percent increase in Russian GDP in the medium run.³ This is certainly at odds with the overly optimistic assumptions of the Gref Plan (launched by Economic and Trade Development Minister German Gref), which aims at a steady 7 to 8 percent per year for a decade.

The above-cited numbers reflect a fairly mechanical process of adjustment to external disturbances, which could happen in any economy, regardless of its economic institutions and policies. When external shocks dominate overall macro performance, it is particularly important to discern which, if any, of the outcomes are attributable to policies and which are a result of circumstantial factors. If we take into account that Russia's terms

of trade have improved tremendously, by 48.1 percent in 1999 and by yet another 66.3 percent in 2000, over 1998 actual figures, it is hard to overlook the enormous one-time windfall component in shaping the macroeconomic landscape in the country. The chief economist in President Putin's administration, Andrei Illarionov, a long-term observer of Russian macroeconomic policies, has provided the following table comparing the windfalls and macroeconomic performance and expressing them as percentages of GDP:⁴

Table 3.1. Windfall and Macroeconomic Performance as % of GDP

	1997	1998	1999	2000
Windfall	-1.1%	3.3%	+1.1%	+12.7%
GDP	+0.9%	-4.9%	+3.5%	+ 7.7%

The author interprets the difference between the two elements presented in the table as a possible measure of *net contribution* that year (i.e., over and above the favorable windfall effects) of economic policies to the overall macroeconomic performance. Given that the Primakov and Stepashin periods saw a deceleration of reforms, and that the year 2000 was mostly spent on presidential elections and the establishment of the new power structure, the strongly negative contribution is anything but surprising. It also helps in explaining why the new president could have been convinced that further reforms were urgent, rather than being content with the status quo of dramatically improving short-term indicators (with the partial exception of unemployment). Moreover, half of the population lives under the World Bank poverty level of U.S.\$2 per day. The level of development at the market exchange rate is below U.S.\$1,900 at PPP (purchasing power parity), about U.S.\$6,000, or two-thirds that of Hungary. All these factors have been rightly seen as stimuli for quick and radical action.

YELTSIN'S LEGACY

Much has been written about this topic, which has grown in significance following the first-ever, successfully completed peaceful handover of power in Russia. The country's economic system was, beyond a doubt, a full-fledged market economy by the time Putin took power in March 2000.⁵

Today, prices mostly reflect scarcities. Money can buy any commodity including foreign currency, and allocation follows market signals, while dominant private owners maximize their asset value and switch their portfolios in response to financial incentives. Certainly the Russian variant of the market economy is not the same as the model set forth in introductory textbooks. Instead, it resembles the developing-country variants

described in advanced courses on comparative and development economics. Still, introducing market order has been a remarkable accomplishment, especially if we consider the relatively low cost of reestablishing the market. (Costs of postcolonial wars, of course, should not be added to this bill.)

The fundamental feature of Russia's transformation has been conditioned by the weak state, which often leads to the strong presence of vested interests and the ensuing market failures.⁶ With the major power struggle phase ended and new rules of the game established, inflation has never gone out of control, as many of us feared following the collapse of the ruble. In fact, annual inflation in 1998 was 84.5 percent, in 1999 it came down to the moderate level of 36.6 percent, in 2000 to 20.2 percent, and in 2001 is forecast in the range of 25 percent. This reflects a consolidation of power and also a common understanding by all those in power that hyperinflation is deadly for a modern economy and society alike. Also reflected in this remarkable outcome is the unwillingness to undergo yet another redistribution of wealth.

Thus, Boris Yeltsin managed to liberalize, stabilize, and privatize the Russian economy. However, he could not get the country over the transformational recession to sustaining growth. Thus, poverty became a predominant feature in large parts of the country, especially outside the metropolitan areas. Yeltsin also managed to preserve the unity of Russia's federal government, creating a situation in which the local governments stood to gain more by cooperating than by seceding.⁷ This is no small accomplishment for a country whose "natural" or "historical" borders are anything but trivial. The bilateral deals, also anchored in Russia's constitution, strengthened and formalized the power of local organs and have been exerting a formative influence over the actual workings of the Russian market economy.

PUTIN'S INPUT

There seems to be a near consensus among analysts that the accession to power of Vladimir Putin represented an attempt to redefine the name of the game as it emerged under the Yeltsin years. Quite in line with the mainstream view on development economics, it was understood that a strong state power, emancipated from the patronage of vested interests, is a necessary condition for achievement of meaningful policy reforms.⁸ Thus, it is self-explanatory why the new president has been focusing so much attention on cutting the umbilical cord that ties him to the Yeltsin group and to constituent oligarchs. At present, it is too early to assess the extent to which this initiative will prove successful. However, the thrust of the initiative can, at least in theory, be interpreted as an attempt to emancipate Putin from dependence on vested interests.

In the first round of managed transition, the 1999 Duma elections produced a so-called floating party system with the emergence of three roughly equal blocks (left, centrist—i.e., pro-government—and right).⁹ This allowed the president to have virtually any law passed. It also removed the powerful obstacle of communist domination, which hobbled Yeltsin in both his presidential terms. Moreover, as the parties seem to be more active in representing economic interests than ideological lines, policy compromises are easier to strike. A detailed analysis of the Communist Party indicates its ideological decay and growing opportunism: it can still create trouble, but it can no longer reverse policy in any major area.¹⁰ Last but not least, the above-cited consolidation of regional power within Russia means that governors cannot secede and lack interest in doing so, thus making them vulnerable to centralizing tendencies.

In addition, certain side effects of the 1998 financial crisis worked to Putin's advantage. This crisis has forever crippled the oligarchs (i.e., those with vested interests based on financial assets rather than industrial holdings). Their vulnerability has come under the spotlight since the Primakov episode,¹¹ while energy sector corporations flourished.¹² Confiscation of bank assets in response to Kirienko crisis management measures left the state-owned banks—primarily Sberbank and Vneshekonombank—without competitors. Most of the surviving private banks are actually no more than financial departments of large industrial organizations. This, of course, allows for the takeover of previously held positions in various areas, as the takeover of the Berezovsky and Gusinskii media empires demonstrated.

In systemic terms, the above developments may be interpreted as a series of evolutionary and policy-led actions that allow for a redefinition of those institutions and of the rules of the game for maximizing wealth that emerged during the late Yeltsin period. In the following section, this chapter attempts to assess the extent to which this potential has materialized or will materialize as a consequence of actual policymaking under President Putin.

Putin has moved with conspicuous speed and deliberation to get rid of symbolic figures and features of oligarchic power. Such cases as the extradition of former Kremlin financial chief Pavel Borodin; the demotion of Viktor Chernomyrdin from Gazprom; the demotion of Rem Vyakhirev from his post of chief executive officer of Gazprom; and the erosion of Moscow mayor Yuri Luzhkov's standing in the presidential campaign, which led to the recent merger of his Fatherland movement with so-called "Bear" Unity party may be seen as milestones for this new drive. Changing Russia's constitution and the procedures for formation of the Council of Federation (the upper house of parliament), depriving local governors of their immunity and even allowing for their demotion, followed by a series of presidential measures that outlawed local regulations, send clear messages. Successful attempts to control the press, put in place "managed democracy,"¹³ and

give the state much more extensive roles than those of chief arbitrator and guardian of the rules of the game, are bound to have immediate repercussions on the way that economic rules and institutions function in reality.

In short, given Russia's current situation, talk of a strong state and "dictatorship of the law" is likely to be a far cry from *Rechtsstaatlichkeit*, (authorities being able to commit themselves to uphold property rights and enforce impartial, private contracts among parties).¹⁴ This is certainly quite a different agenda from establishing one's own control over the oligarchs with new, uncorrupted followers who are loyal to the new bearer of supreme power.

In fact, such reverberations contribute to the overall feeling of insecurity and raise particular questions concerning acquired property rights. They objectively shorten the time horizon under which investors optimize their decisions. The investors are pushed to demand quick returns and to disregard any possible long-term consequences of their actions. Capital flight from insecure to secure places is not criminal, nor is it theft from the country itself, but is a sign of how capital, the world over, behaves in a rational manner, rationally expecting interventions that will destabilize its workings. A poor investment climate deters domestic and foreign investors alike, putting a severe limit on the development potential of domestic financial intermediation (banking and capital markets alike).¹⁵

Under the circumstances described above, it is understandable why the Strategy of Economic Development, based on the workings of the group surrounding Economic and Trade Development Minister Gref (also a member of the Petersburg Clan), aims primarily at securing high growth rates in a sustainable fashion. In order to attain that goal, the plan envisions a series of systemic measures.

It is important to note that the full text of the approved program has not been published.¹⁶ The program seems to reflect a deal between two "market" approaches, i.e., a supply-side cum deregulation approach and a major tax cut approach. The concrete formulation of the plan is reflected in the eighteen-month program adopted for the period of 2002–2004. The main tasks or areas of action can be summarized as follows:

1. Tax reforms;
2. Fiscal reforms aimed at restructuring expenditures;
3. Deregulation and easing market entry barriers;
4. Protecting private property;
5. Decreasing and harmonizing customs duties;
6. Developing capital markets;
7. Reform of natural monopolies;
8. Social security reform, introducing the targeting of social benefits; and
9. Pension reform.

As can be seen, this is perhaps the first multi-year program that truly departs from the Soviet heritage. The program is not dominated by quantitative indicators or sectoral priorities. Rather, it reflects the conviction that structural adjustment is a matter of market process; it treats the diminishing of tax burden as its priority; it aims at creating the comprehensive institutional infrastructure that has been missing from previous reform packages; and it addresses some traditional sore points of Russian reforms, such as overregulation and the underdevelopment of capital markets. In short, the program seems to have addressed the bottlenecks that tended to plague reform efforts during the Yeltsin period. Coupled with a new strength and vigor regained in Moscow, the platform may be seen as promising. In the following section, this chapter tries to assess whether and to what extent these measures suffice for bringing about and sustaining high growth rates. This is the crux of the matter, regardless of actual attainments of the quantitative estimates (which seem to have been proven overly optimistic anyway).

As indicated above, the Strategy for Economic Development was conceived as a medium-term document whose goals are to be implemented primarily in the 2002–2004 period. However, experience with policy reforms throughout the world, especially in Russia, shows that changes must be front-loaded. This means that changes standing a better chance for implementation come first, while those slated to be enacted later often undergo substantive modification or may even be cancelled. Thus, early measures may also be treated as a kind of early warning system in economic policy assessments.

Tax legislation has been simplified significantly by the 2000 modification of the tax code. Further rate cuts are envisioned by the governmental proposal approved in the first reading by the Duma in June 2001: reduction of the corporate tax rate to 15 percent and the marginal income tax rate to 35 percent. The legislation also limits the power of local authorities to levy taxes not specified in federal legislation, or to apply higher rates than federally approved.

One of the problems of these stipulations has traditionally been that local power is often informal by nature, and is based on proprietary and regulatory interconnections between local authorities and locally dominant firms. Thus their deals are often covert and inaccessible to external observers.¹⁷ Corporations take over or simply provide financial support for municipal social services and employ underpaid local officials. The latter, in turn, reschedule debts, tolerate regular nonpayment of taxes, allow for covert subsidies, and impose local customs barriers and other protectionist measures to keep "outsiders" at bay. "Moscow is far away," as the old dictum says. And indeed, despite changes in the balance of power, it would be naive to expect any central organ to be able to penetrate and even less to redefine the intricate interconnections. More likely, any cen-

government representative would be quickly absorbed by the local social and economic networks, if for no other reason than the need for continuous on-the-spot crisis management.¹⁸ This likelihood is very high in light of the first detailed empirical field research results on the implementation methods of President Putin's federal reforms.¹⁹

It would be hard to overlook that federal tax cuts are not supplemented by a radical rollback of entitlements, or that the practice of allotting but not funding federal tasks has been discontinued. Under these circumstances it is hard to conceive of local authorities adopting a hands-off strategy. They continue to be confronted with cumulative economic problems (crime, floods, blasts of pipelines, etc.). They cannot cut taxes in order to simply avoid over-taxation. Given that they too are elected officials, their incentive is to continue with the hidden ways of "taking care of" the area, including raising sufficient tax revenue and protecting "theirs" in the corporate sphere from outside "intruders," primarily foreigners. Incomplete fiscal reforms by definition constrain the effectiveness of any tax measure.

Given that more than 80 percent of output needs to be licensed, granting permits has developed into a profitable business for the authorities to secure their otherwise insufficient funding.²⁰ Thus, it is highly unlikely that the abolished rules would be immediately replaced by "appropriate" substitutes, partly due to tsarist and Soviet legal tradition, and partly out of sheer economic necessity.

Protecting private property is quite important. However, when violent methods of settling disputes have become the norm rather than the exception, the state has leaned toward further strengthening of its proprietary and managerial roles,²¹ as well as setting an example by punishing "plutocrats" in political practice. Ongoing disputes over such well-publicized cases as those of Gazprom, Svyazinvest, and EES, to mention a few, all tend to end up with minority shareholders being marginalized, with their rights diluted. This tendency has been strengthened rather than weakened in 2000–2001.

It is important to recall that while the Duma finally enacted the law allowing private land ownership in June 2001, this law basically condones ongoing practices rather than creating new opportunities. In fact, nonarable land could be purchased for years, and even a modest turnover could be observed in some of the regions. In order to secure support from the communist factions, the law continues to retain most of its previous restrictions.

The issue of natural monopolies also tended to be high on the agenda of the Gref Plan. In the case of the gas industry, market-building measures have formally been postponed for 2002, at the time new leadership is nominated. In the electricity market, state control of prices and ongoing non-payments make deregulation highly unlikely.²² In the case of railways, any market reform would presuppose a partial recapitalization of the underin-

vested company, together with tariff increases. The latter might prove strategically impossible given the arbitrary location of many Russian industries and cities, while investments on this scale do not figure in the approved budget. In the case of pension reform, the underdeveloped state, as well as the shaken reputation of capital markets, makes the switchover to a partially funded system improbable. The ever-growing problem of aging and the lack of an affluent middle class also make such a change politically and economically risky. Moreover, if there is nowhere to invest, a funded system can easily degenerate into a costly gamble.

UNADDRESSED ISSUES AND PROSPECTS

The strategy failed to tackle some important issues from the very outset. The issue of financial disintermediation, which has plagued Russia for a long time, is also known to be a headache for government officials.²³ It is a depressing sign that the Duma has indefinitely postponed even general debates over this issue when limited sustainability of growth is already on the policy agenda. The less the financial system is able to transform savings into investments, the higher the probability of ongoing capital flight, since domestic savings cannot earn good returns for the risk of staying home rather than fleeing abroad. The central government's ability to raise taxes is unlikely to improve once oil prices start to decline. Corporate expansion, based exclusively on retained profits, is likely to be sluggish over the long term.

Along the same lines, large corporations are trying to become self-sufficient, even in ownership terms, which further strengthens the ongoing tendency toward concentrated ownership patterns.²⁴ This means that corporate restructuring is likely to continue via mergers rather than closures and startups. Furthermore, bankruptcy continues to be an instrument used by authorities to punish disobedience rather than serving as a means to promote horizontal deals, including restructuring.

Legislation that covers joint stock companies trying to support creditor and property rights against managerial power was repeatedly dropped from the Duma's agenda in June and December 2000. Meanwhile, neither the privatization law that would discontinue the practice of listing salable and nonsalable firms, nor the nationalization law, which provides for compensation in the event of unilateral state actions, has been approved by the Duma. However, the Duma did adopt a communist-backed general ban on selling large corporations, stopping such obvious targets as Lukoil and Gazprom from listing on stock exchanges around the world.

Legal reform is also generally seen as a weak point. Though Russia regularly posts current account surpluses, a currency law requiring 75 percent home transfers—obviously not adhered to—is still in force. There are many

ouner examples, such as articles prohibiting speculation, or the recent Academy of Sciences circular reintroducing Soviet regulations on contact with foreigners. In sum, anybody can be criminalized, basically for anything. These measures do not create an environment that promotes long-term investment.

The more people worry about Russia's long-term growth prospects being constrained by the extreme poverty of close to half of its population (acting as a demand constraint), the more they see the overall climate as generally unfriendly to business. It is evident that red tape, uncertainty, and lack of market prospects act as major deterrents for the small business sector.²⁵ Special incentive programs or the repetition of business-friendly slogans offer little help in overcoming this barrier. In turn, the domestic demand-based growth path, which is slow but steady, may also prove hard to enter.

The role of foreign direct investment, currently a favorite topic in international development literature, tends to be severely underrated in most Russian policy debates. FDI is not just a means to attract technology or cover current account deficits. In the broader international context it is seen as a pace-setter, a small but vitally important ingredient for the smooth functioning of a modernizing economy. For the time being, investors, even in the energy sector, where it is easiest to survive, seem rather deterred.²⁶ It is embarrassing to read that the president's chief economist (Illarionov) has said that Russia's investment absorption capacity was technically a given²⁷ and that the problem was abundance of capital. This is mixing up cyclical and strategic considerations. Absorption capacity is by definition an "ex post concept" and is conditional upon factors influencing the business climate. In Russia, more FDI could be a way of overcoming the bottlenecks created by decades of underfunding in physical infrastructure, market-oriented production-line developments, and many other areas. Moving away from the Kuwait syndrome is also contingent upon FDI.

On the basis of what has been surveyed, we may venture to forecast that the old *perestroika* slogan, "there is no way back," may be true. There is no room for Russia to regress into totalitarian political and economic structures, as transformations have been too profound. Likewise, there is little hope that Russia will be able to advance to the conditions of a normal Western democracy and market economy, as has been hoped by the elite of the country.

If oil prices remain high, they may help bridge the more obvious gaps in the central budget. Thus slow growth is likely, in the range of 2-plus percent in the medium term. This prediction is borne out by U.N. statistics, which state that Russia's GDP is still around two-thirds of its pre-1989 level. Thus, the room for quasi-automatic recovery is substantial indeed.

Institutional improvement is unlikely to be radical or robust, but slow and steady improvements are conceivable. They cannot be taken for granted. Thus, the revenue-generating and debt-servicing ability of Russia continues to be unilaterally dependent on oil and related revenues. The 1996 peak of export revenues was only surpassed in 2000; volumes decreased, which meant that price was the sole factor. This may create a problem, unless Russia uses most of its windfalls to amortize foreign debts or negotiate generous write-offs for the Soviet-era debt. Both possibilities look unlikely to happen. The most probable scenario is a continuous rollover of debt.

Russia's debt problem has several causes. First, Russia has assumed Soviet-era debt alone and has not shared the burden with any of the other Soviet successor states. Second, Russia's export performance is one of the worst among the transition countries: the Czech Republic and Hungary tripled their exports, Estonia nearly quadrupled exports, and even Poland nearly doubled exports. Russian exports grow and decline with oil prices. Russian exports peaked in 1996 at U.S.\$86.9 billion, and then declined to U.S.\$72.9 billion in 1999, growing, thanks to oil prices, to U.S.\$105.6 billion. However, according to the official medium-term forecast of July 2001, exports are forecast to decline again to U.S.\$94.6 billion by 2004. Thus Russia's economy has not experienced export-led growth in the way economic theory describes the concept; rather, it has simply harvested the windfall from favorable changes in the terms of trade, which is a world of difference.²⁸

A third problem follows from the fact that current account surpluses, registered in statistics, are realized basically by private entrepreneurs rather than the state. Thus, despite these surpluses, total national debt has declined only slowly. Russia's gross foreign debt grew from U.S.\$143.3 billion in 1996 to U.S.\$166.4 billion by 1998 and declined, thanks to trade surpluses, to U.S.\$150.1 billion by 2000, U.S.\$144.4 billion by 2001, and an estimated U.S.\$140.3 billion by 2002. In the same period, current account surpluses totaled U.S.\$12.4 billion in 1996, U.S.\$1 billion in 1998, U.S.\$47 billion in 2000, U.S.\$32.1 billion in 2001, and an estimated U.S.\$21.4 billion in 2002.²⁹ Accordingly, the debt: GDP ratio was 34.3 percent in 1996, 60.3 percent in 1998, 72.8 percent in 2000, 58.7 percent in 2001, and is forecast at 50.6 percent for 2002. Therefore, Russian analysts do not consider the situation to be dramatic, especially if authorities can reduce capital flight and limit the money supply, while at the same time mobilizing hard-currency savings by creating lucrative placement opportunities in domestic banks.³⁰

It is misleading to say that Russia would have no debt problem at all if all currency inflows, as reported in the official balance of payments statistics, had been used to amortize public debt rather than for investments based on capital flight. In fact, the accumulated surplus for the years

1999–2001 would have sufficed to pay back two-thirds of Russia's outstanding payments without any rescheduling or debt relief arrangements. Capital flight is a sign that obviously better informed domestic investors find it more rewarding and secure to invest their funds abroad than at home. If current account surpluses generally exceed foreign investment, this is a telling verdict of market players on the country's attractiveness to investors.

In sum, Russia seems to struggle with three problems: 1) inadequate exports due to antiquated export focus; 2) reliance on raw materials and capital flight; and 3) mismanagement, i.e., the central government seeking debt relief at a time when the country enjoys unprecedentedly large current account surpluses. The real option would be to reverse capital flight by a series of investment promotions and security measures.

Because the measures we surveyed do not seem to be adequate in the eyes of market players to reverse their attitudes, further loosening of the Central Bank of Russia's currency surrender requirement is unlikely to occur. There is no reason for us to believe that the ability of the Russian authorities to collect taxes and attract investments will be radically improved in the medium term. Rather, the three interrelated problems lying behind debt will continue, and a possible decline in oil prices will only exacerbate the debt situation.

On the domestic front the move toward more explicit forms of fiscal federalism seems unlikely, as it runs counter to most of the interests of those participating in it. Likewise, the most profitable parts of the Russian economy are under state regulation. Thus, bargaining with the state remains a major source of revenue. It may well be that a state dominated by oligarchs will be replaced by another system of oligarchs, nominated and dominated by the state.³¹ Insider dominance continues to be a highly influential factor of Russian capitalism. True, this is still superior to no privatization at all (i.e., the Belarusian variant), but it also provides support for an overall business environment that is continuously hostile to foreign ownership and penetration.³² Thus, the scenarios of large-scale modernization and industrial renewal cannot be seriously considered among the feasible options for the medium to long term.

Last but not least, the issue of Western involvement needs to be addressed. In the early 1990s the International Monetary Fund (IMF) and World Bank dominated Russia's financial scene—or at least they were the most visible means of Western leverage over Russia. However, this period is clearly over. As a large country Russia is more likely to be involved and included via such forums as the G-8, the Paris and London Clubs, or KFOR (Kosovo Force). Russia cannot be lost or gained.

As we have demonstrated in the preceding sections, the measures implemented so far are unlikely to foster dramatic improvement in conditions for private investment. The ongoing reforms do not address the funda-

mentals: i.e., connections with local governments and lack of meaningful financial intermediation. Large-scale state involvement is not the way to remedy these problems.³³ For domestic statist policies, the revenue base is simply missing; without it, the country will start down the road to hyperinflation, which is not in the interest of any of the current players—a condition well understood by the reformist team around President Putin. Alternatively, Russia could try to attract more foreign money. Since this is unlikely to be private money (due to the lack of incentives and security), perhaps public money could be mobilized. But experiences with large-scale, publicly funded international projects in the developing world have been so depressing that nobody, even in the international financial institutions, would advocate such a step. Along the same lines, legislative bodies in any major donor country are unlikely to endorse such mega-projects.

In concrete terms, the current situation leads us to conclude that disengagement would be counterproductive. Russia continues to have a stake in world affairs, particularly, though not exclusively, in Europe. It continues to perceive itself as a major European power. Thus, it remains sensitive to confrontations with European norms, be they human rights conventions or the *acquis* of the European Union. World Trade Organization (WTO) membership is an attainable target that may help formalize reform measures, particularly in the trade sector. Involvement in various forums defining good fiscal practices, banking standards, and accounting and disclosure practices may slowly but steadily help Russian reformers to change the entire socioeconomic environment in which they function.

The economic potential that is likely to emerge under the conditions of our baseline scenario, excluding major catastrophes, puts severe limits on the medium- to long-term potential of ongoing revitalization plans for the Commonwealth of Independent States (CIS) as an economic and monetary union, or the reintegration of neighboring Slavic countries. On the other hand, a Russia that perceives itself as alienated and excluded still possesses a considerable nuisance capacity, as events in southeast Europe, the Caucasus, and Central Asia may equally demonstrate. Thus, continued inclusion of Russia within various global forums and agreements, like the follow-up to the Kyoto Protocol or agreements regarding the Internet, as well as various forms of fighting organized crime, will continue to remain on the agenda.

CONCLUSIONS AND RECOMMENDATIONS

President Vladimir Putin has clearly given priority to reestablishing the independence of state authority, shaping the related economic interests, and even—during the late Yeltsin period—trying to dominate it. In a way, Putin has continued the effort begun by Yevgeni Primakov during his short

premiership following the August 1998 financial crisis, though without the current statist, antimarket and anti-Western undercurrents. The "dictatorship of the law" has thus, by definition, little to do with the Western concept of the rule of law, since law continues to be seen as an instrument to attain power and policy objectives rather than an arrangement limiting lawmakers and various authorities in the context of checks and balances. In fact, the often reactionary-style balancing role played by the Duma and the Council of Federation, by elected local officials, and the "not free but independent and pluralist" Russian press, or the view of Western observers of various sorts during the Yeltsin years, has been steadily on the decline. This is quite in line with Putin's intentions.

New legislation, such as the Labor Law, Land Law, and Banking Law, all point in the right direction. However, these fail to address some of the fundamental problems rendering the propensity to save and invest less than adequate in Russia: insecurity of property rights, prohibitively high costs of contract enforcement, lack of impartial conflict regulation by an effective judiciary, and last but not least, a system of sound financial intermediation. Those banks that survived the August 1998 crisis and the campaigns of the authorities are either semi-state units or fully state-owned, like the dominant players Sberbank and Vneshekonombank, or are home banks, accounting departments of large corporations, or regional authorities. Intertwining between state and business at the local level continues to dominate. The incentives and concerns continue to assist building and maintaining local empires, closed autarkic units rather than the allocation and optimization of resources across sectors, regions, and activities.

Recent campaigns concerning natural monopolies, particularly Gazprom, but also EES and the railways, did increase control by top echelons of power. However, this was a poor substitute for market-building measures, for making these markets contestable, and for making their prices and tariffs realistic, which would have made them good objects for domestic and foreign investors alike. The grievances of minority shareholders have not been addressed by the ousting of those previously involved in wrongdoings of various sorts. Actually, the stronger central control is, the lower the probability that minority shareholders can, in case of conflict of interest, enforce their rights via an independent court ruling against the dominant parastatals or the outright state owners. Reforms aimed at introducing elements of competition have either been watered down, as in the electricity sector, or delayed to 2002, as in the gas sector, or not even seriously considered, as in the railway sector. The latter, together with the aging of Soviet-era pipelines, may turn into a severe bottleneck for economic development in the foreseeable future. The sums needed for the recapitalization of these industries are not earmarked in the budgets of the current fat years. Moreover, rearrangement of transport tariffs, essential for any private investment to make sense, are not even envisaged to any degree that would make a difference for an investor in his right mind.

It appears that the government will restructure, rather than discontinue, the intimate intertwining between the public and private spheres, so typical of Russia and much of the developing world. The balance of power between central and local powers and state and business may change, but the name of the game remains bargaining, rather than free competition among political and economic ideas and agents.

As we have seen, the emerging crisis management measures solidify autarkic structures and counter tendencies to reallocate resources, save, invest and grow, and adjust inherited production lines to external demand. Therefore, the sluggish export performance of Russia is systemic rather than caused by high oil prices. The latter may only overshadow deeper problems and allow for continued optimism in forecasting. True, the current medium-term plan, estimating a 3.5 percent growth for 2002, 2.6 percent for 2003, and 4 percent for 2004, is a realistic correction of the over-optimistic estimates of the Gref Plan. However, even this might prove overly ambitious, depending upon oil price developments.

As we tried to prove, limited progress in the economic sphere is directly related to the conceptual limitations of enlightened absolutism, where centralizing political tendencies are married to, more or less, market radicalism. In a comprehensive economy and society in Europe, where urbanization and literacy are dominant, there is no role for the developmental state of the coal and steel and textiles period. Lacking progress in political pluralism puts inherent limits on economic legislation and institution building, whereas the latter will constrain allocation efficiency and the propensity to invest domestically. And even in the most outward-oriented East Asian states, foreign direct investment could only complement, but not replace, domestic savings and domestic private investment as an engine of sustaining growth.

NOTES

1. U.N. Economic Commission for Europe (UNECE), *Economic Survey of Europe*, no. 1 (2001).
2. Comparative estimates reported in *Voprosy Ekonomiki*, no. 3 (2001), p. 44; consolidated deficit figures, *ibid.*, p. 61.
3. Clifford Gaddy and Barry Ickes, *Russia's Virtual Economy and Economic Rebound* (Washington, D.C.: The Brookings Institution, forthcoming) provides detailed econometric evidence.
4. Andrei Illarionov, "Ekonomicheskaja politika v usloviakh otkrytoi ekonomiki so znachitel'nim syrevim sektorom," *Voprosy Ekonomiki*, vol. 72, no. 4 (2001), p. 21, provides evidence and the numbers.
5. Described impartially in detail by *Economic Survey of the Russian Federation, 1999-2000* (Paris: OECD, 2000). For an insider view see the exhaustive analysis of Yegor Gaidar, ed., *Ekonomika perekhodnogo perioda* (Moscow: IEPP, 1998).

6. For an explanation of the paradigmatic and practical significance of this circumstance, see V. Mau, "Politicheskaiia priroda i uroki finansovogo krizisa," *Voprosy Ekonomiki*, vol. 70, no. 11 (1999), pp. 4-19; and László Csaba, "A Decade of Transformation: Russia and Hungary Compared," in Andrzej Brzeski and Jan Winiecki, eds., *A Liberating Economic Journey* (London: CRCE, 2000), pp. 99-140.
7. This point is circumspectly documented and explained in Alfred Stepan, "Russian Federalism in Comparative Perspective," *Post-Soviet Affairs*, vol. 16, no. 2 (2000), pp. 171-73.
8. See the summary chapters of these two authoritative collections, in which the editors highlight this particular point. Robert Bates and Anne Krueger, eds., *The Political Economy of Economic Policy Reform* (Oxford: Blackwell, 1992); and John Williamson, ed., *The Political Economy of Policy Reform* (Washington, D.C.: Institute of International Economics, 1994).
9. Richard Rose, Neil Munro, and Stephen White, "Voting in a Floating Party System: The 1999 Duma Elections," *Europe-Asia Studies*, vol. 53, no. 3 (2001), pp. 438-40. They highlight the low level of representation and lack of ideological orientation among the major factions.
10. Luke March, "For Victory? The Crises and Dilemmas of the Communist Party of the Russian Federation," *Europe-Asia Studies*, vol. 53, no. 2 (2001), pp. 263-90, offers a comparative perspective on the Euro-communist experience.
11. Acting on a law and order platform, Yevgeni Primakov, the first post-crisis premier, attempted to crush the power of the oligarchs by a series of anti-corruption and tax-law enforcement measures. He proved to be much more aggressive and also much more successful in political, if not macroeconomic, terms than any of his predecessors. His success and popularity at the time made him a powerful rival to Yeltsin, who was too slow to get rid of him by appointing the state security chief Sergei Stepashin to the premiership. Primakov then joined forces with Moscow mayor Yuri Luzhkov in forming the "Fatherland" movement, which was then seen as the most challenging opposition movement for the presidency.
12. According to Alexander Radygin, "Sobstvennost i integratsionniie protsessi v korporativnom sektore," *Voprosy Ekonomiki*, vol. 70, no. 5 (2001), p. 26, 64 percent of all profits originated from fuel companies in 1999 and 71 percent did in 2000.
13. See Masha Lipman and Michael McFaul, "'Managed Democracy' in Russia," *Press and Politics*, vol. 6, no. 3 (2001), pp. 117-28, highlighting the limitations this approach puts on any system of checks and balances.
14. See one of the harshest critics of Yeltsin's practices, Stefan Hedlund, "Property without Rights: Dimensions of Russian Privatization," *Europe-Asia Studies*, vol. 53, no. 2 (2001), pp. 234-35. The rest of his article provides extensive historical background to this argument. In a similar vein, see also László Csaba, *The Capitalist Revolution in Eastern Europe* (Cheltenham: E. Elgar, 1995), part I.
15. This point is highlighted strongly in an otherwise optimistic assessment of Russia in Anders Aslund, "Think Again: Russia," *Foreign Policy*, no. 127 (November 2001).
16. This was expressed by an insider in Vladimir Mau, "Ekonomicheskaiia politika Rossii: v nachale novoi fazi," *Voprosy Ekonomiki*, vol. 72, no. 3 (2001), pp. 10-11, calling attention to the compromise nature of the strategy.
17. Aleksei Lavrov, John Litwack, and Douglas Sutherland, "Reforma mezbudzetnikh otnoshenii v Rossii: 'federalizm sozdaiuschii rynok,'" *Voprosy*

- Ekonomiki*, vol. 72, no. 4 (2001), pp. 39-41, in their detailed empirical study of parallel fiscal policies conducted by local authorities.
18. For a similar argument, see Leonid Smiriagin, "Who Runs the Russian Regions?" at the conference "Russia, Ten Years After" hosted in Washington, D.C., by the Carnegie Endowment for International Peace, June 7-9, 2001. He calls attention to the very strong formal and informal power base of elected local leaders against presidential envoys, as well as to the arbitrariness of the newly created seven regions that are already crosscut by actual economic processes.
19. As documented in detail in a monograph by Matthew Hyde, defended as his Ph.D. thesis at the University of Essex and summarized in Matthew Hyde, "Putin's Federal Reforms and Their Implications for Presidential Power in Russia," *Europe-Asia Studies*, vol. 53, no. 5 (July 2001), pp. 719-43.
20. In their empirical study Auzan and Kriuchkova (pp. 80-81) discuss "lock-in phenomena" in which regulators and the regulated develop a joint interest in sustaining the status quo and excluding any new entrant. A. Auzan and P. Kriuchkova, "Administrativniie barieri v ekonomie: zadachi deblokirovaniia," *Voprosy Ekonomiki*, vol. 72, no. 5 (2001), pp. 73-88.
21. Tatiana Dolgopiatova, "Modeli i mekhanizmi korporativnogo kontroliia v rossiiskoi promyshlennosti," *Voprosy Ekonomiki*, vol. 72, no. 5 (2001), pp. 46-60, provides an empirical proof based on a survey of the three hundred largest firms in Russian industry.
22. Some Western analysts draw parallels to experiences of Organization for Economic Cooperation and Development countries where policy expediency and entrenched structures produced similar outcomes. See Martin Siner and Jon Stern, "Reform Electricity Market in Transition Economies: How to Avoid Traps of Deregulation?" *Transition* vol. 11, no. 6 (2000-2001), pp. 8-10.
23. V. Mau, "Ekonomicheskaiia politika Rossii: v nachale novoi fazi," pp. 20-21, adds to this the problem of ongoing conceptual disputes between the government and Central Bank over the future role of banks.
24. A. Radygin, "Sobstvennost i integratsionniie protsessi v korporativnom sektore," pp. 36-38, provides empirical evidence for the process of multidimensional concentration.
25. Empirical cross-country evidence for this point (including Russia) is provided in Robert McIntyre and Bruno Dallago, eds., *Small Business in Transition* (Oxford: Oxford University Press for WIDER, forthcoming); and L. Csaba, ed., *The Hungarian Small Business in Comparative Perspective* (Washington: U.S. Agency for International Development, 1998).
26. J. Laurilla, "FDI and the Russian Energy Sector: An Ill Managed Partnership," BOFIT, *The Russian Economy: The Month in Review*, April 2001, cites profitability gaps due to low prices, high taxes, and nonpayments.
27. Absorption capacity is a technical economic concept, denoting the amount of money any economy is able to put into good use (i.e., producing high returns) in any particular period of time. It has been proven, especially during times of plenty, as in major oil-producing countries following the 1973 and 1979 shocks, that overinvestment can be welfare reducing, even in the long run. It should be obvious that a good investment climate allows for more investment and a bad climate for less, thus this capacity is never technically a given (i.e., by a mere reference to per capita GDP).

28. Anders Aslund, "The Soviet Transformation," *Financial Times*, September 11, 2001, argues forcefully in favor of interpreting post-Soviet growth as export-led and attributable to the new radicalism in reform policies all across the CIS region.

29. "Kreditanstalt," *Central European Quarterly*, no. 2 (2001), p. 53.

30. This argument is advanced by S. Alexashenko, A. Klepach, O. Osipova, and S. Pukhov, "Valiutnii kurs i ekonomicheskii rost," *Voprosy Ekonomiki*, vol. 72, no. 8 (August 2001), pp. 28–31.

31. This is the view expressed in the presentation by Sergei Vasiliev, "The Structure of the Russian Economy and Political Trends in Russia," at the Carnegie conference referenced in note 18.

32. Silvana Malle, "Russia After a Decade of Transition," in A. Brzeski and J. Winiecki, *op. cit.*, pp. 65–97, concludes by stressing both components of the same phenomenon.

33. An English language summary of the arguments for statist policies, still proliferating in the Russian academic and policy-making literature, is presented by Jacques Sapir, "The Russian Economy: From Rebound to Rebuilding," *Post-Soviet Affairs*, vol. 17, no. 1 (2001), pp. 1–22, without, however, addressing the two major points of our critique, i.e., nonavailability of funds and lack of administrative capacity to implement such projects.

4

Russia's Energy Policy

Jurgis Vilemas

This chapter presents the various ways in which Russia's energy policy and foreign policy interacted with each other after the collapse of the Soviet Union and the subsequent consequences for developments in neighboring countries. In the difficult process of transition from central planning and state ownership to a market-oriented economy and private ownership, Russia efficiently exploited several newborn, semiprivate companies such as Lukoil, Gazprom, and United Energy Systems (UES) to expand its economic control and political influence. This chapter presents some concrete examples of that process. Vast reserves of natural resources are a very important factor in Russia's relations with the European Union and other Western countries. Russia's urgent need for huge investments in order to exploit its resources has a particular influence on those relations.

New discoveries of oil and gas around the Caspian Sea have fomented long-running strategic disputes among many countries, particularly in the area of transportation to the markets. The deposits are located between high-volume consumers—today Europe and Russia, China in the future, and Iran—and are of great geopolitical interest for all of them, as well as the United States.

The significance of Russia's vast natural resources, and especially energy resources, to Russian energy and foreign policy cannot be overemphasized. Russia controls the greatest oil, gas, coal, and uranium deposits on the globe. It has a comparatively well-developed technical infrastructure for exploration and development of those resources, and that infrastructure is backed by a cheap and experienced labor force. During its post-Soviet period, Russia used those assets not only to influence the former satellite countries' domestic economic and energy policies, but also as a very powerful instrument of foreign policy. This influence is particularly strong in