Russia in a 10–20 Year Perspective

Anna Jonsson, Fredrik Erixon and Marlène Laruelle
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Preface

This report was written in spring 2009 and commissioned by the Swedish Armed Forces Headquarters. Its main task is to identify and describe alternative scenarios for Russia’s development in a 10 to 20 year perspective. The report was assembled and edited by Anna Jonsson, who also wrote the main sections on domestic developments and foreign policy. Fredrik Erixon and Iana Dreyer contributed with the section on Russia’s economic development and statecraft. Marlène Laruelle wrote the section on domestic challenges and the foreign policy analysis of Russia’s relations with Central Asia, Japan, China and Turkey. She also contributed the text on the Arctic Issue. Svante Cornell contributed to the section on South Caucasus and Iran. Anders Schön made valuable contributions as a research assistant. The authors would like to thank Dr Anders Åslund for valuable comments and suggestions.

Anna Jonsson
Stockholm
October 9, 2009
Executive Summary

Russia is a resource based economy using economic and energy power as leverage in international politics. Its special form of economic growth – based almost entirely on rising prices in the hydrocarbon and mineral sectors – have been conducive to (and fostered) the authoritarian style of economic management that emerged from 2003 onwards. Since Putin’s coming to power traits of state capitalism and authoritarianism have had a significant impact on the performance of the Russian economy. Russia’s main foreign policy tool is economic and energy power, hence the need for state control and influence on the economic development and the energy policy. Russia has been skilled in using its economic and energy leverage. Nevertheless, Russia is still an emerging market. It is a populous country, but the size of the economy is smaller than the large European economies, such as France and Germany. Current and future regimes will depend for support and legitimacy on the continued growth of material wealth amongst the Russian population. In the coming 10 to 20 years Russia is in dire need of improving its health and social services, education system and technological advancement among other things. There are many holes that need to be filled and this together with rising xenophobia, a negative demographic trend and the resulting need for more migrant workers, the Muslim issue and the Siberia question do pose serious challenges to the Russian state and it puts into question its ability to define relevant and efficient policy responses, and more importantly, its ability to efficiently implement them. The financial crisis did not at the time of writing this report fulfil the hopes of those in and outside Russia that saw the crisis as an opportunity for Russia to undertake long overdue reforms and liberalize its economy and its political system. Signs of efforts on the front of the rule of law, such as Medvedev’s anti-corruption measures, do not represent systemic shifts. As long as Prime Minister Putin and his team – with its dual composition of so-called liberals and hard-line nationalists connected to the secret services (siloviki) – are in the driving seat, Russia’s economic fate must be seen within the political economy that prevails in Russia which is proving solidly entrenched.
Trying to forecast domestic developments in Russia in a 10 to 20 year perspective requires a distinction between matters that fall under the control of Russia’s political leadership and those that do not. Examples of the latter include the global financial crisis and the oil price, while the former refers to the regime’s ability to develop and implement appropriate policy responses to the socio-economic situation of its population. In a short-term perspective, the ruling elite will blame the effects of the financial crisis on the West and the U.S. in particular. This approach will buy Moscow time to come to terms with the effects of the crisis at the same time as it benefits Russia’s foreign policy ambitions. The effects on the freedom of mass media, civil society and independent experts are likely to be substantial: in order for the regime to win the blame game, it needs to counter any independent reporting and analysis of the causes and effects of the crisis. This is nevertheless a risky approach. Should the gap between the official rhetoric and the situation that the population finds itself in become to vast, it may undermine the legitimacy that the current regime possesses in the eyes of the Russian people. In order to avoid such a development, the government needs to reinforce its modernization program. Since this process is set on hold, and it is unlikely to restart in the short term, the state is likely to fall back on repressive measures to control public opinion and any manifestations of discontent. It is not likely that there will be any regime change in Russia come the presidential elections in 2012 and Duma elections in 2011 unless there is a systemic breakdown due to the economic developments.

In a 10 to 20 year perspective, Russia will face dramatic demographic changes. The possible rupture in the current social contract and growing regional distortions could undermine the quest for “sovereign democracy” and smart power. The future of Russian domestic politics will be partly determined by the Kremlin’s ability to secure a civic identity to its citizens, which means that the current policy to promote ambiguous nationalist rhetoric will have to be halted. The regime’s lack of experience in managing large-scale social conflicts makes it weaker than it may appear to be. Using the instrument of nationalist mobilization may be a short-term approach to avoid any political challenge, but would in a more long-term perspective form a threat to internal stability.
Russia is likely to continue to strive towards multipolarity on a global level in a 10–20 year perspective and to maintain its realist approach to international politics. Its main goal will be to maintain stability domestically while strengthening its position internationally. In the external domain, Russia’s main challenges lie in its neighboring regions, especially the instability of Central Asian countries and the continued efforts on the part of the western CIS countries to break free from Russia’s sphere of influence. Although any future NATO-enlargement is still viewed as a hostile action by Moscow, it is not likely to lead to a direct confrontation, except possibly in the Crimea. The Middle East, especially Russia’s relations with the current regime in Iran will continue to challenge the U.S. and in the longer run also Europe. Russia’s relationship with Iran is likely to be used by Russia as a card to strengthen its position globally. Russia’s actions in this context in the near term will be of great importance for its relations with the U.S., Israel and Europe in a 10–20 year perspective and will go to great lengths in determining whether Russia is a partner or an adversary to the West.

In conclusion, Russia is likely to strive towards strengthening its smart power, i.e. its ability to combine hard and soft power. This includes improving its diplomatic skills, intelligence gathering and analysis, economic power and technological innovations. The Kremlin’s response to the “color revolutions”, its handling of the information war during the war with Georgia and its lagging behind in technological developments testifies to some of the challenges facing Russia in a 10–20 year perspective. Threats to Russia’s stability and safety are both external and internal. Any one specific situation that would threaten to shake Russia fundamentally is to be found within its borders in the North Caucasus.
Introduction

The purpose of this report is to present three scenarios on Russia’s standing on the international arena and relations with other power houses in a ten to twenty year perspective. When identifying scenarios it is necessary to reflect on both predictable and unpredictable factors contributing to change. Clearly, we are not trying to predict the future. We are however, engaging in a discussion on plausible scenarios in Russia. Our starting point is taken in recent developments in Russia’s domestic, foreign and security policy, and in the development of Russia’s economy based on the assumption that Russia’s economic status is of great importance for its standing and actions on the international scene and its bilateral relations. This report was written in spring 2009.

The report takes its starting point in an analysis of Russia’s economic development and its economic statecraft, including its energy power, based on the assumption that Russia is a resource-based economy and that its economic performance is of great importance, although not necessarily decisive for its foreign policy and domestic developments. Thereafter follows an analysis of Russia’s recent foreign and domestic policy developments. The report discusses possible future developments focusing on Russia’s relations to the surrounding world, its role on the global scene, its primary interests and driving forces in foreign and security policy and the impact of domestic developments on strategy and capacity to reach these goals. It pays certain attention to the nature of power in Russia and its possible effects on future developments. In addition, Russia’s relations with other important powers such as the United States, China, Japan, the European Union and NATO will be included in the analysis, as will regions such as the Baltic Sea region, the Arctic Region, Central Asia and the South Caucasus. The report concludes with three scenarios on Russia’s economic, foreign policy and domestic developments.
Russia’s Economy and Economic Statecraft: Past, Present and Future

Russia experienced a spectacular economic boom in the past ten years. Its first transition period ended abruptly in 1998 with Russia’s severe financial crisis. A raft of macroeconomic reforms by the Yeltsin (1993–99) and Putin (2000–2008) governments restored confidence in the overall macroeconomic management of Russia. Growth picked up early in the 2000s and subsequently took off as world commodity prices soared. From 2002 to 2008, Russia’s economy boomed. Increasing oil and gas prices (gas prices follow oil prices with a time lag of approximately six months) enabled Russia to follow an export-led economic growth model, with increasing revenues coming through the balance of trade. Reserves soared and fiscal revenues enabled Russia to balance its books and, later, to run a significant fiscal surplus. Capital also accumulated in the private sector and a new breed of Russian financiers and capitalists emerged – some of them domestically focused; others with an appetite for investing abroad and acquiring foreign assets. A domestic investment boom followed on the heels of the commodity boom. Asset prices in Russia increased rapidly and a considerable part of net savings ended up in the construction sector. Despite income distributional concerns about the newly acquired wealth, the past ten years saw the emergence of a Russian middle class, rapidly proliferating, with incomes enabling them to travel abroad for holidays and seek a lifestyle vastly different from life during the era of communism or under the turbulent period immediately after the fall of the iron curtain.

But everything is not well in the Russian economy. The global economic crisis that started in 2008 hit Russia hard. Oil prices went from roughly US$150 per barrel in mid-2008 to US$30 in early 2009. For an economy dependent on resource extraction, especially in the hydrocarbon sector, the effect of such rapidly declining prices is felt immediately. The oil price then picked up, but with commodity prices expected to remain in the “low regions” in 2009 and 2010 (low compared to the pre-crisis level), Russia’s economic problems are likely to be sustained for yet some years.
There is another, and arguably larger, set of problems related to Russia’s economy and its institutions for economic policy. Economic institutions and management are weak, unstable and in the hands of the Kremlin. Its special form of economic growth – based almost entirely on rising prices in the hydrocarbon and mineral sectors – have been conducive to (and fostered) the authoritarian style of economic management that emerged from 2003 onwards. As its economy grew in the last decade, the regime led by President (later Prime Minister) Vladimir Putin has become increasingly authoritarian and assertive also on the foreign economic and geopolitical scenes. It has embarked upon an attempt to regain its lost influence over the area that used to constitute the former Soviet empire. The means to achieve this have been economic, rather than military. The war in Georgia in 2008, however, signaled that Russia’s rise can breed international instability of a different magnitude than those caused by its economic statecraft. The economic crisis prompted commentators to believe that Russia’s assertiveness will abate. This, however, is a very optimistic proposition.

Russia’s growing economic power based on its hydro-carbon resources has caused concerns for its European neighbours. Economically, Russia depends more on the EU than vice-versa. Indeed, its growth depends on its exports of hydrocarbons, of which a considerable part is engineered for Europe. The latter represent two thirds of Russian exports. Yet Europe’s energy dependency on Russia, its fragmented energy market, and the absence of a common foreign policy have made the EU a weak partner for Russia and created an asymmetric bilateral relationship. The EU’s interests have been neglected time and again by Russia. European investors have been stripped of invested assets in Russia, and Russia has been able to play such games with the EU as its main energy partners in Europe have been offered energy deals too lucrative to decline. European attempts to diversify its gas imports and introducing a common energy market have been torpedoed by a number of powerful EU member states, which Russia has cultivated with preferential access to its energy and strategic bilateral relations. This situation has harmed the new EU member states in particular. They have brought with them a pipeline network that is a Soviet legacy – their higher
energy dependence on Russia made them the most vulnerable victims of the three-week gas disruptions that occurred in early January 2009.

Put differently, Russia has been skilled at using its economic statecraft: it is leveraging its energy resources and trade for other purposes. It is also punching above its weight. Russia is still an emerging market. It is a populous country, but the size of the economy is smaller than the large European economies, such as France and Germany - the German economy is thrice as big as the Russian. In volume terms, the annual economic growth in the past years has approximately averaged the volume increase in one big European economy (France or Germany). Russia, then, has been able to exercise an influence on regional policy (economic and political) in Europe which is larger than pure GDP figures suggest it should have been.

**Profiling Russia’s Economy and Economic Policy**

*Russia’s Economic Boom*

Russia’s economy grew an average of seven per cent of GDP between 2000 and 2007. Growth continued till mid-2008. The invasion of Georgia was a severe blow to Russia’s economy, as investors fled the country in fear of what might happen, to be followed by the global financial collapse and the economic crisis, which hit Russia hard.

Growth in the past decade was determined by two major factors: the macroeconomic reforms adopted in the aftermath of the 1997–98 Asian financial crisis and the oil price. From 1997 to 2000, the Russian government undertook a major turn and pursued policies aimed at fiscal stability and macroeconomic prudence. Public expenditures were axed in a move until then unprecedented in world economic history – Russia cut expenditures to the equivalent of 14 per cent of GDP. Centralization of power and sheer necessity induced the government to improve tax collection. A new bankruptcy law was adopted in the aftermath of the 1998 crisis, which at first led to a more distinct separation of power between the Kremlin and private enterprises. This imposed hard budget constraints on companies, leading ultimately to greater efficiency. The Ruble was drastically depreciated, which improved export competitiveness.
When Vladimir Putin became president in 2000, reforms continued at first. His first term as president was actually characterized by focus on reform and a willingness to integrate Russia into the world economy in a fashion conducive to basic rules and international agreements for cross-border trade. The need to attract foreign investments was the prime motivation for this outward orientation. Putin’s reforms included a drastic tax reform: a flat income tax of 13 per cent replaced the previous progressive but inefficiently collected tax. Social security contributions were cut. Agencies handling tax collection was unified into one single agency, and small-scale tax violations were decriminalized. A sweeping deregulation move was undertaken in 2002 that promoted business development. It involved reform of business registration and licensing. Russia’s product standardization system was also improved. Government inspections were limited. This reduced bureaucratic harassment and led to an important rise in the number of officially registered enterprises. In July 2002, the last bastion of collective property ownership was abolished: a law on privatization of agricultural land was passed.

A first consolidated government budget surplus was posted in 2001, and peaked at 8.5 per cent in 2006. In the meantime, oil prices soared from around US$10 per barrel in mid-1999 to US$50–60 in 2006, peaking at levels close to US$150 in July 2008. Russia’s population benefited greatly from this economic boom. A middle class emerged, estimated at approximately 20 per cent of the population in 2006. GDP per capita soared from US$1,328 in 1999 to US$11,806 in 2008 (in current prices, not adjusted to purchasing power). Consumption and domestic demand were drivers of economic growth. In 2004, capital flight, a curse that had plagued the Russian economy since the end of the Soviet Union, reversed. Foreign direct investment soared, up from previously insignificant levels. While hydrocarbons and mining were the main FDI destinations, real estate and wholesale trade as well as manufacturing have been increasingly important.
In January 2004, the Russian government introduced a Stabilization Fund to store its rapidly accumulating revenues from hydrocarbons exports. Its aim was to set revenues aside to avoid inflationary pressures that tend to arise in commodity-export driven economies with pegged exchange rates. Its aim was also to set aside reserve money to provide a cushion in the advent of a fall in commodity prices. In February 2008, the Stabilization Fund was split into two distinct funds: a first Reserve Fund of US$125bn to be invested in overseas investment and government-backed agency bonds; another National Wealth Fund of US$32bn for riskier overseas investments.
Table 1: Consolidated budget for the Russian Federation (% of GDP)

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>39,7</td>
<td>40,2</td>
<td>38,5</td>
<td>24</td>
</tr>
<tr>
<td>Expenditures</td>
<td>31,3</td>
<td>34,1</td>
<td>33,7</td>
<td>32</td>
</tr>
<tr>
<td>Balance (surplus/deficit)</td>
<td>8,4</td>
<td>6,1</td>
<td>4,8</td>
<td>-8</td>
</tr>
<tr>
<td>Non-oil balance</td>
<td>-2,6</td>
<td>2,7</td>
<td>-5,8</td>
<td></td>
</tr>
<tr>
<td>Financing</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Drawdown from Reserve Fund</td>
<td>8</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic borrowing</td>
<td>7</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stabilization Fund</td>
<td>8,7</td>
<td>11,7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserve Fund</td>
<td></td>
<td></td>
<td>9,7</td>
<td></td>
</tr>
<tr>
<td>National Welfare Fund</td>
<td></td>
<td></td>
<td>6,2</td>
<td></td>
</tr>
</tbody>
</table>


Just before the outbreak of the 2008 economic crisis, Russia had amassed the world’s third largest foreign currency reserves, which amounted to almost US$600 billion in mid-2008. Inflation dropped below the two-digit-level in 2006, a substantial fall compared to the 85 per cent of 1999. Yet as commodity and food prices soared and fiscal policies were relaxed in 2008, consumer price inflation rose back to 14 per cent. The introduction of the Stabilization Fund in 2004 and the first three-year government budget in 2008 were the last major economic reform steps towards prudent macroeconomic management and liberal market economy. Resources from this fund allowed Russia to rapidly pay off its US$133bn external debt to international creditors, mainly the International Monetary Fund and the Paris Club.

Increasing State Control of the Economy and the Energy Sector

In 2004, the economic reform climate shifted away from liberal market orientation to increased state intervention and ownership in the economy. The beginning of the process can be traced back to late 2003, and the arrest of Mikhail Khodorkovsky, CEO of Russia’s largest private oil company, Yukos. The arrest and sentencing of Khodorkovsky was the result of the Kremlin’s strategy of reasserting power over the “oligarchs,” a general
move towards centralization, and to take control over energy resources. 

Yukos’ assets were acquired by the state-owned oil company Rosneft through a murky tender procedure and the mediation of a shell company. Foreign shareholders lost their shares as well, without compensation. These sued the Russian state for violation of investment protection rules, and an arbitration tribunal in the Hague is expected to issue a ruling about the applicability of the Energy Charter Treaty (ECT) to Russia. If Russia is ruled to be bound by ECT commitments, numerous claims against the Russian state for expropriation of assets are likely to follow.

The expropriation of Yukos’s assets marked the beginning of a new era. With increasing frequency, the Kremlin intervened in the energy market with the aim to seize control over the extraction and export of energy. Foreign investors like BP and Shell encountered greater difficulties in their explorations, and finally their Russian counterparts grabbed the assets and squeezed their partners out of the companies. Shell’s experience in the Shakhalin-II venture is a case in point.

The state-controlled monopolist Gazprom controlled 85 per cent of Russia’s gas output at the height of the energy boom in 2008. Russian energy majors are, however, also in control of production in neighboring countries. A considerable part of Kazakhstan’s and Turkmenistan’s gas is transited through Russia before reaching consumers in Europe. Gazprom has also made inroads in other countries, e.g. by seeking transit rights for Azerbaijani gas and by forming joint partnerships with other energy companies in extracting gas in Northern Africa. Gazprom also has an increasing stake in Europe’s energy retail sector by investments in some of the larger European energy companies. Partnerships with power-supply companies like Wingas (with operations in Belgium, France and Germany), and with input suppliers to power companies like Siemens, have entrenched Gazprom’s role in the European energy market. The Kremlin also controls the oil sector, albeit to a lesser extent: approximately 50 per cent of output of crude oil comes from Kremlin-controlled companies.

There were several motivations for the Kremlin’s move to reassert control over Russia’s energy resources. First, there was widespread discontent with the murky ways in which some of the oligarchs had gained control
over energy companies. Foreign investors were also accused of having benefited inappropriately from the ‘fire sale’ of energy assets. Regaining control over these assets was seen as a way to ‘close the books’ of the 1990s and leave its turbulence behind. Second, because privatized energy companies performed very well, the Russian government and its cronies wanted greater access to their revenues. The newly privatized energy companies enriched the owners and created good revenues for the government. However, the Kremlin believed it could not sufficiently increase revenues through taxes. Higher taxes could have become punitive and a disincentive to production. By controlling ownership, however, the Kremlin could take a larger share of the revenues while influencing the decision-making procedure to the benefit of the government. This is the logic of state capitalism, and in Russia it did briefly work well as a strategy to increase revenues to the government. However, government-controlled companies have not been good at bringing new resources on stream, which is why the Kremlin has grabbed control over resources when other companies had done this job for them. This motivation for seizing control was amplified by the fact that the Kremlin and the government-owned companies had invested too little in gas and oil exploration and extraction.

Consequently, the Kremlin-owned companies did not create the revenue stream other companies did; but by seizing control over other companies, the Kremlin could jump its own investment problem. Government-owned companies remain ineffective and perform far below the standard among independent energy firms. The crisis has made the inefficiency of the big energy majors even more visible, with Gazprom cutting its production much more than independent gas suppliers. Third, Russia could not leverage its energy power as much as it wanted to as long as large energy resources were in private hands and mostly run in a commercially rational way. By controlling the assets, the government also gained greater power in controlling energy prices in other countries. With greater control of energy firms, the Kremlin could also leverage its energy power to a greater degree towards Former Soviet Union countries (FSU) that were re-orienting themselves away from Russia and toward the west. Obviously, Ukraine after the Orange revolution was one of Kremlin’s targets. This was neither the first
or last time it leveraged its energy power against Ukraine, through which 80 per cent of Russia’s energy to Europe is transited. But these tensions were aggravated after the Kremlin lost control over the Ukrainian government.

But the state capitalism that emerged in Russia was not only confined to the energy sector. Since 2004, the development of ‘strategic industries’ became a government priority. Mandatory levels of state ownership and control, and limits on FDI were imposed on companies in a broadly defined list of sectors. Aside from energy and defense, these sectors include shipbuilding, banking, telecommunications, automobiles, and nanotechnology. While clarifying legal uncertainties, the long list of sectors on which restrictions were ultimately introduced in 2008 revealed the extent of the state’s intervention in Russia’s productive sector. State assets grew to roughly 40 per cent of the RTS, Russia’s biggest stock exchange in 2007. The EBRD registered a 5 per cent increase of state ownership in the overall Russian economy in its 2005 statistics. Re-nationalization was accompanied by restrictions on competition, from within or abroad: tariffs in the automotive industry were raised; foreign ownership in the oil and gas sector was limited in 2008 to 10% in the oil and gas sector (5% when foreign ownership is in state hands); in 2006, a Gas Export Law strengthened the monopoly of Gazprom’s pipelines over exports of Russian hydrocarbons, along with the state-owned oil pipeline operator Transneft.

Box 1: Economic challenges for Russia

| Excessive reliance on hydrocarbons exports for its economic growth: Russia’s dependence on hydrocarbons and commodities exports has risen in the last years. According to the Russian statistical agency Rosstat, minerals accounted for 53.8% of Russian exports in 2000, and 64.7% in 2007. The next major Russian export commodity is metals. These represented 21.7% of Russia’s exports in 2000 but only 16.1% in 2007. Although it is a relatively large economy, Russia’s exports correspond to about 30 per cent of its GDP. It is thus highly exposed to fluctuations in the global economy and particularly vulnerable to the developments in one single commodity. |
| Underinvestment: Investment represents only 23% of Russia’s GDP. Russia’s investment needs are high. One must set its average economic growth of 7% in... |
the last years against major East Asian economies, which have enjoyed levels of investment of 30%. Consumption became a strong driver of economic growth in Russia in the last years. But this pattern tends to be typical of a resource-rich economy. Consumption cannot be relied on as major GDP growth driver when commodity prices collapse, unless the economy diversifies.

**Insufficient development of high value-added manufacturing and of the services sector:** In Prime Minister Putin’s “Russia 2020” strategy, high tech features as one of the priority sectors for Russia. The government has set up several state-owned companies or funds to develop high technology activities, such as the company Rosnanotekh (created in 2006), or Rostekhnologii for the development of the defense and aerospace sector (created in 2007). Yet the efficacy of such companies in fostering innovation-driven companies remains to be proven. Russia has an immense backlog in information technology development and absorption, its intellectual property regime is weak, its universities in need of major reform, and its investment climate notoriously deterring. Russia’s service sector is also underdeveloped. Russia’s economy is still shaped by a Soviet legacy of overemphasizing capital-intensive manufacturing. Russia’s financial sector does not fulfill a satisfactory mission of efficient financial intermediation – which explains Russian companies’ excessive reliance on external borrowing previously to the current crisis. Total Russian corporate foreign debt was US$488bn in October 2008. Most other services sectors, both tradable and non-tradable, are widely underdeveloped. Foreign investment into Russia’s services sector is strongly limited. Banking, insurance, transport, telecommunications are among the most restricted sectors for foreign investment in comparison to other BRIICS economies.¹

**Deficient infrastructure:** Russia’s infrastructure is a major impediment to its economic growth and diversification. Except in the electricity sector, where Russia has undertaken moves to bring in competition and foreign investment in order to develop capacity, the state of Russia’s infrastructure is as parlous as one might expect when no investment has occurred since the collapse of the Soviet Union. Russia’s roads in particular are famed for their wretched state.

**Deficient social systems:** Russia’s population is shrinking: it lost 5 million people between 2000 and 2008 alone. Russia’s male life expectancy is low, 59 years, and has declined in recent years. This can be attributed to the countries’

¹ BRIICS refers to an OECD classification of the world’s biggest emerging markets. These are Brazil, Russia, India, Indonesia, China and South Africa. For an overview of data on protectionism levels, please refer to Razeen Sally (2008).
deficient health care system. Russia’s higher education system is in need of modernization and is known for its corruption. Such developments lower the prospects for economic growth and for the levels of labour productivity growth required for Russia to fulfil its stated goals towards 2020.

**Deteriorating investment climate, corruption and excessive bureaucratization:** Russia’s bureaucracy has doubled between 1999 and 2008. Corruption has also risen (see Annex I). Russia’s record in the World Bank’s Doing Business indexes indicates that it is a very difficult environment to operate in as an investor, whether domestic or foreign. It ranks 120th out of 180 in the World Bank’s listings. Its worst record is in dealing with construction permits (rank 180 out of 180), trading across borders (rank 161) and paying taxes (rank 134).

**Dissecting Economic Indicators**

*Prudent Macroeconomics*

Table 3 gives an overview of Russia’s macro economy between 2006 and January 2009. GDP growth has been high, but the industrial sector has not kept pace with overall growth. The typical pattern for an emerging market is the opposite: industrial production grows much faster than the overall economy. In Russia, fixed capital has expanded rapidly, and a considerable part is denominated by investment in real estate. The government has run a significant fiscal surplus. There has also been a significant surplus in the current account, in the region of US$75–100 billion per year. The trade surplus has been larger than the current account surplus. Also significant is the expansion of reserves, which peaked in mid-2008. Inflation has remained at high levels despite constant efforts with sterilizing the trade surplus. On almost all fronts, the macro-economy deteriorated in the last quarter of 2008 and the first month of 2009, when industrial production contracted rapidly, falling by 16 per cent in January 2009. For 2009, Russia was predicted to have a fiscal deficit in the -5–8 per cent region.
Table 3: Main macroeconomic indicators

<table>
<thead>
<tr>
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<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>Q4 2008</th>
<th>Jan 09</th>
</tr>
</thead>
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<tr>
<td>GDP growth %</td>
<td>7,7</td>
<td>8,1</td>
<td>5,6</td>
<td>1,1</td>
<td>-8,8</td>
</tr>
<tr>
<td>Ind. production growth, y-o-y %</td>
<td>6,3</td>
<td>6,3</td>
<td>2,1</td>
<td>-6,1</td>
<td>-16</td>
</tr>
<tr>
<td>Fixed capital inv. growth, y-o-y %</td>
<td>16,7</td>
<td>21,1</td>
<td>9,8</td>
<td>-2,3</td>
<td>-15,5</td>
</tr>
<tr>
<td>Federal gov. balance</td>
<td>7,4</td>
<td>5,5</td>
<td>4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inflation (CPI)</td>
<td>9</td>
<td>11,9</td>
<td>13,3</td>
<td>13,3</td>
<td>2,4</td>
</tr>
<tr>
<td>Current account, bn USD</td>
<td>95,6</td>
<td>76,6</td>
<td>98,9</td>
<td>8,1</td>
<td></td>
</tr>
<tr>
<td>Unemployment %</td>
<td>7,2</td>
<td>6,1</td>
<td>6,3</td>
<td>7,1</td>
<td>8,1</td>
</tr>
<tr>
<td>Reserves (incl. Gold), bn USD</td>
<td>303,7</td>
<td>478,8</td>
<td>427,1</td>
<td>427,1</td>
<td>386,9</td>
</tr>
</tbody>
</table>

The two most significant trends are the sharp decline of the current account surplus and the decreasing reserves. Energy (and mineral) export has pushed up the current account surplus, but as oil and mineral prices contracted enormously, the value of Russia’s exports fell. Even if prices pick up, Russia’s surplus in 2009 would be cut to around a third of 2008 levels. Reserves also declined. From autumn 2008, the government intervened massively on the currency market to keep the ruble from falling. In a series of forex interventions, the Russian Central Bank used about a third of its reserves. After a few failed interventions to restore the value of and confidence in the ruble, the surge slowed down. Interventions were partly conducted to accommodate the effects of repatriating foreign investments; investments reversed shortly after Russia’s invasion of Georgia, after which the balance remained negative. The financial crisis itself pushed more money to leave the country as Russia was not a safe destination to store capital during financial turbulence, as the ruble is not a reliable currency, and as several investors feared similar treatments as in 1998, when many foreign investors were badly mistreated by the Russian authorities. Another reason for preventing a sliding ruble was the high debt levels of large conglomerates, which have a considerable part of their debt in foreign currencies. As these companies needed to roll over debt their cost could have increased
considerably had the ruble continued its downward path. For some, the cost could have been too high, and given the Russian industrial-policy structure the Kremlin would be forced to intervene – as it did when aluminium major Rusal, and its disreputed owner Oleg Deripaska was on the brink of financial collapse in the Fall of 2008.

_Economic Output_

Russia’s economic and social ambitions are subsumed in Prime Minister Putin’s “Russia 2020” program, announced in 2008. Its objective is to raise Russia’s GDP per capita from US$12,000 in 2008 to US$30,000 in 2020 and make Russia the fifth largest economy in the world after the U.S., China, India, and Japan. Russia’s GDP would increase on average 6.5 per cent a year from 2007 to 2020. Its per capita GDP would rise from one quarter of the U.S. level in 2008 to half in 2020, and Russia’s share of world GDP in current dollars would expand to 4.1 per cent in 2020. With the economy likely to contract by 2–3 per cent in 2009, such ambitions look sanguine, bordering to the naïve. They are also unrealistic when assessing the growth potential of the Russian economy. Nor does the current design of Russian economic institutions and management support such an ambition. The Kremlin has embarked on policies that are likely to defeat its own economic ambitions. The re-monopolization of the economy, sketched above, will pose long term problems for Russia, because state-controlled companies in Russia do not work better than state-controlled companies elsewhere. Other resource-rich countries demonstrate that it is possible to develop even when assets are owned by the government (although the resource curse is more likely if the experience of other countries is the guide), but only to a point. Resources and commodities are valuable, but they cannot substitute the emergence of an economy driven by several other factors. From the viewpoint of economic history, countries really become rich when they have grown out of their dependence on a small number of goods or resources. Furthermore, sustained and high growth appears when countries move from extensive growth (using more input factors) to intensive growth (increasing the productivity of existing input factors). The question for Russia is whether it has the capacity to get other sectors to drive economic
growth and to make energy-based growth less determined by increasing inputs. At current trends it will become difficult to achieve such a goal without major changes in the structure of production and trade.

Russia was able to expand its sources of growth and not only rely on energy revenues. Domestic demand, an important source of growth, clearly increased and, consequently, the export sector’s share of GDP declined from around 45 per cent in 2000 to 35 per cent in 2005 to approximately 30 per cent today. But these figures are not necessarily a reason to be upbeat about Russia’s prospects. This is the case first, because Russia’s domestic demand increased disproportionately in the construction sector. The construction boom has been severely affected by the financial crisis and has in practice ended. Private consumption also grew, signalling increasing real income and purchasing power. Unsurprisingly, consumption fell considerably since the 2008 crisis. The broader story is that high demand growth in construction and consumption signals unsustainable growth – growth that disappears once the boom ends. Second, recent non-energy output growth has primarily emerged in the non-tradable sectors. There has been no equivalent expansion of output in the tradable sector. Trade is still driven by exports of hydrocarbons. Manufacturing output has increased significantly, but it has also been highly volatile and only grown behind high barriers to foreign competitors (barriers that have increased significantly amidst the crisis as the Russian government used trade barriers as anti-crisis measures). Industrial expansion has not been sustainable and will diminish unless a sector increases productivity and becomes competitive. Third, Russia will have great difficulty in expanding its tradable industrial base and increase manufacturing exports as long as hydrocarbons dominate exports. Russia is infected by the “Dutch disease”: a commodity sector dominates exports and pushes up the (real effective) exchange rate to a degree that makes other sectors uncompetitive. In short, Russian manufacturing exports become too expensive. Russia’s real effective exchange rate almost doubled between 2004 and 2008. Consequently, its dependence on hydrocarbon exports increased from 53.8 per cent of total exports in 2000 to nearly 65 per cent in 2007.
Table 2: GDP growth by main sectors (value-added)

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total GDP growth</td>
<td>7,7</td>
<td>8,1</td>
<td>5,6</td>
</tr>
<tr>
<td>Tradable sectors</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agriculture, forestry</td>
<td>3,8</td>
<td>2,6</td>
<td>8,4</td>
</tr>
<tr>
<td>Extraction industries</td>
<td>-3,3</td>
<td>-2,6</td>
<td>0,2</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>7,3</td>
<td>7,8</td>
<td>0,9</td>
</tr>
<tr>
<td>Non-tradable sectors</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Electricity, gas, water</td>
<td>5,7</td>
<td>-0,7</td>
<td>1,2</td>
</tr>
<tr>
<td>Construction</td>
<td>11,8</td>
<td>9,3</td>
<td>13,2</td>
</tr>
<tr>
<td>Wholesale and retail trade</td>
<td>14,1</td>
<td>13,7</td>
<td>8,4</td>
</tr>
<tr>
<td>Financial services</td>
<td>10,3</td>
<td>12,5</td>
<td>6,6</td>
</tr>
<tr>
<td>Transport and communication</td>
<td>9,6</td>
<td>3,4</td>
<td>6,9</td>
</tr>
</tbody>
</table>

Source: Rosstat

Current Account

Russia’s current account has been in surplus for many years. It is the trade surplus that has determined the overall current account profile. As the price of oil and gas has increased, the trade surplus has followed suit. Russia is highly dependent on its export of hydrocarbons. Together with minerals, this sector represents almost two thirds of Russia’s exports. Metals and precious stones is the second largest category of exports, and manufacturing only represents 6 per cent. By any account, Russia’s export performance is centered on its commodities. Its non-commodity export is insignificant and is typically only destined to FSU countries with special deals involving manufacturing import from Russia.
The European Union is by far the single largest export destination for Russia. The dominating part of all its energy and mineral export is for Europe. Turkey is the second largest export destination, also a consequence of energy trade, followed by Belarus and Ukraine. The EU is also the most important import origin for Russia. Europe is not as dominating on Russia’s import side as it is on the export side. But more than 50 per cent of Russia’s imports come from Europe.

Table 4: Russia’s top ten export destinations (mn US$, current prices)

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<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>EU (excl. Baltic states)</td>
<td>59078</td>
<td>80603</td>
<td>81721</td>
<td>100748</td>
<td>133532</td>
<td>187887</td>
<td>231545</td>
<td>264376</td>
</tr>
<tr>
<td>Turkey</td>
<td>1644</td>
<td>3098</td>
<td>3358</td>
<td>4807</td>
<td>7440</td>
<td>10841</td>
<td>14290</td>
<td>18332</td>
</tr>
<tr>
<td>Belarus</td>
<td>2965</td>
<td>5568</td>
<td>5922</td>
<td>7602</td>
<td>11219</td>
<td>10118</td>
<td>13099</td>
<td>17187</td>
</tr>
<tr>
<td>Ukraine</td>
<td>7149</td>
<td>5024</td>
<td>5885</td>
<td>7595</td>
<td>10770</td>
<td>12402</td>
<td>14983</td>
<td>16323</td>
</tr>
<tr>
<td>China</td>
<td>3371</td>
<td>5248</td>
<td>6837</td>
<td>8252</td>
<td>10105</td>
<td>13048</td>
<td>15758</td>
<td>15893</td>
</tr>
<tr>
<td>Switzerland</td>
<td>3525</td>
<td>3857</td>
<td>5360</td>
<td>5814</td>
<td>7707</td>
<td>10774</td>
<td>12167</td>
<td>14201</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>2555</td>
<td>2247</td>
<td>2403</td>
<td>3279</td>
<td>4664</td>
<td>6524</td>
<td>8967</td>
<td>11963</td>
</tr>
<tr>
<td>USA</td>
<td>4315</td>
<td>4644</td>
<td>3989</td>
<td>4216</td>
<td>6624</td>
<td>6323</td>
<td>8638</td>
<td>8048</td>
</tr>
<tr>
<td>Japan</td>
<td>3173</td>
<td>2764</td>
<td>1803</td>
<td>2421</td>
<td>3404</td>
<td>3740</td>
<td>4457</td>
<td>7383</td>
</tr>
<tr>
<td>Republic of Korea</td>
<td>747</td>
<td>972</td>
<td>1271</td>
<td>1324</td>
<td>1963</td>
<td>2359</td>
<td>2735</td>
<td>6150</td>
</tr>
</tbody>
</table>

Source: Rosstat
Table 4 demonstrates that Russia is highly dependent on Europe as a destination for its exports. In fact, strict comparisons of trade volumes suggest Russia is more dependent on Europe than Europe is on Russia. But dependence is not necessarily symmetric; in this case it is clear that there are real asymmetries in dependency and more importantly in strategies and end goals over a long term perspective. Russia makes real efforts to diversify its exports away from Europe while Europe’s efforts at diversifying its energy imports have been more rhetorical than real. As the EU member states’ domestic sources of gas are diminishing, and as investments in alternative supply are small and hardly substitute the declining domestic sources, Europe’s dependence on Russia’s gas is projected to increase. The European Commission estimates that Russia in 2030 will represent 60 per cent of the EU’s energy imports (up from approximately 40 per cent today). Using marginal analysis it is quite clear that Europe is more dependent on Russia than vice versa. What is also striking is that the power balance between an exporter and importer of energy is quite different than in other sectors. Russia can put its energy export to Europe on hold for a few months without losing significant parts of its business and customers, while Europe cannot be without Russian gas for more than a few days before experiencing serious repercussions on European output. In this regard, it is a seller’s market. With high and increasing dependence, Europe cannot use sticks as a method to obtain a better trading relation. The gas conflict in January 2009 between Russia and Ukraine demonstrated clearly the problem Europe has with its gas dependence and its lack of a cross-border power grid to substitute temporary cuts in one source of power.

**Russia’s Trade Policy**

Russia’s trade policy is mostly a reflection of its economic profile. Russia is the largest economy in the world that is not a member of the World Trade Organization (WTO), the premier international body for regulating commercial behaviour. Russia applied to the GATT, the predecessor to the WTO, in 1993. In the first years of Putin’s presidency (2000–2004), Russia prioritized WTO accession. Most bilateral protocols for accession with the
58 members of the accession working party have been signed. But a sensitive protocol with Georgia remains to be signed, and since Ukraine acceded to the WTO in 2008, they too are likely to demand such a protocol. Nor is the multilateral process of Russia’s accession protocol, which involves disclosure of WTO-relevant regulations, finalized. The WTO accession process with Russia lost impetus a few years ago, and is now on hold. At the time of the writing, it is difficult to find a clear Russian policy towards WTO accession. Russia declared in mid-2009 that it wanted to withdraw its bid for WTO accession and rather pursue a Customs Union with Belarus and Kazakhstan. Then Russia communicated it wanted to join the WTO collectively together with the two partners in the planned Customs Union. Later communications, however, suggest this is not necessarily what Russia wants. The prime motivation for Russia to accede to the WTO is to gain better reputation as a destination for investments. However, its export sector will not benefit much, but its uncompetitive industrial sector will lose. Russia’s energy exports are not faced with tariffs, and considering its high dependence on energy exports, one can understand the limited interest for joining the WTO as this body does not cover energy trade. It is nevertheless a great obstacle for foreign companies that Russia is outside the WTO; without such membership, there are few other factors that constrain Russia from arbitrary policies, and shifts of policies, which damage foreign exporters.

Russia is a signatory to the Energy Charter Treaty (ECT) but claims it is not bound by ECT commitments on investment protection and energy transit. Russia’s argument is that it has never ratified the ECT, and can hence not be bound by it. This, however, is not necessarily true and there are currently ECT tribunals in a process of determining the ECT’s applicability to Russia. While it is correct that Russia has not ratified the ECT, it did sign a treaty which clearly specifies that the treaty is provisionally applicable until it has been ratified. If Russia wanted to renege on this commitment, it could – as other countries – have used the opt-out clause of the treaty, but it has not. During the summer of 2009, Russia declared it would withdraw from the ECT article on provisional application of the treaty.
Russia’s bilateral trade policy is principally geared towards CIS countries. Russia has launched many ambitions to create regional custom unions and other forms of free trade agreements, but not much has happened in reality. There is now a proposal to create a Customs Union with Belarus and Kazakhstan, and negotiations have several times been said to soon reach a successful end. But this is unlikely to be a meaningful effort given the dire state of Belarusian trade policy and the low ambitions attached to this Customs Union. If the three proposed partners were member of the WTO, it is highly unlikely that the outcome of current negotiations (if they ever materialize into an agreement) would qualify as a Customs Union under current WTO regulations. The existing bilateral agreements have low coverage and are extremely weak. They are not fully respected and do not work as a constraining factor. The Kremlin claims it soon will finish negotiations over deeper economic agreements with a selection of CIS countries, such as the Customs Union mentioned above. Several studies show with great clarity that Russia has little to benefit by closer economic integration with CIS countries. The same applies for CIS countries: they have little or nothing to benefit from deeper de facto economic integration with Russia. Already now they overtrade with Russia and undertrade with the rest of the world. Entrenching such a trade pattern will be a net loss to Russia. None of the larger economies in the world has been interested in negotiating bilateral trade agreements with Russia as it is not a member of the WTO. Several countries, however, have signed bilateral investment treaties (BITs) with Russia.

Europe is also the largest destination for outward FDI from Russia. Russian investment in CIS countries is small – in 2007 it did not amount to more than US$3 billion. Cyprus, the Netherlands, the United Kingdom, Switzerland and Bermuda are the largest destinations of Russia’s outward investment flows, demonstrating clearly that Russia’s outward FDI have little to do with Greenfield investment – it is principally of a financial character.
Russia’s Economic Statecraft

Russia is highly dependent on one particular export market – the EU – and its investment relations are principally with the same region. It does have foreign economic leverage in the CIS countries but it is far from as significant as has been suggested. Russia’s economy has exclusively been shifting to the west for the past 15 years. Clearly, Russia is diversifying its energy exports, and it is primarily Asia that represents the new region of energy commerce for Russia. Pipelines to China are under construction, and the new LNG strategy targets primarily Japan. South Korea is also increasing its imports of Russian energy. The high dependence on exports and on the European export market also means that Russia is effectively part of another currency zone. It keeps its own currency, but the most important strategy for its monetary policy is to keep a stable relation to the larger foreign currencies, the euro and the dollar. Russia’s structure of private debt, which is highly biased in favor of European lending, amplifies to exchange-rate structure. The ruble’s relation to Russia’s factor market is overshadowed by keeping stability with the euro. Russia’s currency is of some importance to the FSU countries, but less so than expected. Since the main commodity for trade is energy, the long-term price development also affects the exchange-rate relation. Russia’s economic statecraft has other sources.

First, Russia’s statecraft is regional. It can wield its foreign economic power over Europe because the latter is dependent (and growing more dependent) on Russian energy. Its statecraft in the FSU comes from its control over pipelines, its energy pricing power in non-energy CIS countries (Ukraine, in particular), and the many Russian tourists (with relatively significant purchasing power) who travels to CIS countries. Second, Russia represents an important emerging market which is of interest to foreign exporters. Russia’s tariffs are relatively high and combined with many non-tariff barriers to trade and investment. This negative statecraft is important: it is these barriers, and not market-based barriers, which prevent foreign companies from entering Russia or from expanding operations and sales there. Foreign companies then have an interest to get these barriers lowered and are willing to make efforts to that end. Russia also uses its tariff-based
statecraft, partly to defuse tensions over its practices in the energy sector. When criticism has reached a point that Russian interests can be negatively affected, it lowers some of the barriers to buy off criticism from important countries. Third, European countries in particular have interests in Russia to defend, especially in the oil sector and on the Russian stock market. Investors know Russia is an unsafe destination and all investments there have an “unpredictability factor” added to them. But the fact that Europe has substantial interests to defend also prevents countries and companies from using commercial and legal sanctions against Russia. Fourth, Russia is not part of the basic international agreements for commerce, which is why legal recourse to international treaties is often not an option for companies whose economic rights have been violated. Russia’s position has been to avoid constraining its discretion by international economic agreements, and absent such constraints it is difficult to punish Russia. Such unconstrained discretion is frequently used to pursue arbitrary and assertive commercial policies.

**Russia’s Economic Crisis and Why the Authorities Responded the Way They Did**

Russia witnessed a very quick reversal of its fate after September 2008. In July 2008, the oil price peaked at US$147 per barrel. That summer, Vladimir Putin threatened Mechel, a coal firm, with sanctions if it did not apply a price policy of his wishes. The British-Russian oil joint-venture BP-TNK was in the midst of an unprecedented and obscure row over control and management of the firm. Capital flight slowly began to be felt in May 2008. Yet it became massive when Russia invaded Georgia. US$ 20bn alone left Russia in August 2008. Capital flight reached US$130bn altogether in 2008, with a further US$ 440mn pulling out of the country in January 2009. Unemployment, which had hit historical lows in 2007 and early 2008, soared. By March it had risen to 9.5 per cent, up from 5.6 per cent the previous year, and is now estimated at around or above 10 per cent – the government decided to stop publishing unemployment statistics after March 2009.

Russia’s initial response to the crisis was one of massive fiscal support targeted at the financial sector and big enterprises. In 2008, these sums
amounted to 2.6 per cent of GDP, according to World Bank estimates. In 2009, fiscal support measures are expected to cost more approximately 4 per cent of GDP. The first months of the crisis were dedicated to lavish support to the financial sector and to propping up big companies owned by tycoons well-connected to the Kremlin. The government also resisted strong ruble devaluation throughout the autumn. This cost it almost one third of its foreign reserves, i.e. US$200bn.

However, with the deepening of the crisis rising unemployment, a rapid meltdown of the Reserve Fund, and lower tax receipts, the government shifted its priorities in February-March 2009. It eliminated a controversial US$50 billion loan support program for companies introduced in September, which had been strongly criticized for supporting powerful billionaires. The government also announced the government would nationalize assets only as a last resort. Its new focus was to halt the tide of rising unemployment. This involved a major bailout of carmaker Avtovaz in March. It planned to distribute income to vulnerable sections of the economy in its revised 2009 budget, and announced it would proceed to international borrowing in 2010 to counter the foreseeable depletion of the government’s reserve fund. The government also aired plans to allow so-called “strategic sector” companies to swap debt or equity, which is said to facilitate entry of foreign investors into these sectors, a move yet to be confirmed at the time of writing.

The government expected its budget deficit to reach 7.4 per cent in 2009, with 4 per cent on anti-crisis measures. Revenue forecasts are down 32 per cent from the initial budget. Protectionist measures were also part of the policy response. These included raising import duties on cars to 35 per cent and on pork and poultry. Public procurement measures were introduced that strengthened discrimination against foreign producers of manufactures. Russia’s fiscal policy in the crisis can be considered an attempt at a balance between fiscal responsibilities and supporting a contracting economy. Although it is clear that parts of the government have perceived the limits of government intervention in the economy – be it only for fiscal reasons – so far there has been no indication that it embarked on economic reform to raise productivity and diversify the economy.
Why the Authorities Responded the Way They Did – A Political Economy Analysis

In order to understand most economic and political decisions taken under the Putin administration, both during boom and during crisis times, an analysis is required of the political economy dynamics in the existing political system. The main features of the Putin system can be very sketchily summarized as follows. The overriding objective was to restore the authority of the state within Russia after its collapse in the 1990s and to give Russia its status back as leading world power. Putin’s people considered financial strength of the state and freedom from international debt a fundamental prerequisite to achieve this goal; they saw the economy – not the military sector – as a major tool to achieve and express Russia’s new grandeur. The political economy of Russia therefore leaves room for efficiency gains for the economy through market liberalization as long as these concur with the state’s wider interests. The main economic objective is to gain financial independence for the state, and when possible to develop Russia’s financial statecraft in the diplomatic arena. This means the state’s fiscal position needs to be sound, and its external debt levels kept to a minimum. Hydrocarbons and particularly gas are seen as the overriding tool in domestic and international politics. It is a source of rents and of high income, and considered crucial for national sovereignty. It is also a sector that by its very nature tends to be controlled by few operators. These four premises form the background of Russia’s economic policies, both domestically and internationally. These overarching premises involve policy choices and tradeoffs between authoritarian control and economic efficiency considerations that can lead to different outcomes as political and economic conditions change. State finances, relationships between the Kremlin and the oligarchs, and the central role of Gazprom are the three areas in which Russia’s state capitalism finds its unique expression. The response to the financial and economic crisis described above must be seen under these three angles. This will be done in the following paragraphs.

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2 The framework of this analysis is based on the political economy model developed by Brooking Institution’s Clifford G. Gaddy and University of Pennsyl-
Russia’s financial clout has led to attempts at using it as leverage in its relations to its near neighbors in particular. During the financial crisis, it made offers to help Iceland, Eastern European economies and Caucasian and Central Asian economies (such as Armenia and Kyrgyzstan) in financial trouble. Most have not materialized, in particular because the political or economic conditions attached to these were not deemed palatable to potential recipients. Russia’s reserves gave the authorities a sense of invulnerability in the first months of the crisis. However, with a deepening crisis, and the insight that reserves and the fiscal position was deteriorating, the government’s support to the economy became more cautious as the government did not want to lose control of its finances.

During the 1990s, the oligarchs that emerged from Russia’s privatization process had become extremely powerful. They were able to influence Kremlin policy directly and at times made policy in the regions. At the same time many of them did not pay taxes. Vladimir Putin is believed to have concluded an informal pact with these oligarchs during a 2000 meeting. Accordingly, Putin and the Kremlin were to allow these oligarchs to operate freely to create prosperity, as long as they pay taxes, do not challenge political authority, and participate where necessary in geopolitical actions. The exile of prominent oligarchs under President Yeltsin in the 1990s such as Boris Berezovsky and Vladimir Gusinsky, and the jailing of Mikhail Khodorkovsky, who did not accept the rules of the game, fits well into the picture. Over time this system developed into what is often called ‘Russia Inc.’. After the outbreak of the crisis the oligarchs were the ones to receive state support. Analysts have argued that the authorities’ reluctance to let the ruble lose its value – a decision that has cost them one third of Russia’s foreign reserves – was an attempt at avoiding that oligarchs’ debt in foreign currencies became even more expensive to service.

Gazprom and other state-controlled hydrocarbons companies are central to the state-capitalistic system. Gazprom is a centerpiece of the Kremlin’s geopolitical strategy and tactics. The ambivalence of Gazprom, with its mix of commercial and political approaches with neighbors, is archetypical. In Gazprom’s dealings with Ukraine and Belarus in the gas conflicts of 2006–2009, commercial considerations such as the request to be paid at market prices or to have debts reimbursed were intimately mixed with expressing dissatisfaction at these countries’ rapprochements with the West. The balancing act between seeking efficiency and pursuing direct state control is pervasive in the management of Gazprom. For example, the state only owns 51 per cent of Gazprom, the market the rest. Gazprom remains inefficient. Not least because it has been given an increasing array of monopolistic powers (assets stripped from foreign investors in Sakhalin or Siberia were transferred to Gazprom, Gazprom recently bought Italy’s Eni’s 20 per cent stake in Gazprom Neft.). Yet it is itself subject to substantial “milking” by the government. A 27 per cent tax on hydrocarbon exports is one of the principal causes of Russia’s massive underinvestment in hydrocarbons extraction. Gazprom has been the Russian hydrocarbons company that suffered most from the economic crisis, partly a result of corruption. It is also the company with the highest level of debt in the country (US$47.6 billion in mid-2008). It has suffered losses that led Moody’s to downgrade its credit rating in April 2009. Gazprom announced major cuts in its investment programme for 2009 that were approved by Putin, and also cut production. Russian oil production cuts are also a move to coordinate these with OPEC objectives. But Russia’s relations with OPEC are strained.

Russia’s corruption level is unusually high for a country of this level of GDP per capita. This means the economy’s efficiency is set to deteriorate unless the problem is addressed head-on, something the authorities appear aware of. President Medvedev introduced a set of anticorruption laws that were approved by the Duma in January 2009. In 2009, civil servants began to be prosecuted for corruption. In late March, a probe was launched against Gazprom and Novatek employees for having diverted 2 billion rubles of gas purchases. It is too early to assess whether these measures are
mere window-dressing or the beginning of a process of genuine fight against Russia’s plight.

A final consideration concerns the role of foreign investors is that as the latter have experienced, foreign investors cannot be part of the picture in the current system in Russia unless they serve its purposes. One could summarize the issue as follows: retailers are in, but oil majors are out, unless they indulge in special deals backed by friendly governments. This is the reason why foreign investors have not, so far, been called back as a means to help Russia find a path back to prosperity.
Russia in the Twenty-First Century - Foreign and Domestic Policy Developments

Russia’s Foreign and Security Policy

Russia’s foreign and security policy is best described as pragmatic, geopolitically focused, realist rather than value-based, and striving towards a multipolar world by seeking to undermine the West’s influence in international affairs, especially that of the United States. According to the 2008 Foreign Policy Concept of the Russian Federation the three main objectives are to ensure national security, create favorable external conditions for modernizing Russia, and influence global processes to ensure the formation of a just and democratic world order. Russia’s overriding foreign policy goals are to establish Russia as one of the most important global powers, and to create a multipolar international order. Multilateralism is frequently referred to in the Concept. However, several studies show that Russia’s understanding of multilateralism in international affairs is rather a form of multipolarity characterized by a collective decision-making procedure amongst a handful of great powers, or at best a selective and instrumental use and understanding of multilateralism. This means that Russia supports multilateralism as long as it affirms its great power status and deals with issues and interests of leading states - hence a great power multilateralism that will take into consideration the interest of small states only if they coincide with the interest of leading states, and if rational, following a cost-benefit analysis. Russia’s vision of great power multilateralism is best practiced within the UN Security Council.

Russia’s strategy for the creation a multipolar world is to strive towards the establishment of several power centers on a global level; economic, political, cultural and military. In its 2008 Foreign Policy Concept Russia refers to global competition acquiring a civilizational dimension. Both the Security and Foreign Policy Concepts underline the importance of the Russian language, culture and history. Such an approach has had, and is likely to continue to have, implications for those of Russia’s neighbors that have
large groups of Russian-speaking minorities, since the protection of Russian citizens or nationals abroad remains a Russian foreign policy instrument. The Russian view on international developments and the world order is well illustrated by the following passage in the Foreign Policy Concept:

The contradictory trends determining the current state of international relations are a result of the transitional period in their development. Those trends are reflecting differences in understanding of the genuine meaning and consequences of the end of the Cold War. It is for the first time in the contemporary history that global competition is acquiring a civilizational dimension which suggests competition between different value systems and development models within the framework of universal democratic and market economy principles.

Clearly, and understandably from a Russian perspective, Russia’s foreign and security interests will not be taken into consideration unless Russia has a say in the formation of international politics. Therefore, securing a seat at the table has been one of the main priorities of Russian foreign policy. Although constantly referring to the importance of international organizations and international law, the current regime’s assessment of the influence of international organizations and law is based on a realist perspective. Hence its focus on bilateral cooperation and multipolarity instead of multilateral cooperation through international organizations and its attempts to change the European security architecture and reformulate international law. As a result, Russia’s actions on the international scene contribute to undermining the current international order while at the same time trying to create a momentum for the creation of alternative structures under Russia’s leadership.

Thus, Moscow is acutely aware of the struggle between value systems and development scenarios, something that is explicitly stated in the 2008 Foreign Policy Concept. One important step for Russia to obtain and consolidate a great power status is to cement itself as a dominant power in the former Soviet space. As a result, both Vladimir Putin and Dmitry Medve-
dev have forcefully and repeatedly underlined the fact that Russia considers the former Soviet states as part of its sphere of interests. Subsequent to the war in Georgia in August 2008, president Medvedev formulated the doctrine of privileged Russian interests in the FSU, which Foreign Minister Sergei Lavrov also underlined during a speech in Washington D.C. in May 2009. One consequence of the policy of privileged interest in the FSU, as understood by Moscow, is that Russia should always have the final say regarding policies towards and within the FSU. Any attempt to circumvent Russia and Russia’s interests will be considered a hostile action. Russia’s interests should always be taken into consideration. Clearly, Russia’s view of its neighbors and of external actors’ policies towards them will have consequences for the domestic and foreign policymaking autonomy of the states concerned, indeed of their very sovereignty. External actors such as the EU and the U.S. will have to take this into account when conducting a cost-benefit analysis of a certain policy.

Russia’s leverage in consolidating itself as a regional great power, which is an explicit goal, is its energy and economic resources in combination with a common language and history, i.e. the cultural factor. The failure of the EU and NATO to form and stick to a long-term strategy towards the FSU plays into Russia’s hands. In this context, Russia’s soft power ambitions, and their potential effects, should not be underestimated even if Russia was to be economically weakened by the financial crisis. Russia’s regional and global great power rhetoric is not matched by its abilities to act; this is where Russia’s pragmatic stance to foreign policy is most visible. Moscow will push as far as possible, but has shown an ability to back down when faced with a setback – thus far without losing face.

From 2000, Russia’s foreign policy has become increasingly assertive. However, Russia’s attempts to reinforce the perception of Russia as a great power on a global level began already in 1993–94. The dominant features of Russia’s perceived great power identity have shifted according to the capabilities of the Russian state and the policy decisions taken by its leaders. Between 1990 and 1993 Russia’s most important foreign policy goals was to integrate with Euro-Atlantic structures and organizations. At that time, Russia’s self-perception was that of a normal power, similar to any of the
influential Western states. Cooperation and integration was to be based on shared values and mutual interests. In 1993–4, however, then President Boris Yeltsin started to propagate Russia as a Eurasian great power with distinct national interests, and U.S. unilateralism came to be perceived as one of the major threats to Russian national interests. While recognizing that it did not have any real power on the international scene, Moscow propagated principles such as non-intervention and peaceful solutions to international problems. An enhanced international status was perceived as compensation for lack of material power. Russian foreign policy between 1993–4 and 2000 has best been described as being dominated by “Geopolitical Realism” (Thorun 2009). But during Vladimir Putin’s first term as Russian president (2000–2004) the understanding of Russia’s role and interests in international politics began to change. Thorun characterizes this period as determined by ‘Pragmatic geo-economic Realism’. During this period, Russia’s great power status rested on its economic might and historical right. Russian foreign policy was perceived and portrayed as responsible and constructive, and one of the major means to defend Russia’s status as a great power was to use economic power in order to gain influence. Russian foreign policy between 2004 and 2007, on the other hand, was characterized by a competitive effort on the international scene regarding influence and values, and was dominated by “Cultural geopolitical Realism”, which also appears valid for the 2007–2009 period. During this period, Russia’s great power status rested on is its cultural and historical uniqueness and its regained economic and military powers. The objective of Russia’s foreign policy at this time was to establish Russia as an independent great power – a sovereign democracy. The Foreign Policy Concept (2008) and National Security Concept (2009), respectively, assert and confirm Russia’s view on international politics as competitive concerning values and influence, something that is illustrated by the following paragraph from the 2008 Foreign Policy Concept:
The reaction to the prospect of loss by the historic West of its monopoly in global processes finds its expression, in particular, in the continued political and psychological policy of “containing” Russia, including the use of a selective approach to history, for those purposes, first of all as regards World War Two and the postwar period.

As a result, President Medvedev in May 2009 established a commission with the purpose to counter alleged attempts to falsify Russian history. Observers assess its main purpose as tackling anti-Russian propaganda in the FSU. Medvedev has ordered the commission to investigate and counter “falsification” of Soviet and Russian history that might damage Russia’s international prestige. The commission should also be viewed as a brick in the increasingly important “information war” on both regional and international levels.

Until 1993–94 Russia’s main strategy to reach its foreign policy goals was to cooperate and integrate with the West in parallel with referring to the threat of revisionist forces in Russia. As for the subsequent period described as dominated by “Geopolitical Realism”, the revisionist argument was still used in parallel with creating counter-alliances and diversifying relations in order to balance the influence of the West. Between 2000 and 2004, when Russian foreign policy was described as “Pragmatic Geoeconomic Realism,” the strategy was to portray Russia as a reliable partner on the international scene in combination with a careful balancing act between accepting realities where Russia had no influence, and to maximize gains when gains seemed possible. The strategy between 2004 and 2007 was to present Russia as an alternative to the West, actively search foreign policy opportunities and use them to the fullest extent and to Russia’s advantage, and to ensure reciprocity when cooperating with the West. This is also valid for the period between 2007 and 2009, although one should add to this the cultural aspects of foreign policy in combination with an offensive use of information campaigns and tactics of information warfare.

It is clear that Russia is building, brick by brick, a foundation for its role and status in international politics using various strategies and tactics that all point in the same direction. Russia’s overriding foreign policy goals
have shown a strong continuity from 1993–4 to 2009. As a result, the main question is therefore not what Russia’s foreign policy goals are, but rather what means and methods are likely to be used to attain these goals, taking into consideration factors such as economic development and popular support. Furthermore, this visible continuity allows the conclusion that drastic changes in Russian foreign policy are not to be expected, unless Russia totally implodes.

The National Security Strategy of the Russian Federation up to 2020, adopted on May 12, 2009, outlines Russia’s energy resources as one of the most important tools for reaching its foreign policy goals. The Concept points out the control of the sources of energy in the Middle East, on the shelf of the Barents Sea and other parts of the Arctic, in the Caspian Basin and in Central Asia as the main attention for international politics in the long term. While the West has retracted to conducting value based international politics, Russia is increasingly forcing the West into a model of international politics determined by realism, geopolitics and policies based on interests rather than values. Russia clearly has the upper hand in this game, and the West faces a serious challenge.

As has been argued and illustrated here, Russian foreign policy combines realism with the self-perception of a great power. Interests, strategies, actual powers and abilities will need to be taken into consideration in order to discuss potential future developments. In addition, in order to understand – and possibly seek to predict – actions in a given situation, one needs to understand the nature of power in Russia, decision-making structures and mobilization potential. These questions will be dealt with in the following sections after a short analysis of Russia’s regional strategies and preferences.

Former Soviet Union

The former Soviet Union (FSU) is a central Russian foreign policy concern. Maintaining an exclusive sphere of influence over these states, and preventing the encroachment of other, particularly Western powers into this area, has been a key Russian goal since 1993, with added impetus after 1999. It is likely to remain a focal point of Russian policies in the foreseeable future.
The FSU is indeed the only place where Russia is ready for a military intervention and a direct confrontation with the West, whereas for all other issues on the international scene - nuclear control, arms control, Iran and North Korea issue, etc. - Russia may raise its tone but in fact seeks to avoid all head-on conflict. Yet the intensity of Moscow’s assertiveness in these areas differs, as do the challenges Moscow faces. The FSU can be roughly divided into three components areas: the Western CIS, consisting of Ukraine, Belarus and Moldova; the South Caucasus; and Central Asia. Among these, Moscow’s most acute concerns are in the South Caucasus, where governments are more determined to escape Moscow’s domination. It is also the area where Moscow has deployed the fullest range of coercive instruments, including full-scale war. However, Ukraine is the single CIS country most central to Russia’s strategic outlook. But because Moscow possesses more leverage in Ukraine, and the country’s internal politics are more complicated, the intensity of its policies has been somewhat lower. Finally, in Central Asia, Moscow has a larger level of influence, while the Western presence is considerably lower. Here, on the other hand, the looming challenge for Moscow is managing growing Chinese influence – in a relationship that is likely to become more adversarial over the next decade.

South Caucasus

The South Caucasus occupies a central place in Moscow’s strategic calculations. Indeed, since the early 1990s, Moscow has displayed a readiness to use means of pressure in the South Caucasus before using them elsewhere, if at all. Even before the 2008 invasion of Georgia, the region was the only one in which Moscow had repeatedly used military force to achieve its goals. Moscow’s assertiveness in the region is based on several factors. First, the Russian leadership harbors a deep conviction, dating from the nineteenth century that control over the South Caucasus is the key to stability in Russia itself, especially the unruly North Caucasus. Second, the nations of the South Caucasus have shown a greater determination than any former Soviet areas, save perhaps the Baltic republics, to escape Russia’s domination. Finally, Moscow’s perception of the strategic importance of the South Caucasus is increasingly shared by other actors as well, not least the U.S.
and EU, which see it as a corridor both for Caspian energy supplies to Europe, and for access to Central Asia and Afghanistan. In combination, these factors explain the growing level of tensions in the South Caucasus at least since Putin’s coming to power in 1999. Yet they also suggest that the South Caucasus will remain an area of contestation between Russia and the West for the foreseeable future. State-building processes in the 2000s have made the countries of the region real and functioning states that are increasingly subjects rather than objects of international relations. That makes the voluntary subordination of either Georgia or Azerbaijan to Russia extremely unlikely. Ironically, Moscow’s assertiveness in seeking domination of the South Caucasus in the past two decades has been directly counterproductive. Moscow’s fomenting of ethnic conflicts in the region in 1988–94 generated deep-seated hostility toward Russia across the region, which was only entrenched by subsequent Russian activities – especially in Georgia, where it used the full spectrum of coercive diplomacy (including economic warfare, creeping annexation of secessionist territories, subversion and military incidents). In a sense, therefore, the long-planned and premeditated invasion of Georgia in August 2008 was as much a result of weakness as of strength. Having exhausted instruments of coercive diplomacy with little result, Moscow was forced to either accept Georgia’s departure from its sphere of influence – or to take the extreme and very damaging step of engaging in a full-scale military invasion to achieve its objective. In the short term, that invasion (and the weak western reaction to it) strengthened Russia’s position in the former Soviet space. But Russia’s position in the South Caucasus is one based almost exclusively on coercion and intimidation, making it extremely fragile in the long term. Meanwhile, the economic and political realities of the South Caucasus are a slow but inexorable integration with European structures, which reduce Moscow’s long-term leverage. Given American and European trepidation, however, there is no international security mechanism operating in the South Caucasus. That will ensure that the South Caucasus remain geopolitically contested. Russia’s assertiveness is likely to continue, especially because, for Moscow, controlling the South Caucasus means controlling the North Caucasus, but the domes-
tic realities of the regional states and western interests in the region are likely to prevent a return to Russian dominance.

**Western CIS**

From the Russian perspective, Ukraine is the most important country in the FSU ahead of Georgia, but the Russia-Ukraine relationship is more complex, less hostile and more multi-faceted than that between Russia and Georgia. In addition, Russia has more and more diversified leverage in Ukraine. The internal Ukrainian power balance is the key: Moscow sees Ukrainian democracy as continued threat to itself, and is therefore highly likely to seek to undermine it. The Ukrainian Security Service (SBU) has openly raised the question of the intensification of Russian intelligence activities within Ukraine and its return to Soviet-era KGB tactics. The Russian Black Sea fleet stationed at Sevastopol and the high presence of Russian security services and economic actors throughout Ukraine is likely to be the main challenges to Ukraine’s national security in a 10–20 year perspective. Russia has other ports on the Black Sea at its disposal, so it would not as such be a problem if the Black Sea fleet left Sevastopol, but this geopolitical act would be heavy with consequences for Moscow, as much for reasons to do with historical memory as for issues concerning its political control over the Ukrainian future. Russia can be expected to continue meddling in Ukraine’s domestic affairs. In order to take further control of Ukraine, it is possible but not probable that Russia could use military means. Control could be achieved by more subtle means and it would not be difficult for Russia to destabilize Ukraine very swiftly, especially in the Eastern parts of the country and on the Crimean peninsula. European integration is likely to remain one of Ukraine’s primary foreign policy goals, with focus shifting toward the EU rather than NATO.

Moldova is a key strategic country as it borders the EU and NATO, and constitutes a western flank toward Ukraine for Russia. Continued Russian efforts to dominate developments in Moldova are likely. Russia’s economic and energy power is strong in Moldova, and its leverage is hence considerable; Russia remains Moldova’s largest trading partner. From Moldova’s perspective, the Moldova-Russia relationship is characterized by realism
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and is determined by the principle of balance of power. Moldova seeks to balance its European integration goal with a friendly relationship with Russia based on historical ties. The Transnistria question remains a conundrum for Moldova and for the EU. Moscow does not support the idea of integrating the secessionist republic into Russia and prefers to leave the issue unresolved to give itself a point of leverage over Chisinau. However, its complicated relations with Romania may push Moldova more toward Russia. An example of this dynamic was the uprisings in Chisinau in April 2009 following contested elections, and the subsequent uniform rhetoric of outgoing president Voronin, the Russian State Duma and Russian Foreign Minister Lavrov.

Concerning the Russia-Belarus relationship, questions that appear frequently are of a chiefly economic nature and relate to the potential Russia-Belarus Union. Russia clearly does not see Belarus as an equal partner, and Russia’s control of Belarus is substantial. President Aleksandr Lukashenko, pressured by Moscow to pay its debts to Russia, recently turned towards Europe; yet Belarus’ dependency on Russia is almost total. In combination with the total control of information flow in Belarus, this makes it unlikely that Europe would be able to offer anything that would begin a real process of European integration within Belarus in a 10-year perspective, and hence that Europe would overtake Russia’s role in Belarus. As with the Ukraine and Moldova, Russia’s main leverage are energy and its economic power. Thus far, there has been no real challenge to Russia’s influence on and control of Belarus.

Central Asia

Russia has two main goals in Central Asia: to control energy resources and to maintain regional security. Moscow’s economic interests are largely focused on its oil and gas reserves, yet Central Asia also has other resources that arouse the Russian appetite, such as electricity, uranium, gold, and precious metals. Russian companies (chiefly Gazprom and Lukoil) are involved in the development of gas and oil deposits, building oil and gas refineries, renovating existing oil and gas pipelines, and constructing new export routes, mainly in Kazakhstan and Uzbekistan. Moscow is still one of
the driving forces of the Central Asian hydrocarbon market. Always on the lookout for possibilities to export resources and collect transit rights, it is contributing to the increases in export levels of Central Asian resources out of the region (85 per cent of Kazakh oil products are exported to countries outside of the CIS, while the figure for Turkmenistan is 78 per cent) and to reducing internal trade between the five states. Russia is thus reinforcing Central Asia in its role as an exporter of primary resources by neglecting to develop its hydrocarbon refining capacity, especially the manufacture of products with high added value. This is ultimately an inefficient, and even dangerous, trade pattern from the point of view of Central Asia’s long-term economic interests. However, it seems likely that Moscow will partly lose its control over this regional market. Not only have new actors emerged, notably China, but the development of shipping in the Caspian Sea as well as rail transport has somewhat reduced the importance of land pipelines. Moreover, the fact that Russo-Central Asian energy exchanges are run mainly by state-controlled companies involved in government-directed activities entails a political will for cooperation that sometimes runs counter to the commercial interests of each state.

Russia remains a dominant economic actor in Central Asia. It is an important actor in heavy industry and infrastructure, both of which are old Soviet specializations. But it is a relatively modest and rather uncompetitive actor in terms of small and mid-size enterprises and new technologies. This stratification offers a more general reflection of the Russian economy as a whole, which is still in logic of rent and is having problems diversifying itself. But it is also explained by the state of the Central Asian economies, in which small and mid-size enterprises and new technologies struggle to find a place. These economies, it seems, are destined to serve above all as transit zones for Russo-Chinese trade, hence the emphasis on infrastructure and all the freight-related services.

The second key domain of Russian activity in Central Asia is that of regional security. This domain has been the primary driving force behind Moscow’s continued presence in the region since the early 1990s. However, since 2000, the mechanisms of this collaboration have been profoundly transformed. The security challenges for Russia in Central Asia are multiple
and complex: any destabilization in the weakest (Kyrgyzstan, Tajikistan) or the most dangerous (Uzbekistan) states will have immediate repercussions in Russia, including such things as: Islamist infiltration in the Volga-Ural region and the North Caucasus, indeed in the whole of the country; an increase in the inflow of drugs reaching the Russian population, which is already widely targeted by drug traffickers; a loss of control over the export networks of hydrocarbons, uranium sites, strategic sites in the military-industrial complex and electricity power stations; a drop in trade exchanges; a loss of direct access to Afghanistan; an uncontrollable surge of flows of migrants, in particular of refugees. For Moscow, the security of the southern borders of Central Asia is seen as a question of domestic security, not out of imperialism, but of pragmatism: the 7000 kilometers of Russo-Kazakhstani border, in the heart of the steppes, are nearly impossible to secure. They require that the clandestine flows are better controlled downstream, as it were, which goes to confirm Central Asia’s role as a buffer zone for Russia.

Of the CIS institutions, only the Anti-Terrorist Center (ATC) is fully functional. Russo-Central Asian multilateral collaboration is geared mainly toward the Collective Security Treaty Organisation (CSTO). The Collective Rapid Deployment Force (CRDF) is the only one with trained armed forces capable of intervening in real time. Common military exercises are carried out each year in one of the member countries to simulate terrorist attacks (‘Rubezh’) or anti-narcotics operations (‘Kanal’). But bilateralism dominates in the domain of security. Russia is still the main Central Asian provider of military equipment, the main partner in training military cadres, still has or has regained a number of military and research facilities and strategic sites in Kazakhstan, Kyrgyzstan and Tajikistan, and has revived cooperation between military-industrial complexes.

Though Moscow hopes to remain Central Asia’s number one partner, it no longer imagines its presence will be exclusive. The Kremlin has therefore learned, to its detriment early on, to compromise with other international players. The Russian elite knows that the Central Asian states are prepared to exploit international competition in pursuit of their own national interests, and that the Central Asian governments will not give them preferen-
tial status on the grounds of sympathy alone. Russia’s return in Central Asia has been a partial success insofar as it has again become an important partner and a legitimate ally in a no longer monopolistic Central Asian arena. Russia is therefore in the process of becoming a power like others in the region: its positions are by no means guaranteed and remain subject to global geopolitical hazards. It is true that neighboring regional powers such as India, Iran and Turkey do not have the means to challenge Russia. However, this is not the case with China, which is going to prove a challenge for Russia in the long-term. Russian-Central Asian relations can also be affected by the global power struggle between Moscow and Washington, as was seen during 2001–2003. An improvement of Central Asian-US relations, which is desired by the Central Asian regimes, could help the latter to raise the level of competition to Moscow’s detriment. The possible closing of the Manas base in Kyrgyzstan is clearly a strike to US interest in the region, but other players such as Uzbekistan or Turkmenistan could potentially turn toward Washington to balance the Russian influence.

The Central Asian governments perceive Russian statements about “privileged interests” in the CIS as disrespectful to their independence. Aware of Russia’s incapacity to build a coherent plan for its partnership with the region, the Central Asian elites are somewhat resentful. They criticize Russia for simply riding on the inertia of its historical legacy and being incapable of innovation. Indeed, Moscow no longer produces any real expert knowledge on this region. Despite its old Orientalist traditions, knowledge on Central Asia is drying up and reflection on the future of Central Asia in Russian think tanks is minimal. This means that in the years to come, an ill-advised Kremlin could prove unable to manage its reaction to events, for instance to the failure of a weak state such as Kyrgyzstan. As a result, Moscow tends to focus attention on the western and Caucasian fringes of the former empire. Central Asia enjoys lesser attention since Russia’s influence over it is considered obvious, an established fact that does not bear mentioning, and which, by contrast to the western fringes, it is not necessary to fight for. For the moment, therefore, Russia has almost no long-term vision of the relations it would like to entertain with its “south”, nor any strategy that offers Central Asia a status other than that of being Moscow’s geo-
graphical and political appendix. The Russian ability to seduce the Central Asian states will remain limited: the recognition of South Ossetia’s and Abkhazia’s independence, tensions with Belarus within the CSTO, Uzbekistan’s increased autonomy and the underlying conflicts between Moscow and Tashkent are confirmation that Russian control over the zone is far from being taken for granted.

**China**

Border conflicts between Russia and China were settled definitively by a 2005 treaty, and complemented with a Border Line Agreement that was ratified in 2008. Since the beginning of the 1990s, the two countries have been pursuing a rapprochement: their relationship rests in large part on their mutual desire to oppose the “hegemonism” of the U.S. and to defend multipolarity on a global level and refute the supremacy of Western values. However, this relationship remains ambiguous since neither of the two states wants either a direct confrontation with the U.S. or a slowdown of their integration into the international community. The relationship between the two countries is therefore pragmatic and primarily functional. It is not likely to transform into a political alliance in the next decade.

The arms exports and the transfers of military technology are one of the strong points of the Moscow-Beijing relationship. Russia has supplied 85 per cent of Chinese arms imports since the beginning of the 1990s, while these large Chinese weapons contracts represented about 40 to 50 per cent of Russian arms exports for the 1992–2004 period. Chinese orders are vital to the Russian military-industrial complex. However, tensions are emerging, since Beijing is looking to increase its purchases of technology rather than ready-made weapons. Moscow reacted to this with a fear both of losing its Chinese clients, and of Chinese actors becoming competitors on the international arms markets. In addition, real cooperation in the military domain remains modest. Joint military exercises were held for the first time in a bilateral manner in 2005 and thereafter in a multilateral setting under the auspices of the Shanghai Cooperation Organization (SCO). These exercises are above all designed to demonstrate the military power of the two countries and to send signals
to the U.S. – at the most in an attempt to secure Central Asia – but neither of their military headquarters envisage any exchange of strategic information or a deeper partnership with one another.

A similar ambiguity is visible in their economic relations. Russia wants to develop its economic partnership with China, in particular in the energy domain, in order to have a counterweight to its tense relations with Europe. Bilateral trade reached US$40 billion in 2007 and is set to double sometime around 2010–12. The real scale of Russian-Chinese trade is much higher than is suggested by official statistics from Russian and even Chinese sources, because of shuttle trade in the Far East. Trade figures clearly show Russia’s orientation towards primary resources, and China’s role as a supplier of finished products. The level of cooperation between the two countries in manufacturing and investment is almost negligible. The Russian authorities are therefore increasingly disquieted by China’s economic dynamism, which will enable Beijing to present itself as the dominant power both in Central Asia and in the Russian Far East within the next decade. As was manifest in Russia’s hesitation regarding the route of future gas and oil pipelines in Siberia, Moscow is banking on China’s with Japan and South Korea to avoid having to go head-to-head with China, which would certainly not be to its advantage. Over the long term, the points of friction seem likely to increase. These points will combine rivalry over Central Asia and the North Pacific as a sphere of influence, with tensions in the Russian Far East that may arise from the strong demographic and economic pressures that are pulling this region into Beijing’s sphere of influence.

**Japan**

Russo-Japanese relations are complex: while the geopolitical issues in the Pacific have yet to be resolved, bilateral economic cooperation is growing, and Russia needs a counterweight in the eventuality that China becomes too powerful. To date, economic cooperation has been partially impeded by the non-resolution of territorial conflicts, but today both governments are hoping either that they will soon find a resolution, or that they will be able to put these issues aside and fully develop the Russo-Japanese partnership. The signing of a peace treaty between the two countries has been blocked
since 1945 by the question of the Kuril islands. The status of South Sakhalin is also controversial, but it is even less probable that Russia will cede on this question. Both governments regularly declare their wish to continue the dialogue, but local conflicts (particularly in the fishing zones), not to mention the claims made in Japanese textbooks about Japanese sovereignty over the Kuril islands, has tested this official goodwill. The stakes for both sides are high: these territories are of economic interest, as much for their subsoil resources as for the fishing zones that they offer, and they occupy a strategic position, although of diminishing value in the North Pacific. Russia would find it hard were it to lose key territories for its Pacific front, while Japan wants to put an end to the historical “injustices” committed as a result of its status as a loser of the Second World War.

In the 1990s, Tokyo made a large part of its aid conditional on the settlement of the territorial issues, but later put such conditions aside and opted for a more pragmatic stance to prevent it from being outdone by its Chinese rival. In 2008, annual bilateral trade reached US$30 billion, a figure that tripled compared to 2004, and it is bound to keep increasing. Moscow, on its side, hopes to negotiate territorial concessions in exchange for Japanese capital and technologies, while Tokyo would like to profit from Siberia’s oil and gas reserves, and prevent them from being monopolized by China, from whom it would then have to buy them. The new Russo-Japanese partnership is principally manifest in Sakhalin-2, a monumental oil and gas project of some US$20 billion, whose extractable reserves are estimated to be a billion barrels of oil and 490 billion cubic meters (bcm) of natural gas. Three offshore oil rigs have been built in the Okhotsk Sea, as have partly underwater pipelines that connect the north and the south of the Island, the location of the new US$22 billion LNG plant that was inaugurated in February 2009. 65 per cent of future production is destined for Japan and the rest for South Korea and the U.S. Sakhalin Energy will have an annual capacity of 9.8 million tons of liquid natural gas, being about 4 per cent of world production, and about 7 to 8 per cent of Tokyo’s gas requirements, which is looking to reduce its dependency on the Middle East. Gazprom, the principle shareholder in the project, is hoping, for its part, to entice Japan and China to become major partners so that it can reduce its
dependency on exports to Europe. In April 2009, the two countries signed their first nuclear energy co-operation agreement that will enable the transfer of Japanese technology to Russia and the sale of more nuclear fuel to Japan.

Russia and Japan have more to gain than to lose by reinforcing their bilateral cooperation: such cooperation enables both Moscow and Tokyo to re-balance relations with their traditional partners (Europe for Russia, the U.S. and the Middle East for Japan) and to prevent China acting unilaterally. Russia’s ruling elite, more and more concerned by China’s rise to power, as a result are bound to turn to Japan (and South Korea). This seems to have already been shown in 2007 with the inclusion of Sergei Naryshkin, an economist specialized in Asia, in Putin’s inner circle, and then again, in 2009, with the nomination of Viktor Ishayev, known for his promoting of rapprochement with Japan and issuing of warnings against Chinese migrations, as a special representative to the Russian Far East.

Turkey

In the 1990s, relations between Russia and Turkey were strained, mostly due to the geopolitical reorganization of Eurasia following the demise of the Soviet Union. The two countries entered into direct competition in strategic zones like the Caucasus, Central Asia, and the Balkans. However, relations began to improve at the end of the 1990s. Public recognition of this Russo-Turkish strengthening of relations was consolidated during Putin’s visit to Ankara in December 2004, which was immediately followed by Recep Tayyip Erdoğan’s visit to Moscow in January 2005. Economic cooperation is one of the motors of this rapprochement, and Russia is now Turkey’s second largest trade partner after Germany. Military cooperation is similarly progressing, and Ankara has ordered Russian military equipment. At a geopolitical level, the number of issues opposing the two countries has clearly diminished. Today, Moscow supports Turkey’s position concerning the Turkish Republic of Northern Cyprus and its membership bid for the EU, while Ankara, for its part, approves of Moscow’s growing role in the Middle East and acquiesces to its dominance in the South Caucasus. In addition, both countries have reduced cooperation with Israel and increased
cooperation with Syria and Iran, thereby tracing the possible outline of a Russia-Turkey-Iran alliance (possibly also including Syria) that would undermine American ambitions in the region. The prospects for such an alliance would depend on a further estrangement of Turkey from the West, which is possible but not probable. Moreover, nationalist and anti-Western movements are growing in Russian as much as in Turkish political circles. While Moscow insists on Russia’s status as a great power, the ruling Turkish Justice and Development Party is endorsing the notion that Turkey belongs more to the Muslim world than to Europe. In Turkey as much as in Russia, certain decision-making circles with links to nationalist milieus, and in particular military staff, are advocating a strategic rapprochement between the two countries in order to impede the EU influence’s on its eastern fringes. The new Russo-Turkish “partnership” remains a relatively precarious affair, however, since both countries are as likely to become competitors as they are partners. However, the Turkish ruling elite’s growing discontent with EU and NATO membership could create an opening for further rapprochement with Moscow.

Iran

Russia’s warming relations with Iran have been an important component of the changing regional geopolitics. Iran’s decision to embrace a highly pragmatic and cautious foreign policy toward the former Soviet Union reassured early fears that it would push an ideological agenda there. In fact, Tehran’s policies toward the North differ fundamentally from its assertive policies toward, and support for extremist and terrorist movements in, the Middle East. In practice, Iran came to defer to Russia on most policy areas concerning Central Asia and the Caucasus. For example, Iran joined Russian in discretely supporting Armenia over Azerbaijan, and used its influence in the Organization of the Islamic Conference to shield Moscow from criticism over its brutal war in Chechnya. A key component of the bilateral relationship has been Iran’s growing reliance on Moscow for arms as well as its nuclear program. Russia’s support for Iranian nuclear energy programs – most distinctly its Bushehr reactor – has been paramount in Iran’s determination to develop a nuclear weapons capability.
The consistency of Russia’s policy on Iran makes this policy likely to continue at least into the medium term. Moscow’s strategic thinking on Iran appears to be based on Iran’s role in its vision of a multipolar world: by constituting the main obstacle to the influence and prestige of the United States in the Near East, Iran is aligned with broader Russian interests. Moreover, given available information on the high levels of corruption in the Russian military-industrial complex, it is more than likely that high-level Russian political and military officials benefit personally from the sale of arms and nuclear equipment to Iran. Both of these factors undermine the thesis, so often repeated in the West, that Moscow shares Western opposition to Iranian nuclear weapons and that Moscow is the “key” to managing Iran’s nuclear weapons program. All other things equal, Moscow would probably prefer Iran without nuclear weapons; but its policies so far have rather enabled than hindered Iran from developing such capabilities. In fact, concerning Western demands for sanctions on Iran, Moscow’s policy over the past decade has been to delay and prevent the implementation of sanctions. However, Moscow has repeatedly gone along with limited sanctions after having succeeded in watering them down. Indeed, rather than seeking to prevent Iranian nuclear weapons, Moscow appears to see this as an inevitable prospect and prefers to ensure positive relations with the future nuclear power. No major change in this policy is to be expected; instead, Moscow is likely to seek to extract the maximum concessions from the West on its dominance in the post-Soviet space for the semblance of cooperation on Iran.

The United States

The U.S. remains Russia’s main perceived antagonist, but it is also considered as the main “brother-enemy” to which to be compared: Russia expects more from the U.S. than it does from any other international partner, especially respect and symbolic recognition. The dominating view in the Russian elite is that the U.S. has moved forward its strategic positions to the detriment of Russian security and Russia’s position globally. According to Russia’s 2009 National Security Concept, the United States Ballistic Missile Defense program is being constructed to destroy the Russian monopoly on
gas supplies to Europe. NATO enlargement, the decision to place missile defense systems in Poland and the Czech Republic, and the U.S. non-ratification of the Treaty on Conventional Forces in Europe testify to this fact, according to the Russian foreign policy and security establishment. The Russian view is that the U.S. is employing hard line tactics to uphold its unilateralism on the international scene while at the same time disregarding Russia’s interests. Nevertheless, Russia is deemed to have a generally positive stance on multilateral co-ordination on nuclear non-proliferation issues within the UN and international regimes. Taking into consideration the Obama administration’s decision to put this issue high on its agenda, it can have the effect of strengthening the ties between the U.S. and Russia – especially so, subsequent to President Obama’s decision not to continue the missile defense program in Poland and the Czech Republic.

However, the underlying zero-sum vision dominating Russian foreign policy is likely to block attempts to improve Russian-American relations in the medium to long term, irrespective of Washington’s policies. Indeed, Moscow’s strive for a multipolar world results in efforts to undermine American influence, both in Russia’s neighborhood and globally – implying support for the forces and processes that challenge American supremacy. Moscow is thus often torn between policies, on the one hand, that would appear to be in its interest as well as America’s; and on the other, those that would undermine American influence. The former would include helping to halt Iranian and North Korean nuclear non-proliferation and helping defeat the Taliban in Afghanistan. The latter would imply ignoring or even facilitating nuclear processes and hindering American objectives in Afghanistan. Too often, Moscow appears to lean toward undermining American objectives even when that would appear against its interests, as when Moscow shuts American bases in Central Asia or facilitates Iran’s nuclearization.

NATO
The dominant view in Moscow on NATO remains that it is an offensive military alliance, which threatens Russian security, ignoring evidence of NATO’s fundamental shift since the mid-1990s. NATO enlargement is seen
as a violation of the promises allegedly rendered in the beginning of the 1990s when Germany was re-united, i.e. that NATO would not expand further and that it would transform into a political organization. NATO enlargement is also seen as encircling Russia while at the same time intervening in its sphere of interest. At the same time, Russia has shown a pragmatic stance towards NATO meaning that the rhetoric, both domestically and internationally, tends to be harshly anti-NATO, in parallel with the decision-making procedure being driven by pragmatism. Historically Moscow has tended to approve and support NATO-led operations, which Yeltsin did concerning the Balkans and Putin did when he (reluctantly) consented to U.S. military bases in Central Asia as well as to NATO taking the lead of ISAF in Afghanistan. During NATO’s second enlargement Russia voiced its discontent, but abstained from acting for pragmatic reasons, as the perceived cost would be too high. From NATO’s 2008 Bucharest summit and especially following the war in Georgia in 2008, conclusions as to Russia’s possible response to a third round of enlargement are not as straightforward. Clearly, Russia has put the use of force on the table as an instrument it is prepared to use. That would most likely not take the shape of a frontal attack on NATO, but rather of provoking tensions that would be used to justify some form of Russian intervention. Although not clearly stated in the Foreign and Security Concepts, this is clearly the strategy applied by Moscow in this regard. Thus, the main target in hindering further NATO enlargement is not NATO or its Member States per se, but rather the aspiring states – although in parallel Russia will seek to more forcefully influence NATO, possibly through its NRC membership. The Georgia war illustrates the effects of the game of great powers from Russia’s point of view. Should Russia feel itself ignored or marginalized by other great powers, it may use violent means. The antagonism between NATO and Russia is likely to increase, taking into consideration that Georgia, for example, wants to join NATO primarily in order to benefit from defense cooperation and the hard security provided by NATO. In particular, the next decade is likely to see a continued security vacuum in the region between NATO and Russia, roughly speaking the eastern Black Sea region. Four countries – Azerbaijan, Georgia, Moldova, and Ukraine – seek to avoid complete absorption into
Russia-dominated structures such as the CSTO (which Armenia and Belarus have accepted) while their prospects for NATO and EU integration have stalled. These four countries are likely to be the major hotspots in European security for the foreseeable future.

It should not be taken for granted that a weakened Russia, whether economically, military or politically, would not engage in armed attacks should the third round of enlargement proceed. On the other hand, Russia’s track record is one of opposing such moves vociferously until they happen, and once they do, to adapt to the new realities. Such a scenario is also possible in a third round of enlargement.

**The European Union**

Russia’s relationship with the EU shows a great deal of ambivalence that includes both pragmatism and realism. The main issues in EU-Russia relations in the beginning of the twenty-first century include: the EU Eastward enlargement procedure, including the European Neighborhood Policy (ENP) and the Eastern Partnership launched on May 7, 2009; energy security; and the EU’s attempts at diffusion of European norms and values. It is clear, as in the case of NATO, that there is a potential conflict between Russia’s interest in and strategy for ‘the near abroad’ and the EU’s eastward enlargement. This is especially the case concerning Ukraine, Georgia and Moldova. Moscow considers any EU activity in this area as an intervention in Russia’s sphere of interest; since the 2004 Ukrainian elections, Russia’s views of the EU have become increasingly negative. In particular, the Eastern Partnership is considered as an affront against Russia. In addition, Russia views any criticism or other comments on its democratic development, or rather backtracking, as attempts to intervene in Russia’s internal affairs. The current Russian regime does see Russia as a European state. However, it does not recognize Europe’s normative agenda in relation to Russia. The concept of sovereign democracy was introduced partly as a means to underline that Russia is a democracy and hence that it can be part of Europe, but that it is a democracy Russia-style. Russia’s preference for bilateral cooperation with individual EU member states has weakened the strategic
partnership between the EU and Russia – which has been Moscow’s intention.

Russian and EU strategies to achieve influence and uphold security in the FSU differ substantially. While the EU views political and legal reform and European integration as a prerequisite for stability in the region, Moscow’s strategy rests on informal influence and economic and energy pressure, in combination with outright destabilization efforts, and even, as in the case of Georgia, war. Moscow will view every action in the FSU that it perceives as norm-setting and/or which proceeds without Moscow’s explicit consent as a hostile action against Russia’s interests in the region. This position is not likely to change drastically in a ten-year perspective. Unless the EU tones down its democracy and normative agenda in the region in combination with recognizing what Moscow regards as its privileged position in the region, the tensions there are likely to increase. Additionally, Moscow remains convinced that the new EU Member States, and the policies they represent, will have negative consequences for EU-Russia relations. Russia is likely to continue to act in the near abroad from its realist geopolitical perspective, which means a zero-sum game. According to Russia’s medium term strategy for the developments of Russia-EU relations presented in 1999, Russia welcomes the ESDP as a way of restricting the U.S. and NATO, and the NATO-centrism in European security.

The Nordic Countries and the Baltic Sea Region

Although Russia has accepted the Baltic States’ accession to the EU and NATO, these states are still, together with Finland, considered of great strategic importance to Russia. The main issue in a 10 to 20 year perspective in the region is going to be the energy transit question, i.e. the Nord Stream project, which is likely to contribute to a militarization of the region. A direct military attack is not plausible, but destabilization attempts are likely to occur. As for the respective states, Russia’s leverage differs greatly between them. As for Estonia, Latvia and Lithuania, the global financial crisis has caused severe damage to the state and the economy. This is especially the case in Latvia. Such a development opens up opportunities for increased levels of influence and corruption. Russia has a strong influence on the state
and the economy in Lithuania, it is on the increase in Latvia and Estonia has been subjected to serious destabilization attempts, such as cyber-attacks (which the state-support pro-Putin youth group Nashi in 2009 claimed responsibility for but which intelligence experts concur was orchestrated by the Kremlin), Nashi demonstrations on Estonian territory, and riots in connection with the changing of locations for the Bronze statue in Tallinn. In addition, the Russian speaking minorities in Estonia and Latvia can be used as destabilizing factors and as a way of exercising leverage.

The Arctic Issue

Acquiring control of the seas, and especially of the Arctic Ocean, is one of the main geostrategic challenges of the 21st century. The stakes are numerous and of a diverse nature, including territorial claims; control over the maritime routes emerging as a result of the melting icecap; the modernization of the navies of some Arctic countries; and the active involvement of public and private economic actors interested in taking possession of the potential offshore energy market. Russia submitted a claim to the UN Commission on the Limits of the Continental Shelf in 2001. Moscow asserts that the Lomonosov Ridge is a geological extension of its continental Siberian shelf, and thus that 1.2 million km\(^2\) of Arctic waters fall under its jurisdiction. On the strategic level, Russia hopes to take control of the Arctic and is intensively modernizing its Northern Fleet. Moscow is planning to build new nuclear-powered icebreakers starting in 2015 to maintain and expand its current level of operations. In July 2008, the Russian Navy announced that its fleet had resumed a warship presence in the Arctic. Military ships began patrolling near NATO defense zones and strategic bombers flew over the Arctic, for the first time since the end of the Cold War.

The Arctic is seen a new Eldorado for oil and gas with an estimated 15–30 per cent of the world’s undiscovered hydrocarbons reserves, and is set to become the booming economic frontier of the 21st century. The economic competition has already begun: several Russian companies, especially Gazprom, are planning to be operational on the technical level as soon as possible in order to make their moves before those of their international competitors. With the melting of the polar ice cap, the Arctic is also destined to be-
come a major international shipping route. An ice-free Arctic by 2040 (which remains highly speculative) would make the transportation of commodities to international markets easier and significantly reduce transportation costs between the Pacific Rim and Northern Europe. The profitability of the route nevertheless depends on the transit fees imposed by Moscow. Russian experts estimate that the traffic passing through their waters is likely to be around 10–15 million tons towards 2015–20. Currently the navigation conditions in the high latitudes are still too perilous. However, shipping companies the world over, in particular Chinese and Japanese, are already preparing for this commercial race. The Japanese government has made an open display of its interest in the question, which could become one of the driving forces of the Russo-Japanese partnership in the coming decades.

Russian interest in the Arctic will only be partly subject to the evolution of Russian-American relations and the global economic crisis. The project has too much potential for the global economic downturn to affect it greatly. Indeed, for Russia, the project is so important for maintaining Russia’s long-term future as a great power over the next fifty years that it is unlikely to be scaled back by any future Russian government. Moscow will nevertheless have to compete with the U.S., which decided to re-launch its Arctic policy; with Canada, which certainly intends to participate in the race; but also with the EU, which is attempting to formulate its own Arctic strategy. This will also involve NATO, which has declared its intention to make the Arctic one of its future topics of discussion; Japan, which is becoming increasingly interested; and China, which is developing a new maritime strategy. Russia will therefore act upon prognoses of climate change regardless in order to advance its dominion over the Arctic. Its interest in this region is not subject to the evolution of Russian-American relations nor to the global economic crisis.

*Russia’s Foreign and Security Interests in a 10–20 Year Perspective*

Russia is likely to continue to strive towards multipolarity on a global level in a 10–20 year perspective and to maintain its realist approach to international politics. Its main goal will be to remain stability domestically while
strengthening its position internationally. Russia’s main challenges are to be faced in its neighboring regions, especially the instability of Central Asia countries and Western CIS countries’ alleged continued wish to break free from Russia’s sphere of influence. Although any future NATO enlargement is still viewed as a hostile action by Moscow, it is not likely to lead to a direct confrontation, except for possibly in the Crimea. In the Middle East, Russia’s relations with the current regime in Iran will continue to challenge the U.S. and in the longer run also Europe. Russia’s relation to Iran is likely to be used by Moscow as a card to play to strengthen its global position. Russia’s actions in this context in a near future will be of great importance for its relations with the U.S., Israel and Europe in a 10–20 year perspective and to answer the question whether Russia is a partner or an adversary to the West.

Russia is likely to strive towards strengthening its smart power, i.e. its ability to combine hard and soft power. This includes improving its diplomatic skills, intelligence gathering and analysis, economic power and technological innovations. In order to assess Russia’s future smart power one will have to take into consideration the status of Russia’s economic state craft as discussed above in combination with the use of economics and energy as political tools. This will not be enough to reach any tentative conclusions however. Smart power requires a well educated population, resources for development of modern technology and a modern, sophisticated and well informed diplomatic and intelligence gathering community. Kremlin’s response to the colored revolutions, its handling of the information war during the war with Georgia and its lagging behind the technological development testifies to some of the challenges facing Russia in a 10–20 year perspective. Threats to Russia’s stability and safety are both external and internal. Any one specific situation that would threaten to shake Russia fundamentally is to be found within its borders in North Caucasus. The next section will elaborate on Russia’s domestic developments and the challenges it is facing.
Domestic Developments

Russia’s standing in the world is closely connected to its domestic developments, which the introduction of the concept of sovereign democracy by Putin’s advisor Vladislav Surkov in 2004 testifies to. The concept signals that Russia is on par with the West, that it is not anyone’s pupil, and that Russia is independent from EU and the U.S. and that it expects to be treated accordingly. Clearly, the idea of sovereign democracy, although not systematically used by Russian leaders, laid the foundation for developing a state ideology that in its turn aims to consolidate a national identity. Its impact on Russian foreign policy is at this point evident: sovereign democracy constitutes one of the theoretical foundations of Russia’s foreign policy. Nevertheless, only a modern Russia up to date with the latest technology and knowledge can compete on the global arena. The need for swift adaptations combined with strong human resources and access to intelligence – often referred to as smart power - is a precondition for successful participation in the global competition. In February 2008 Putin proposed a long term plan for modernizing Russia, known as the “Conception for Development through 2020”. Due to the financial crisis, this ambitious modernization plan is put on hold and it is not likely to restart in the near or mid-term.

The sovereign democracy concept is likely to have implications for ideology-shaping processes and mass mobilization in Russia in a 10 to 20 year perspective. The concept has both domestic and foreign policy aspects to it, which are closely interlinked. The current regime seeks to modernize Russia and consolidate power in the name of “statism,” in parallel with trying to establish Russia as one of the world’s great powers. For the Kremlin sovereignty equals capacity, and capacity in its turn requires economic independence, military strength and cultural identity (the latter includes creating a nationally-minded elite). One of Russia’s primary foreign policy goals is to boost Russia’s role and status internationally. In order to achieve that goal, criticism towards domestic developments in Russia needs to be neutralized, hence the introduction of the term sovereign democracy.
The ruling elite are challenged by having to handle two parallel processes – the modernization of the Russian state and economy on the one hand, and the search for a national identity on the other. The focus chosen by the current regime in search for a national identity is likely to be dependent on its abilities, especially economic resources, but also Russia’s standing internationally. With Putin’s modernization program at a freeze, nationalism, great power rhetoric and antagonism toward perceived foreign enemies are likely to be used in the identity-shaping process. In sum, this means that Russia’s identity shaping process is still stuck between nineteenth-century values and actions, and a more modern conception of power involving globalized ways of interacting combined with soft-power tools.

While the 1990s was a turbulent decade for the Russian people and the Russian ruling elite, the beginning of the 21st century has gone in the sign of stability and predictability. Russian citizens are as rich as they have ever been, the middle class is growing, and although poverty is still common, wealth is starting to spread in the country. At the same time Russia, is becoming increasingly authoritarian and in general considered a ‘not free’ country (according to Freedom House’s assessment). Generally, popular opinion in Russia has been favorable to the current regime – mostly as a result of three factors: the booming Russian economy during President Putin’s time in power (2000–2008), the feeling of a normalization of everyday life and of a more secure future, Russia’s return to the global arena as an influential player, and the restoring of Russia’s identity as a great power, derzhavnost. At the same time, the well-informed part of the population has no illusions as to the current regime and the power-sharing between President Dimtrii Medvedev and Prime Minister Vladimir Putin. Medvedev’s election as president in 2008 did not constitute a regime shift with far reaching consequences for either the ruling elite, policy content or decision-making procedures. The legitimacy of the current regime in the eyes of the Russian people rests on its ability to deliver a higher material standard and pride in the mother country, often called “the social contract.” Should the regime fail to deliver on this, without being able to change its legitimacy base, it is likely that it will be challenged. However, for such a development to pose a threat to the current regime it presupposes that uprisings are or-
 orchestrated and lead by forces able to stand up to the current regime and its administrative resources and other power tools, including repression and control of information flows. Taking into consideration the current regime’s hard grip on important state structures, this is not likely to happen if the current system does not totally implode. In case of total failure of the social contract, a potential alternative source of legitimacy and support for the regime is nationalism and strong anti-West sentiments. Such trends are already visible, for example the global financial crisis is blamed on the West, the U.S. in particular, and its ability to regulate and control the financial system. Thus, if anything, the effects of the financial crisis might increase anti-Western sentiments amongst the Russian population. In addition, the playing ground for nationalism as a mobilization instrument is already laid. Such a development could nevertheless constitute both a blessing and a curse for the regime. If push comes to shove, the current regime would probably choose to strengthen its nationalistic agenda and rhetoric instead of trying to engage in an educative and responsible dialogue with its citizens on the challenges that Russia is facing.

Nevertheless, Russian power has no experience in managing large-scale social conflicts and might find itself taken by surprise by a social movement, whether spontaneous or orchestrated by opposition forces. The authorities were concerned by the “color revolutions” in Georgia and Ukraine and alarmed by the idea of being scuttled without bloodshed. They might therefore react brutally with violent repression should they feel threatened – overreactions to demonstrations before the elections in 2007 and 2008 point in this direction. However, it is likely that social discontent will continue to show itself not by direct confrontation but through indirect forms such as the resumption of emigration (4.7 million people left Russia between 1990 and 2003) and the continuation of the demographic decline and destructive social practices. Moreover, if the current regime, seen as the driving force behind Russia’s economic boom, comes in contradiction with the new middle classes, it risks appearing as weak and unstable. Vladislav Surkov did not hide his disquiet at the end of 2008 concerning the political impact of the financial crisis and called for voluntarist measures to be taken to maintain consumption levels and avoid a loss of confidence: “If the 1980s
were the year of intellectuals, the 1990s those of the oligarchs, the 2000s are the years of the middle classes,” to whom the Kremlin must devote all its energy, according to Surkov.

Nationalism is an instrument of power in the attempt to control society. Since the end of the 1990s, the cult of the fatherland and the idea of sovereign democracy have established themselves as the matrix of the new social contract proposed by the Kremlin: the patriotic reference creates norms of identification and articulates a representation of self as nation beyond all social and ideological divisions. The ruling party, United Russia, and the Presidential Administration are convinced that maintaining the status quo in their favor will only be possible in the long term if the citizens themselves also remobilize in their daily lives and endorse the rebirth of Russia as a great power and the party that is supposed to embody it. To this end, the Kremlin has worked out a patriotic program centered on the return of symbols of the fatherland and the institutionalization of an official historical memory, the instrumentalization of Orthodoxy as symbolic capital, the development of a militarized patriotism founded on Soviet nostalgia, and the indoctrination of the youth, either through the school system or by its politicization of youth movements like the Nashi or the Young Guard. These state-controlled organizations accentuate the undemocratic tendencies among the youth. The Kremlin’s will to appease contradictory forms of memory and to reconcile diverse segments of society gives rise to an explosive mixture of, on the one hand, a Soviet nostalgia fixated on past greatness and the victory of 1945, and, on the other hand, calls to construct Russia as a twenty-first-century leader, at the vanguard of globalization. Therefore the “managed democracy,” created by Putin has given rise to a “managed nationalism;” the Kremlin has created a nationalist demand and, at the same time, seeks to co-opt or eliminate every nationalist mobilization that it has not fomented or cannot control. Thus, threats to social stability, whether in the form of uncontrolled migration, demographic challenges or the rise of political extremism and religious radicalism are not handled in a serious way by the ruling elite. The current regime has no long-term solution to propose to the population. The state’s response to such questions is
likely to run up against huge difficulties in the coming years and the developments do pose a serious challenge to Russia in a 10–20 year perspective.

Nature and Sources of Power in Russia

The most important sources of power in Russia are control of the administrative resources, mass media, and the power structures, together with control over strategic natural and economic resources. This nature of power is not of a democratic kind. It is based on control and suppression; It is exercised in a non-transparent manner, is not based on accountable institutions, and for an outsider it can seem arbitrary. However, for insiders the rules of the game are, if not clear, at least not unknown. Loyalty to the state and its main actors are presupposed. Both the political and economic elite are expected to act in the interest of the state and to take its foreign and security policy considerations into account. Failure to do so brings severe consequences. As stated above, the main sources of power are control of the power structures on the one hand, and of economic and natural resources on the other. Control, however, is only efficient if exercised with the implicit consent of the population. The legitimacy of the current regime rests with the economic development that took place under Putin and Russia’s international standing. Since the struggle for political power in Russia is a zero-sum game with the control of the presidency as the main goal, the tendency of cooptation of former adversaries is growing increasingly strong. The current regime is characterized by its merger of the economic and the political elite. Taking into consideration the enormous wealth that the state has generated to well-placed individuals at different ministries and agencies, they are not likely to rock the boat unless in exceptional circumstances or serious signs of weakness on behalf of the tandem in power. The political opposition remains weak and is not likely to overthrow or in any other way outplay the current regime. Hence, any drastic power changes in Russia in a 10 to 20 year perspective are likely to be the caused by infighting between different groups within the ruling elite. Ministries and state agencies are played out against each other in order to create a balance in the system, and the final arbiter is the power holder, be it the president or as currently is the case, the Prime Minister. Putin, both as president
and Prime Minister, has served as the arbiter between different power
groups within the ruling elite but he is also its hostage, and is limited in his
range of action by games that he cannot master. In conclusion, the fact that
power in Russia is connected to persons, informal networks and economic
power in combination with weak formal institutions does make Russia a *de
facto* fragile state. The upcoming Duma and presidential elections in 2011
and 2012 are likely to cause some stir within the ruling elite. However, this
struggle is not likely to take place in the open and it will most likely not
take the shape of a regular election campaign. It is of course impossible to
foresee the outcome or the developments preceding the presidential elec-
tion. Nevertheless, any drastic measures should be seen as a means to take
control of power and potentially as a sign of weakness. This tentative con-
clusion can be drawn in the light of Putin trying to calm observers by sta-
ting that no matter what turns will be taken there will be an understanding
and an agreement between him and the president.

*Control of Information*

The strict control of mass media and other public information channels in
Russia has several reasons and effects. With the second war in Chechnya,
launched in 1999, came repression of freedom and information. If not tota-
ly controlled by the state, Russian media outlets are now more or less self-
censured. This policy continues to be developed: a new media project
started in May 2009 will ensure that regional media outlets will be provided
with information on international and domestic issues by state-controlled
news agency RIA Novosti and Interfax in cooperation.

The control of information has several purposes. First, it has been part of
Moscow’s anti-terrorist strategy. Second, it hinders information that por-
trays the state as inefficient, corrupt and weak from reaching the people.
Third, it is a tool in presenting Russia as an important international actor.
Fourth, it is a key tool in mass mobilization and the identity-shaping
process. Fifth, it is a weapon in domestic and international information
wars and a way to stop any oligarch who would like to invest his money
for a political goal. The effects on mass mobilization and identity-shaping
processes might be positive from the ruling elite’s point of view. Mass me-
Media plays an important role in forming the nationally minded elite that is one of the cornerstones of Russia’s sovereign democracy. Control of mass media further means that the ruling elite controls what image of Russia’s international standing is transmitted to the people. This means that Russia’s actions in international affairs will be portrayed as successful to the domestic audience even if this is not the case objectively. An effect of this can be that Russia’s hard line rhetoric is not necessarily matched by hard line actions. Thus, for the surrounding world, this can be both a blessing and a curse in that it can allow for the ruling elite to combine hard line rhetoric with pragmatic actions. Clearly, the outcome of any future domestic or international antagonism or power struggle is going to be more or less determined by who wins the information war. As Paul Goble argues, Russia perceives having lost the international information war that followed the war in Georgia in 2008. It is not prone to repeating this mistake if it can avoid it, though this also illustrates the gap between world opinion and the Kremlin’s perception of the world.

The think tank sector is still relatively recent in Russia and remains limited: it has been held back by an absence of private financing, and a regime which is unfavorable to the expression of political diversity, has a general lack of interest for ideological debate, and saw a collapse of its human resources in the intellectual domain during the 1990s. However, during Putin’s time as president think tanks increased rapidly in number: Russian leaders are not content with having to rely on a few shadow councilors; instead, they now rely on an increasingly large network of competitive experts. However, the opinions of think tanks remain consultative. The Department of Domestic Policy at the presidential administration (GUVP) continues to be the central decision-making institution. Freedom and pluralism of information is one of the cornerstones of efficient policy making. The situation regarding freedom of information is not likely to change drastically in 10 to 20 years, especially taking into consideration that ideological wars within the Russian elite are likely to increase. The only wild card is the internet, which has the potential to disrupt state control of information flows in Russia, as was visible during the Russia-Georgia war. That leaves open the possibility that like Iran or China, Russia could increasingly censor the
internet. In conclusion, the most serious effect of control of information is that it is likely to have a potentially negative effect on the ruling elite’s policy analysis and decision-making process.

**Decision Making**

Putin’s reforms aimed at centralizing the decision-making procedure while at the same time strengthen the power vertical was a necessary step when Putin took over the presidency in 2000. However, the results are not necessarily a more efficient and secure decision-making procedure. Non-transparent and non-inclusive decision-making processes tend to result in inefficient measures based on weak, and sometimes faulty, analysis. Under Putin, the Russian state’s presence in all parts of society has increased. Putin is said to rely on the information and analysis presented by the security apparatus rather than the responsible ministries and agencies. That would explain behavior which to the outsider seems more or less irrational or ill-advised, such as violently crushing rather small and peaceful demonstrations close to elections, the miscalculation of the Orange Revolution in Ukraine, and the genocide argument at the outset of the war in Georgia, which was rapidly revealed to be wildly erroneous. There are obvious risks with such decision-making procedures. Not only does the Kremlin have very limited chances of controlling facts and analysis; moreover, manipulation, group think and distorted analysis and facts may lead to very risky decisions in both domestic and foreign policy.

During Putin’s presidency, the president always had the final say in foreign policy matters. Clearly, there have been no substantial shifts in foreign and security policy under Medvedev and much point to Putin remaining the ultimate decision-maker in foreign affairs although a slight shift toward Medvedev can be detected following the war in Georgia. Still, the difference between Medvedev and Putin is rather one of image and possibly of rhetoric, but not of substance. Overriding policy goals such as an improved international standing and the strengthening of the Russian state are not likely to change. In an authoritarian state like the Russian, policies decided by the ruling elite will be enforced since there are no actors or elements in society to challenge them. In conclusion, this situation is not likely to
change drastically in a 10 to 20 year perspective. However, taking into consideration the risks with informal and insulated decision-making combined with a lack of multiple channels for facts and analysis, it is probable that unexpected and possibly ill-advised decisions with severe consequences for Russia’s population, its neighbors and the rest of the world will occur. In order to be able to foresee such decisions, there is a need for improved understanding of the system for collection and analysis of intelligence, and for the process of decision-making at the highest level. The developments as to the power tandem between Putin and Medvedev will be important and the overall question is still whether Medvedev is an autonomous decision-maker in relation to the Prime Minister and his support structures.

Domestic Challenges: Demography, Migration, Social Unrest and Extremism

Among the challenges likely to face Russia in the coming decade, four issues stand out: Russia’s demographic decline, the related problem of managing migration flows; as well as the risk of social unrest and growing extremism of various types in society. Confronted with multiple challenges, the Russian state has formulated responses that are hesitant in terms of public policy and ambiguous in terms of sanctioning extremism. This situation can be explained partly by the multiplicity of state actors involved and poor coordination between ministries. To this is added substantial competition between the different groups in power and confusion between real and false enemies in the attempt to build political legitimacy and a national identity.

The Demographic Issue

Between 1989 and 2001 and in spite of substantial migration to Russia, Russia’s population went from 147.8 million to 145 million, and dropping to approximately 142 million people in 2009. The long-term demographic forecast is largely negative: in 2025, Russia is predicted to have approximately 125 million inhabitants. Approaching 2050, large international organizations have predicted that the country will lose close to a third of its population compared to the end of the twentieth century, leaving it with a population of about 100–110 million inhabitants. This demographic decline
can be explained by the conjunction of several elements. Firstly, since the end of the 1960s, the fertility rate has been below the minimal rate of reproduction. Secondly, the death rate has been rising constantly since the demise of the Soviet regime, mostly because of the deterioration of the health system due to a lack of public financing. In addition, the rate of HIV infection has increased exponentially, leading to the return of illnesses such as tuberculosis. The main knot of the demographic crisis in Russia lies in excessive male mortality: life expectancy for men in Russia is 59 years, which is 13 years less than that for Russian women – one of the largest differences in the world. Alcoholism, (alcohol consumption has increased from 10 liters of pure alcohol per inhabitant per year in 1988 to more than 15 liters today) is one important explanation. More importantly, the figures of alcoholic children and adolescents are constantly rising. Alcoholism is directly or indirectly responsible for hundreds of thousands of violent deaths, including road accidents, work accidents, violence and family violence. One third of deaths are reportedly alcohol-related.

The great number of violent deaths impacts the country’s demographic situation even more than the poor state of the public health system. It also shows that the life of citizens is not a public policy priority. Even during Putin’s presidential term (2000–2008), when the public treasury was full, the authorities were unable to address the situation. The management of the HIV/AIDS epidemic, despite the implementation of a care program, failed to curtail its spread. The state is not leading any real information campaign about the transmission of HIV, is not seeking to improve the sanitary conditions of prisons, and still casts drug users as being criminals and not victims. A large road safety campaign was eventually launched in 2007. But the authorities do not seem to be concerned about violent, alcohol-related deaths. Though the health care budget tripled in the 2000s, it remains insufficient for modernizing the public health system and it has been impacted by the current economic crisis. Although the survival of the Russian state and its territorial integrity is at stake in the long run, the authorities thus far seem incapable of addressing the demographic issue effectively, or of implementing a strategy that recognizes the fact that one of the country’s principle sources of wealth resides in its population.
The rapid modification of the age pyramid in Russia is beginning to have an impact on the country’s economic capacity, and this situation will only worsen in the coming decades. As of 2015, the number of youths between 15 and 24 will be reduced by half compared to today. Within the last few decades, the number of persons over 60 years of age has doubled and this ratio is set to double again until 2020. The Russian state will therefore very quickly have to face up to several challenges: difficulties in paying for the retirement of its aged citizens, which although minimal, does require monetary expenditure; lack of labor to keep the national economy functioning; and a lack of youths. The latter fact will have an impact on the army, which is still based on compulsory military service. By 2010, the Armed forces will only be able to draft half of the 2007 annual cohort of 132,000. The school and university system will also be greatly affected, since it will have to deal with a reduced number of staff, with all that this entails for the production of knowledge and technologies in the face of worldwide competition.

However, since the beginning of the 2000s, Russia has become the country with the second highest immigration rate in the world, following the U.S. Figures vary considerably since the official figures cannot account for the illegal flows. It is nevertheless possible to confirm a figure of close to 10 million migrant seasonal workers in Russia, most of whom come – illegally – from the former Soviet republics of the Caucasus (Azerbaijan in particular) and of Central Asia (Tajikistan, Uzbekistan, Kyrgyzstan). Their massive presence in Russia is part of an uncontrolled element in post-Soviet decolonization: the cultural influences between Russia and Central Asia, the linguistic and social exchanges, mixed marriages, and the increase in the number of Muslims within the Russian Federation are no longer factors decided on by Moscow, but depend on Central Asian societies. The debate stemming from the nineteenth-century about whether Russia is a European state with Asian colonies or a specific Eurasian state has now taken on a very concrete form: as a result of migration, the Russian Federation is almost destined to become “Orientalized,” to contain more and more ethnic non-Russians, and more and more Muslims, and to develop new relations with Central Asia.
Russian society is also increasingly fragile as a result of multiple forms of extremism. Extremist political groups find fertile soil in the thriving xenophobia. These groups are often situated on the extreme right of the political spectrum, but can also be found on the extreme left, as is the case with the National-Bolshevik Party. In addition, the situation in Chechnya has imperiled the tradition of religious tolerance in Russia. Islamic extremist currents are multiplying, while fundamentalist Orthodox movements are trying to cement their institutional positions within the Moscow Patriarchate. These currents influence political decision-making, as the mobilization potential of these groups has increased over recent years. Paradoxically, the country’s economic progress has reinforced feelings of marginalization among some social classes, while freedom of movement and the widespread use of the internet among the young generation have enabled numerous extremist militants to develop international networks. Poverty has been reduced, but inequalities have not. Since the poverty levels peaked in 1999 at 41.5 per cent, poverty was cut in half to 19 per cent by 2002 and was estimated to be at 14 per cent in 2007. The North Caucasus, Southern Siberia, and parts of Central Russia are the poorest regions of the country. In addition, households from the provinces and rural areas are much poorer than those in the large cities, which is a sign of growing polarization in the country. According to the World Bank, the most vulnerable group is the rural population: about 30 per cent of which live in poverty.

Despite the magnitude of social reforms in the last two decades, the political situation has remained relatively calm and there has been only limited violent opposition among the discontented parts of the population. There have been conflicts – particularly in the industrial regions where the workers regularly go on strike to protest against their working conditions, although they do not receive much media attention. One of the larger social mobilizations occurred in January 2005, when the Russian state decided to replace aid in kind (mainly free transport and medications) traditionally granted to the poorest classes, with financial compensation. The monetization of social benefits triggered large spontaneous demonstrations from several tens of thousands of persons and forced the Kremlin to reverse its decision. Current social conflicts are often organized by the Communist
Party and its supporters, principally retirees with strong feelings of nostalgia for the Soviet period. This age group is going to gradually disappear and with it so will the protest electorate of the Communist Party. It can be assumed that new parties and social movements will form to channel popular discontent in the coming years. The new middle class strata that have benefited from the country’s economic boom in the 2000s have been largely demobilized and individualized. In addition, they are rarely unionized and take little interest in politics. However, in the case of a chronic social crisis, the social contract between the ruling elite and the population can be undermined quickly.

If Russia’s social malaise receives little expression in terms of political opposition, it instead manifests itself via the rise of xenophobia, being fuelled by the traumas people have experienced since the dissolution of the Soviet Union. Most sociological surveys show that about two-thirds of Russian citizens are anxious about the growing presence of migrants in their country. The slogan “Russia for the Russians,” previously wielded only by the extreme right, has become widespread in society, with more than 60 per cent of those surveyed voicing approval for it. The anti-Chechen sentiments that previously dominated have generalized into hostility to people from the Caucasus more broadly – a kind of “Caucasophobia” – and have also affected Muslims as a whole. This xenophobia has not only been directed at foreigners in the legal sense of the term but also at the national minorities. According to surveys, half of Russia’s citizens consider that minorities have too much power. Xenophobia is spreading widely throughout all social and political groups. A broad social consensus has emerged based on xenophobic, functioning regardless of political orientation, social class, educational level, income or age. Sociological surveys even show that the youth and the intellectual elites manifest the highest rate of xenophobia. The skinhead movement, which itself reportedly includes around 50,000 persons, is developing in this context, making Russia the country in the world with the largest number of skinheads. Largely unorganized at first, the movement slowly started to structure into multiple associations and succeeded in overcoming the doctrinal divisions that divided the small, extreme right-wing extra-parliamentary parties by centering its action on xenophobia and
the fear of migrants. Racist attacks are constantly on the rise: in total, associations specialized in the defense of human rights counted 270 racist attacks (including 47 fatal) in 2004, and 515 (including 96 fatal) in 2008. During 2009 several human rights activists have been murdered, both in the streets of Moscow and in Chechnya. The sense of impunity that comes with the state institutions’ failure to protect these persons and to solve their murders has the potential to further trigger a dangerous spiral which in its self poses a threat to social stability.

The debate on demography and migration divides the ruling elite. Some advocate an opening of borders with the argument that if Russia wants to become a great power and a modern state that is economically and intellectually competitive, then it has to have an offensive migration policy based on the U.S. model and welcome the millions of volunteers from the “near abroad” who are still Russian-speakers and share the same Soviet culture. Others consider migration as a threat, underlining the risk that the country will be “Islamicized,” and hence endorse a restrictive migration policy, hoping to see an “ethnically Russian” Russia. A large part of Russia’s future resides in the confrontation of these two approaches and in the choices made in favor of one or the other by the political authorities in the coming years. The solutions that have been chosen thus far are ambiguous. In 2007, the Russian state, which until then has refused to formulate a detailed migration policy, resolved to simplify the procedures of legalization for working migrants, but maintained quotas that are much lower than what is needed by the Russian economy. Less than 4 million people were authorized for 2008, a figure that was halved in 2009 in order to manage the economic slowdown resulting from the global financial crisis. In every case, these figures remain largely insufficient and result in illegal migration and corruption in state organs. With the global financial crisis and the economic slowdown in Russia, it remains to be seen whether the Kremlin will manage to convince its citizens of the need for a more liberal migration policy.

The inability of the Russian state to handle the demographic and migration issues is closely connected to the search for a national identity in Russia. Despite their declared opposition to the ruling elite, extremist currents are not without influence on political-decision making. The Islamist cur-
rents have their access to the decision-making circles in the republics (Dagestan, Kabardino-Balkaria, but also Tatarstan, etc.), while the Orthodox fundamentalists, extremist right radical movements and racists also have important intermediaries to the Kremlin. These exist, in think tanks close to the presidential party United Russia, in certain parliamentary groups in the Duma such as the Communist Party and Vladimir Zhirinovsky’s LDPR, in certain committees of the Duma such as the committees for Geopolitics, National Policy, and the Common Wealth of Independent States (CIS) Affairs and Relations with Compatriots, as well as in the power ministries (Interior, Defense, and Emergency Situations). Moreover, acts by skinhead go largely unpunished because they benefit from more or less discreet support from a part of the political class. Some local authorities, in particular in Moscow and in many provincial towns (Krasnodar, Stavropol, and Pskov), have even used these groups as informal street militia. In addition, legislation against this type of aggression is still lacking, and when it exists, is hardly implemented.

The Muslim Question

Russia’s Muslim question is underlined by the rapidly changing demographic shifts in the country. While Russia’s population is in rapid decline, that decline affects mainly the Slavic population, while the Muslims of Russia are actually projected to increase in numbers. This increase in absolute terms implies a much more significant increase in relative terms.

Russia’s Muslim population is diversified both in terms of religious belief and practice, and also in how it relates to the federal center in Moscow. Peoples of the Volga-Ural region, the Tatars and Bashkirs, have long been part of the Russian state and are less in a situation of conflict with the Russian state than other populations, mainly those in the Caucasus such as the Chechens or the peoples of Dagestan. The growing xenophobia results in a rise of Islamophobia, despite that this phenomenon has been historically very rare in Russia. The state’s endorsement of Orthodoxy as an element of the national identity exacerbates the critique put forward by Muslims concerning the disrespect of state secularism. The Russian Muslim elite are divided, and the main Spiritual Boards are competing amongst themselves.
Some recognize that the Muslim population is a minority religion within the mostly Orthodox Russian Federation and thus that it ought to adopt an attitude that is more conciliatory than confrontational; others maintain that the Russian state ought to remain a secular state in which Islam is granted the same rights as Orthodoxy, especially regarding sensitive topics such as religious education in the school system and religious rights of soldiers. However, the main challenge for official Islam is the growing influence of the underground groups spreading radical conceptions of Islam. Led by conservative Hanafi theologians, who advocate a re-traditionalization of society, the Spiritual Boards wish for a return to Islamic moral values, but refuse to get involved in politics. They are openly at war with local Salafi movements, which are considered to be too fundamentalist, too politicized, too Universalist, and too pro-Arab in their conception of Islam. Among the principal foreign proselytizing movements is the Tablighi Jamaat, a Muslim missionary and revival movement originating in India, as well as the Turkish Nurcu movement, whose ambition is to contribute to the re-Islamicization of the post-Soviet “Turkic brothers.” Numerous observers note that a rampant Islamicization is taking shape, in daily practices but also in the framework of the school system, in all regions with a predominantly Muslim population. It is visible in the debates taking place on the Russian internet and in the growth of Islamist publications in the Russian language. It also seems that a radical conception of Islam is discreetly defended by the young generations of Russian-born theologians that have studied in Middle Eastern countries.

The main issue of concern, of course, is Moscow’s handling of the Chechen conflict, exacerbated by two successive wars. The small rebellious republic, which demanded independence in 1991, is now considered as “pacified,” and the Russian troops stationed there are being reduced. This so-called stabilization is very fragile. Power has been handed to the Kadyrov clan, which controls the local FSB, and whose subservience to the Kremlin guarantees it political and legal immunity. Under the cover of normalization, the Islamic order is returning. Sharia law is regularly applied, including a ban on selling alcohol, the veiling of women working in the administration, calls for the legalization of polygamy, and the assassination of un-
faithful wives, to name a few examples. This places Chechnya in a situation of legal autonomy with respect to Moscow, since federal law is no longer implemented in the republic. The Kremlin has “Chechenized” the conflict, which means that Chechnya is the arena for a latent civil war. Apart from participating in human rights violations, the Russian forces supervise the violence going on between Chechen clans. The Kremlin and the local elites that it has co-opted endorse a re-traditionalization of Chechen society that is supposed to block the spread of internationalized Islam. If this handling of the situation has permitted a momentary reduction in armed clashes, the view is nonetheless very short-term, whose medium and long-term consequences could be immense. Chechnya will remain a lawless zone for a long time, in which the misery of the population (80 per cent of the population is reported to be unemployed), radical Islamism, and the shadow economy are taking root in a social fabric torn by more than 15 years of fighting.

Now the scene fora low-intensity conflict without any prospect of settlement, the Chechen question is in the process of destabilizing the whole of the Northern Caucasus. It has had an impact on the neighboring republics for several years, in particular Dagestan, North Ossetia, Ingushetia and Kabardino-Balkaria. Scarcely quelled and badly handled, these conflicts threaten to unsettle to whole region.

In Dagestan, Ingushetia and Kabardino-Balkaria, the key is to avoid the destabilization occurring in Chechnya, but Islamist attacks have occurred there (mainly Beslan in 2004 and Nalchik in 2005, but also numerous political assassinations in Ingushetia since 2008) and local political life remains unstable. All the socio-economic signals are negative. Organized crime dominates economic life, even by Moscow’s own account; hundreds of thousands of refugees from the Chechen conflict have no ways to integrate into the neighboring republics’ societies, which already experience high unemployment; and the number of people living below the poverty line is extremely high, including two-thirds of the rural population of Dagestan. In addition, there is an ongoing instrumentalization of the memory of old historical antagonisms and an exacerbation of tensions between ethnic groups being carried out as much by the local elite as by semi-clandestine circles seeking to fuel conflicts. The deterioration of the situation risks having an
impact on the whole of Southern Russia, including in the regions that are not autonomous, such as those of Stavropol and Krasnodar.

Moscow’s incapacity to solve the Chechen issue undermines not only the situation in the North Caucasus but, more broadly, the Kremlin’s ability to propose a social contract to its growing number of Muslim citizens. Indeed, the official focus on the “Wahhabi threat” to justify the second war in Chechnya contributed to the assimilation of all the peoples of the Caucasus, and partly of all Muslims of Russia, into a large “Islamic threat.” The majority of the ruling elites, although they continue to hold a politically correct discourse about Russia’s tradition of tolerance and multi-nationality, are worried about the rise to power of Russian Muslims. Orthodoxy benefits, for example, from privileges within the Armed forces that are not equally enjoyed by Muslims. The patriotic propaganda measures set in place by the Kremlin are centered on references that are “ethnically Russian”, historically speaking, and make mention of the key role of Orthodoxy, leaving barely any place to the religious and national minorities. In addition, the migration processes have worked to reinforce the image of an “Islamic threat,” since the majority of migrants are of Muslim tradition. With a growing Muslim proportion of the population, such policies and tendencies may become untenable.

The Siberia Dilemma

The population deficit in Siberia elicits numerous social fears linked to the risk of the disappearance of ethnic identity and the threat to territorial integrity. The driving factor of these fears is clearly the proximity with China: whereas the Russian district of the Far East counts less than 7 million people, the Chinese province of Heilongjiang (former Manchuria) counts 40 million. The theme of the “yellow peril” has thus become one of the most widespread clichés in Russia. Public opinion, but also numerous experts and decision-makers, have developed a catastrophist vision of the Chinese demographic dynamism in the region: the figure of Chinese migrants settled in Siberia, they claim, has gone from 35,000 persons – the official statistic of the 2002 census that includes only persons settled permanently and legally – to 7 million. But these latter figures are advanced by Russian na-
tionalist circles, while specialists estimate that there are about half a million Chinese migrants settled in Siberia. Supplies from the European regions to Siberia collapsed with the fall of the Soviet Union and have only been partially re-established, in particular because of the very high transport costs. Today, 86 per cent of the foreign trade of Far East district is conducted with countries of the Asia-Pacific region (close to 30 per cent with China, 30 per cent with Japan, and 17 per cent with South Korea); the figure for Siberia is more than 32 per cent, while in the European regions, this share ranges only from 7 to 17 per cent.

Alarmed at the fact that the centrifugal logic that led to the implosion of the Soviet Union might be reproduced in Russia, the Kremlin called, at the start of Vladimir Putin’s first term, for the country’s re-centralization. The rights of the republic were weakened, as was the autonomy of local governors. However, though the stakes are no longer formulated in the political terms of secessionism, Russia continues to confront centrifugal economic tendencies. Currently, the Kremlin continues to think of the development of Siberia in terms of permanent population and has therefore tried to revive the voluntarist population programs, although the results are not significant. Opting for a population that is sparser and composed of a few large urban centers and of brigades that work on a temporary basis for the exploitation of subsoil resources, is not yet seen by those in power as a pertinent approach to take.

Moscow’s main challenge is to be able to benefit from Siberia’s natural resources without jeopardizing the unity of the country. The Kremlin called for Russia to become more integrated with Asia, at the same time as President Vladimir Putin brandished the threat of a Chinese-speaking Siberia to be stopped only by introducing migration quotas. The Asian interface of the Far East could be utilized as a unique opportunity for regional integration of these peripheries and, through them, of Russia with the Asia-Pacific. The Siberian elite is therefore looking to integrate Siberia with neighboring Asian countries to put the brakes on their under-development. Local authorities in Vladivostok are placing their bets on Asia and wish to transform the city into the face of the new “Russia of the Pacific” before the 2012 APEC summit. The boom in trade exchanges with Asian countries gives
them greater room for maneuver with Moscow, meaning that China is becoming an instrument in the domestic Russian game of re-composition of the center-periphery relations. Russia must therefore meet the challenges of overcoming spatial disparities, and of the reversal in the traditional economic flows – which in the future are bound to go from the East to the West – without undermining the political supremacy of the capital over its Siberian peripheries.

Military Capacity

The Russian Armed Forces face a number of challenges. Although some reforms have been implemented, the pace is slow and does not match the actual reform needs. Due to positive developments of Russia’s economy under Putin, the defense budget has increased, which has also had an effect on the capabilities of the Armed forces. However, the state of Russian military material remains well below contemporary technological norms: with the exception of specific leading-edge sectors, the material is largely outdated. The reform plan announced at the end of 2008 anticipates a large transformation of the Russian army, to make it an army with less men, who are more mobile, better educated, and better equipped. For this, the officer corps is set to be reduced by from 150,000 to 200,000 men by 2012, which will be transferred to the reserve army. Besides structural problems, the demographic situation impacts the Armed Forces negatively and the question of the transition to a professional army will come up again in years to come. Russia is indeed trying to establish itself as a regional military power, and it seems likely to succeed in this endeavor even if Russia’s attempt to establish the CSTO as a counterpart to NATO has failed thus far. The CSTO is not likely to emerge as a NATO equivalent in the short or midterm, which might cause Russia to strengthen its capacity to act unilaterally even further. Russia has thus far failed to participate constructively in multilateral operations and this is a trend likely to continue. The Armed Forces, as well as the Russian state in general, is plagued by non-transparent decision-making procedures, which should be a larger cause of concern than potentially increased capabilities. The Armed Forces are most likely to be used in territories in which Russia considers itself to have a privileged in-
terest and position, i.e. Ukraine, Georgia, Moldova and potentially Central Asia and possibly, but not likely in the Baltic States.

**Summary of Russia’s Domestic Challenges in a 10–20 Year Perspective**

The declining population will pose a serious challenge to Russia’s great power ambition in the sense that it is depending on both human and economic resources to entertain its economic state craft and its international standing. Russia, as well as Europe, is depending on an influx of migrant workers. Migration to Russia, especially from Central Asia is not likely to diminish. Thus the influx per se does not pose a problem. However, the state’s and society’s inability to provide a secure environment for migrant workers should be of serious concern. In addition, the growing xenophobic sentiments in Russian society do in the long run pose a serious challenge for social stability in Russia. North Caucasus will continue to pose a serious challenge to stability in Russia as a whole. The situation is manageable today inter alia due to control of mass media and the use of repressive measure.

Russia is not likely to develop into a more democratic state in a 10–20 year perspective. The growing middle class has shown no clear interest in politics. On the contrary, the political climate in Russia is turning increasingly authoritarian. Not so much as a result of repressive state policies as was the case under Putin, but more as a result of a self-censorship and adjustment in society.

In order for Russia to become a smart power serious domestic reforms are needed. Russia being a non-democratic state with a state capitalism lacks the methods and dynamics needed to encourage and allow reforms. This is Russia’s main challenge in a 10–20 year perspective. In order to have a chance of maintaining its economic development, stimulate progressive technological innovations, and develop relevant analysis tools and methods, Russia is depending on being integrated with the rest of the world, be it the Western or the Eastern hemisphere.
Scenarios on Russia’s Economic, Foreign policy and Domestic Developments

Russia is mainly a resource based economy and its primary means to achieve foreign policy goals is its economic and energy power. Russia’s economic system is best described as one of state capitalism and authoritarianism. At the same time as this has constituted the very foundation for Russia’s increasingly assertive foreign policy and the current regime’s high numbers of popularity and legitimacy domestically, it does pose real challenges to Russian power holders in a medium to long term perspective. Drawbacks and risks with state capitalism and authoritarianism have been described above. In the following conclusions will be drawn as to potential development scenarios in Russia. Due to the fact that Russia’s leverage is mainly decided by its economic capacity, which in its turn is a function of the oil price, each scenario will take its starting point in an assessment of potential economic developments.

The crisis did not at the time of writing fulfil the hopes of those in and outside Russia that saw the crisis as an opportunity for Russia to undertake long overdue reforms and liberalize its economy and its political system. Signs of efforts in the area of rule of law, such as Medvedev’s anticorruption measures, do not represent systemic shifts. As long as Prime Minister Putin and his team – with its dual composition of so-called liberals and hard-line nationalists connected to the secret services (siloviki) – are in the driver’s seat, Russia’s economic and political fate must be seen within the political economy that prevails in Russia which is proving solidly entrenched. The question is whether the economic crisis will be extreme enough to allow room for substantial systemic change in a 10 to 20 year perspective, and with it, how Russia’s neighbors and partners might be affected. These considerations constitute the basis of the three proposed scenarios for developments in Russia.

The three scenarios draw from the insights gained from Russia’s foreign policy, domestic and economic development since the beginning of the 1990s. The economic components of the scenarios will be based on the fol-
ollowing assumptions: First, the authorities in Russia are likely to act in such a way as to maintain the stability of the system that has crystallized under Vladimir Putin’s rule, and which has been sketched above. Policy choices are likely to involve a balancing act between two different directions: efficiency, which means economic and institutional reform, and control, which means monopolies and state intervention. Both choices present advantages and risks to the prevailing equilibrium.

Secondly, the oil price is the single most important ingredient in Russia’s economic performance in the short-to-medium term. As for other petro-states, it is also the most important material factor to determine broad economic policy trends. The oil price determines the state of government coffers and key policy decisions at home. It can be assumed that the oil price is exogenous, (the Russian authorities cannot influence it) and that it is determined by global demand. Global demand is itself dependent on the health of the global, and, for Russia, in particular the European economy.

**Scenario One – Continuation of the Status Quo**

This scenario envisages an oil price that will progressively pick up from current levels approaching or equaling US$100, which is around the forecasted equilibrium price of oil. It also foresees a healthy global economic recovery from 2010 onwards. Recovery will be widespread but principally follow the current profile of world production, meaning that demand volumes are going to grow most in large economies. The role of Asian emerging markets, China in particular, in the global economy will become stronger as a consequence of the crisis, but the key markets will remain the EU and the U.S.

Russia will be able to weather the current economic storm with the use of its reserves, and will soon be on track of a fairly rapid recovery that will be sustained. Prices will be sufficiently high to enable Russia to largely act in the same fashion as it did in the years before the crisis. The crisis soon will be forgotten: the economy will function at full employment, per capita levels will continue to grow, the new Russian middle class will continue to expand, foreign investors will be back at pre-crisis levels and Europe’s ex-
ports to Russia will expand again. By 2012, Russia will have accumulated foreign reserves that will equal pre-crisis levels. Already in 2011, the fiscal balance will be positive. Russia’s relative might in the world economy will grow as key economic powers will have remaining problems which keep growth much lower than in Russia.

The exchange rate will pick up again. The value of Russian holdings will thus grow, but diversification will be made more difficult as other sectors will not have any stimulus from a depreciated currency. Hence, industrial production will remain at relatively low levels. Russia will struggle to increase the role of manufacturing, but ambitions in that direction will be difficult to materialize also under the current trade-policy regime. The Kremlin will increase its willingness to have foreign investors taking greater shares in the manufacturing sector, and overall investment into Russia will be encouraged, but few are likely to invest substantially under conditions of low manufacturing productivity and relatively high labor costs.

The role of energy in Russia’s economy and export will increase under this scenario. Recovery in the industrial sector is likely to be slower than in the energy sector. Domestic demand will determine the rate of recovery in non-energy sectors, but demand will remain in the low regions for some time as revenues will still be too small to allow for a return to pre-crisis levels. House and corporate debt structures will have to stabilize before there will be a return to considerable growth in domestic demand. As the Russian government will prioritize the build-up of fiscal reserves – even more important as past reserves have been used to stimulate the economy – government consumption will not return to pre-crisis growth rates and expenditures on public investment will remain in the low regions.

Lower gas demand in the next five years may be a “blessing in disguise” for Gazprom and the Kremlin. The west Siberian fields which supply most of Gazprom’s exports to Europe today will diminish and until the Yamal pipeline is up and running, Gazprom would, at pre-crisis demand levels, have to depend on gas from independent suppliers and imported gas from Turkmenistan and Kazakhstan to substitute the declining Siberian output. Now it can switch to Yamal in an orderly fashion without having to increase its dependence on independent producers. Around 2015 the Yamal
pipeline will be operational. The pipeline to China will be completed and a new important destination for Russian energy will be established. The Nord Stream pipeline will be completed a few years into the next decade, but South Stream will be put on hold for a few years.

In this scenario, Russia will have resources but, as the oil price is not at 2008 levels, also the incentive to use whatever means necessary to change practices in other countries that work against Russia’s mercantilist interest. This is the worst possible scenario for many of Russia’s neighbors and commercial partners. With the oil price at US$100 per barrel, the revenue is too high to warrant policy change but too low not to prompt action, at home and abroad, when key commercial interests are challenged. In practice, this means a Russia exerting more power against Ukraine while it is pressing ahead with diversification away from Ukraine. In a low-price scenario, Russia would not have the resources to back up claims against Ukraine with real diversification – it would have to use moral persuasion to change practices in Ukraine. Under this scenario, it can return to its bullish approach and back it up with real changes on the ground: finishing Nord Stream, steering Yamal gas away from the Ukrainian corridor, negotiating sweet deals for Turkey to transit energy, and possibly advancing the South Stream project and prepare itself for the Artic race. Global demand for Russian energy will also return to high levels in a few years time and enable Gazprom to continue with its current strategies. Gazprom will not go forward with some of its grand investment plans as it still will have financial difficulties. But its business model will remain intact: controlling pipelines and exerting pricing power. It will again become a driver for building a Gas cartel – a “Gas OPEC.” Nor will this scenario prompt the Kremlin to deviate from its current reform plans. Authorities will attempt to clean up Gazprom from corruption. But Gazprom’s monopoly on pipelines will be maintained.

The banking crisis will be prolonged, but the Kremlin and the Central Bank will modernize Russia’s banking system, as they had planned for, but will maintain the central role of a few key state owned or backed banks. Russian financial operators will also be shielded from increased foreign competition, and under high barriers it can continue to develop financial-
service connections to the Middle East without having to be concerned with regulations set by international bodies. The Kremlin will certainly become a larger owner of companies as a consequence of the crisis. Its bailouts of firms already fostered greater state ownership, and this trend is likely to continue. Privatization will be difficult as only domestic investors will be accepted as main owners – and domestic investors will not have as much resources as they did before the crisis. The newly acquired stakes in companies are likely to remain in the hands of the government.

Overall, economic reforms will be scant. Russia will not be pressed to undertake comprehensive economic reforms and the Moscow power center will not be induced to change. In fact, reforms might prove to become even more difficult than before. Foreign investors, however, will be allowed greater and easier access to new infrastructure projects. Russia’s law on Strategic Sectors will be amended and slightly liberalized to make way for increased foreign investments at the margins of the industrial sector.

Foreign investors will be better treated than they have in the recent past when all types of investors were harassed. Russia will need marginal investment and the Kremlin will see an advantage to have more foreign investors operating in the country as long as they – individually or collectively – do not challenge the economic model. Yet the hydrocarbons sector will remain largely closed as revenues rise with the oil price. Russia’s pressures on Ukraine, Moldova, Belarus, and Georgia will continue unabated and will temper these countries’ drives at integrating with the West. Russia will continue to hesitate to become a member of the WTO or to ratify the ECT.

In this scenario political liberal reforms are not probable. The economic development will be stable but just enough to maintain Russia’s foreign policy status, its economic and energy power, and socio-economic situation domestically so that it will not result in upheaval. There will be no real political regime shift. Any transfer of power will be well orchestrated and controlled. There might be attempts for “oppositional” forces to grab power. Any such attempts will be warded off decisively. The Putin-Medvedev tandem is likely to remain, at the very least Putin will remain in power. Medvedev is exchangeable. Stability is threatened mainly by domestic challenges such as increasing xenophobia and political radicalism. The Russian
elite will be nationalized in terms of identity, loyalty and behavior. Russia’s continuous economic growth in combination with a negative demographic development will bring with it a need to attract migrant workers. However, due to the ruling elite’s nationalizing policies resting on the concept of sovereign democracy there will be hesitations in policy toward migrants, and potentially a total lack of state policy to integrate them, which in turn is likely to contribute to interethnic and social tensions. Ethnic Russians will be considered first among equals and measures will be taken to protect the Russian language and to reinforce the status of Orthodoxy, which, as a result, multiplies tensions with the growing indigenous minorities and migrant communities alike, who object to their status as second-zone citizens. The Russian middle class will be potentially expecting more than what the state can deliver. Social tensions are controlled by a reinforcement of the apparatus of coercion that limits racist violence since the latter is seen as a potential source of social destabilization, in parallel with upholding a national state ideology unfavorable to the integration of minorities, migrants and the expression of political diversity. Social discontent has difficulties in finding political outlets.

The situation in the North Caucasus remains a challenge to Russia’s stability and territorial integrity. Moscow holds only a virtual control of the region, which functions quasi-autonomously from the central power, on a model close to those of the tribal zones in Pakistan, thanks to informal networks founded on the shadow economy and Islamism. In the other Muslim regions of Russia, re-traditionalization, combined with the influence of Islamist currents, starts to become more and more visible. Tensions between the Spiritual Boards and the Russian state intensify, the latter accusing the former of not being able to halt the rise of Islamism. The situation in North Caucasus and the “Muslim question” turns into one of the main problems of the Russian state whose response will be more repressive the closer we get to the Olympic Games in Sochi 2014.

Russia will stay the course in its foreign policy. In this scenario the main threats to Russia’s stability and positive development is self-imposed international isolation due to its policy towards the “near abroad,” including potential Russian military interventions in the region and ill-advised deci-
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sions in specific situations that might cause Russia great damage, for example disproportional repression of domestic democratic forces. Nevertheless, Russia’s foreign policy goals are not likely to be altered in this scenario. It will continuously strive for a multipolar world with Russia as one of a handful of great powers. Europe and the U.S. will find it more difficult to engage constructively with Russia, which would be determined to conduct a pragmatic foreign policy based on narrowly defined self-interests and geopolitics. The West will either have to engage in pragmatic geopolitics and realist foreign policies or conduct a value based foreign policy which is genuine and coordinated, or as today, fragmented and plagued by double standards. A value based, coordinated Russia policy is likely to agitate Russia to the degree of self-imposed isolation from the West combined with strengthening ties with the Middle East, Asia, Latin America and Africa. In general, Russian foreign policy and its conduct internationally will be predictable and, from a Russian perspective, rational. One of Russia’s foreign policy goals will be to establish a “Second Europe” around Russia, which means restoring Russia as a regional great power. Focus on “the near abroad” and an excessive sensitivity to the issue of the Russian “sphere of interest” will remain. There will still be tensions with the South Caucasus, the Baltic States and Ukraine on the interpretation of the Soviet past. Due to Russia’s comparatively positive economic development it will be able to develop more cultural leverage in the FSU through Russian schools, Russian universities, Russian media, and Russian businessmen. Information and ideological war-like methods will be more actively used in Russia’s policy toward the FSU.

Partnerships with Turkey, Iran, China and Japan are likely to continue to grow. Due to the Siberia question, China will continue to be viewed as both a strategic partner and a threat. In order to balance China Russia will improve its strategic relationships with Japan and India. Russia tries to reduce its dependence on Europe by developing its relations with Asia, but the U.S. and the EU remain its main partners. In this scenario, Russia depends on a constructive relationship with the West for its economy to continue to develop. Hence sensitive issues such as a new European Security Structure which primarily aims to weaken NATO’s influence in Europe will be toned
down for pragmatic reasons. Russia will continue to be active on the Iranian issue and concerning the Middle East. In the long run Russia will join the U.S. and the West on the Iranian issue, although it will be careful not to come across as that being the result of the Obama administration’s decision not to install missile defense in Central Europe. Russia will strive toward a solution under UN’s umbrella, but before reaching a consensus will make sure to get the most out of it.

**Scenario Two: A Reinforced Petro State**

This scenario will bring us close to the situation that prevailed before mid-2008. The oil price will quickly rise above US$100 as early as 2010 and then stabilize at levels around US$130–150 per barrel. The global economy will be recovering fairly quickly, with Chinese demand playing a greater role in stimulating trade and output internationally. American consumers will not drive global demand expansion but others will substitute them.

GDP in Russia will soon return to high growth rates. Growth will also be higher than the pre-crisis trend. Virtually all economic indicators will be favorable although inflation will return to double-digit levels. Russia’s banks avert a crisis in 2009 thanks to the quick reversal of its economic fate from July 2009 onwards. The industrial sector will also recover as soon as demand picks up. Construction will increase, but not be as dominating as before the crisis. Russia’s middle class will continue growing and real income will grow by plus-ten per cent a year, effectively making the middle class interested in keeping status quo in economic policy.

Russia’s foreign reserves will reach almost US$1 trillion by 2012 and amount to more than US$3 trillion in 2020. Russia will create investment vehicles like sovereign wealth funds that will target investment abroad. Russia will also become an influential buyer of treasury bonds in countries that have expanded deficits during the crisis. These countries include the U.S., the United Kingdom and many other European countries whose non-cyclical deficit has increased sharply. Overall, Russian finance will become too powerful abroad for other governments to interfere with investments or to block them. FDI into Russia will climb back to 2007 levels. The new pipe-
line to China currently under construction will start functioning in a few years time. Non-European exports will grow significantly, with China leading the trend. Japan and Korea will also drive this new eastward orientation.

This scenario implies that Russia has the financial resources it needs for exerting its power in CIS countries and in Europe. Other countries will be deferential towards Russia as the race for accessing energy resources will be tough. Russia has resources to expand its network of pipelines, expand operations in new countries and new parts of the energy supply chain, and it will have the resources to fund inefficient exploration of new energy sources. No real economic power can be exerted by other countries to get Russia to change. Russia will not join the WTO. It will shun all other commitments it has made in international economic agreements. It will have no real incentive to press ahead with bilateral economic integration with Europe. It is much more rational in the eyes of the Kremlin to integrate more closely with CIS countries that have energy resources. Russia will also have the resources to give significant aid to CIS countries, and thus buy their loyalty. The lure of preferential access to Russia’s markets will also motivate countries like Ukraine and Georgia to be more accommodative of Moscow’s wishes. Russia will establish itself as a regional great power and potentially as a global great power.

Until new pipelines have been finished Gazprom will yet again cut off gas supplies to Europe and try to influence Ukrainian governments. It will have the resources to invest in Europe’s underfunded power grids, and thus become more influential in Europe. As South Stream will be built, ensuring Moscow acquires the transit rights for Azerbaijan’s gas and as Gazprom’s investment in Northern Africa will continue, an increasing number of EU countries will be dependent on Russian gas. Protectionism will rise in Russia. European companies will find it even more difficult than today to access Russia’s markets.

The European Union will remain weak in its policy towards Russia. It cannot exercise any real foreign economic power as it is too dependent on Russian energy. High energy prices means less opportunities for European governments to choose between energy partners or energy sources: Euro-
pean countries will need access to all energy pools it can get access to, especially if demand in Eastern Europe returns to pre-crisis growth levels. Furthermore, a high oil price implies a Russia pressing ahead with new delivery routes to Europe. Not only will Nord Stream be finished, but South Stream will be built, and possibly other ventures will be started. The role of Ukraine as a transit country will diminish in the long term, but Russia will remain dependent on the Ukrainian pipelines for the next 20 years. Europe also has another concern: as Gazprom and other Russian energy companies make new inroads into other parts of the energy supply chain, especially teaming up with European power suppliers, the EU and many governments will be in no position to set the rules in relation to Russian energy. Another concern for Europe is that Russian consumption will grow quickly in this scenario. The lure of greater access to Russian markets is too important to motivate stronger actions against Russian misbehavior in the field of energy. Powerful exporters in Europe will ensure that relations are calm and that nothing disturbs their access to Russian consumers. Eastern European countries will be more vulnerable to Russia’s influence in their economies, energy sectors, and politics.

Ukraine will not sign the free trade agreement negotiated with the EU. It will slide into greater control by Russia, despite the fact that its main markets are in Europe. But as the Ukrainian economy has defaulted and is in need of capital, the Kremlin and Russian tycoons take over Ukrainian companies and Russian banks become powerful as other foreign banks have deleveraged away from Ukraine.

However, the strong economic development will not spur necessary economic or institutional reforms. Practically no economic and institutional reforms will be undertaken. The Russian elite will continue to feed its material and economic appetite, combined with increased state social spending and something equivalent to a welfare state will arise. Russia will rise social spending as dissatisfaction with inequality and the regime rises. A growing number of spontaneous protests will be met with systematic repression. Corruption will continue to be pervasive and government control over the media will continue to tighten. Crime and violence will continue to rise since the state is not paying enough attention to the problem and shows no
interest in controlling violent groups in society. Therefore, migrant workers will still be in danger in Russia. Nevertheless, the demand for workers will increase as will the migration flow. In this scenario the Russian state will spend more resources to stabilize North Caucasus, so the phenomena of radicalization will be less visible in the region. These measures will be shallow however and do not try to get to the bottom of the problem.

Democratic rights will be suppressed. Also in this scenario any transfer of power is likely to be controlled and well-orchestrated. Should anyone be ousted from power it is likely to be Medvedev. In this scenario the ruling elite will have every possibility to achieve sovereign democracy. National identity will mainly be defined by statism with focus on Russia as a strong state and a great power.

In this scenario it is likely that Moscow will conduct an open migration policy to welcome workers from the FSU. Such a development will have implications for both the Russian state and the peoples of the FSU. It will bring with it a feeling of continuity with the Soviet Union and Russia will be considered as a “homeland” for Russian-speaking workers. Taken together this will increase Russia’s leverage on the FSU states and the structure of Russian society will be profoundly modified in national and religious terms. Russia is more influential, but equally more “Asian” by dint of its population, and has a greater interaction with East and Central Asia than with Western Europe. The demographic situation revives partly due to population flows of working-age persons and to a marked increase in reproductive behavior.

Managed democracy will be extended to include managed nationalism. More money will be devoted to schools, healthcare, infrastructure etc. which will be appreciated by the population and hence the social contract will be upheld. In this scenario all mobilization cards are controlled by the state. Russia continues to be authoritarian but the ruling regime is considered legitimate because is it able to render material wealth and social welfare to its citizens.

Russia will become even more assertive in its foreign policies in this scenario and it will have the abilities to back its rhetoric. In conclusion, Russia will still be a predictable country but an uneasy partner for the internation-
al community. It will continue to follow a foreign policy agenda to establish a multipolar world in which Russia is one of the power houses both in terms of economic and military power. Criticism towards the West will continue and alliances with Asia and Middle East will be formed. In this scenario Russia is likely to be successful in its endeavour to establish itself as the center of the “Second Europe” and its soft power in the FSU will be consolidated. It will be closer than ever to establish itself as a global power.

Scenario Three: Partial Liberalization or More Repression

This scenario presumes the stabilization of the oil price around US$50 in per barrel in the next two years with only a slow pick-up in the decade to come. Eventually, the oil price, and other commodity process, will reach equilibrium, but this scenario is based on a long and sustained recovery cycle with great uncertainty about how soon prices will reach that equilibrium. Furthermore, this scenario assumes that the global economy will be growing slowly – far below its pre-crisis levels – over several years. The recovery cycle in all big markets will be slow, and demand in the U.S. and Europe will remain at low levels as the financial crisis prompts high and sustained saving ratios. Consequently, the demand for hydrocarbons will remain small. Competition on the world market will continue to be very tough as the contraction of global demand has made existing suppliers to compete over a decreasing market. In addition, growing environmental concerns lead to a slow shift away from oil and gas to renewable energy.

Russia’s economy will continue to contract till mid-2010 as a consequence of the sustained global recession. Growth will pick up again in 2010, but growth levels will be in the low regions, around 2–4 per cent, in the next 5–10 years. Such growth will imply double-digit unemployment and small annual rises in income. The shift towards a demand-driven economy will become more difficult as companies and households will keep their savings levels at the currently high rates. The decline in asset prices will flatten out in 2010, but will remain at low levels without any real prospects of increasing to pre-crisis levels.
Russian energy firms are strikingly inefficient in their exploration of new energy sources and in the production of energy. With the oil price at the assumed level, the production cost per barrel of oil in Russia will be above or near its sales price. This will dampen any prospects of using the energy sector as a vector of recovery and growth. It will also put the companies themselves in difficult positions. Russia is more efficient in its gas production, but the low standard of the main pipelines (especially the Ukrainian corridor) leads to significant losses of gas while it is in transit. This, too, pushes the price upwards and makes gas less profitable. Gazprom is not particularly skilled in bringing new sources on stream. In fact, it never has brought a new source on stream. That will change as new sources will be brought on stream, but as demand will be low in Europe Gazprom’s business model, based on controlling the pipelines and exerting a monopolistic or oligopolistic pricing power, will become even more important. The high cost for exploring new gas resources that Gazprom has paid for with the help of the government will imply much smaller revenues for Gazprom and, by extension, the Kremlin. If new projects like the Yamal pipeline are finished within the next years, Gazprom will substitute the gas it today buys from independent operators in order to export to Europe with gas from Yamal. This might cause difficulties for the current partners as they cannot easily switch to other consumers.

In addition, current gas sources are diminishing. As Gazprom’s debt problem will grow worse, and as the Kremlin will have fewer resources to subsidize new explorations, Russia will have to open its energy sector for foreign investors that can bring capital and skills. A grand return for foreign energy companies will probably not happen. The Kremlin will target its close friends in Italy and Germany, and give them preferential access to enter the market in strategic partnerships with Gazprom and state-owned oil majors. But the invited companies will demand greater investment protection than they have demanded in the past, and such protection will imply fewer chances for the Kremlin to increase revenues in the future by regaining control over strategic assets. Overall, the singling out of 42 strategic sectors shielded from the embrace of foreign investors will have to be buried. Such policies only work when revenue streams from the energy sector
provide Russian investors and the Kremlin with sufficient capital to be invested in the non-energy sectors. A few sectors, like arms production, will remain closed, but most of the others will have to be opened if Russia is interested in stimulating economic growth.

Developments according to this scenario will benefit non-energy sectors with export potential. Already now we can see a clear decline in the real effective exchange rate, which means that industrial production is becoming more competitive on world markets. This decline will continue and stimulate the industrial producers (assuming they can access other capital). The diversification will, however, be slow. It will take decades for Russian industrial firms to become competitive. Russia’s industrial sector is in such a bad shape that it will take considerable structural change to make it competitive. They also have small or no market shares abroad, which is why continued low demand abroad will make it difficult for new market entrants to increase sales. Furthermore, as Russia will have to enter the manufacturing market as a competitor to China and emerging markets in Asia, they will have to increase productivity drastically. This can only be done by increasing investment and investment efficiency (Russia’s incremental capital-output ratio, ICOR, is very low) as wage levels in Russia are far higher than in China.

The debt problems in Russian companies will become more severe, especially as the downward pressures on the ruble exchange rate will grow. The Kremlin will be able to bail out some of the companies – especially the bigger conglomerates – but it will not be possible for the Russian government to spray money on ailing companies. At any given moment in the near future, also under the assumed uncertainty, it will be more rational for Russia to use reserves and government resources in the energy sector than elsewhere. Supporting the banks themselves will also be necessary to avoid them entering into difficulties. Only after that will attention be given to industrial firms. It is likely that the Kremlin will be not able to solve their debt problems. Some of them will have to go bankrupt. Others will survive only with new equity from foreign investors.

A severe second wave of Russia’s banking crisis will emerge. The Russian banking system is fragile. It is highly fragmented, but has a few big
banks at the top, most of them owned by the government, which also act as instruments for industrial policy. The level of non-performing loans is already now high in Russia, but will become higher as real estate prices continue to fall. Russian banks have been shielded from real competition from abroad, why they are inefficient. They are also a source of corruption.

Russia’s foreign currency reserves will stagnate to close to zero. The Reserve fund will be depleted by the end of 2009. The government will be forced to borrow money from international financial institutions and from other governments, not least China and countries in the Middle East. Some resources will also come from the IMF and other international public bodies to financially assist emerging markets. Russia will again become a net debtor.

Low energy prices and low energy revenues will put brakes on Russia’s investment ambitions in the energy sector. Nord Stream will be built, but there will not be resources available to finance other new pipelines, especially not projects aiming primarily at substituting the transit through Ukraine. Russia will be more dependent on other partners taking greater ownership stakes in new pipelines. The investment plans that have been launched were already unrealistic before the crisis; Gazprom does not have a sufficient capital base and structure to finance them. But the crisis has made them even more imaginary. Moreover, Russia will be more dependent on other governments building pipelines to Russia. Hence China will become a more important partner as it is one of few countries which is offering Russia to build the pipelines to Russia. If Russia agrees to such ventures, it will also see control over Kazakhstan’s gas export decline as oil and gas sources there is the first priority for China. China, however, will keep having an insatiable demand for energy, which is why it can accommodate higher investments in energy infrastructure to both Kazakhstan and Russia. The new plans for LNG investments will have to go, however, as foreign investors too will have difficulty in making such investments profitable. Investment in LNG requires high upfront investment in the destination region.

Economic reforms will remain elusive, with selective liberalization. Attempts to re-attract foreign investors will meet with higher reluctance due
to slow growth and the poor investment climate. But if Russia is willing to open some of its shielded sector, non-energy FDI will increase. The banking sector will become more open to foreign investors, but it will be a piecemeal reform with few real alternatives for foreign banks to branch out themselves in Russia.

Russia is more likely to join the WTO if growth remains at low levels. It will need to signal to foreign investors that it is a reliable country to invest in. Furthermore, they must also allow foreign companies to export more of input goods – a necessary vehicle to increase productivity in Russian industrial firms. As the grand strategy for Russia’s industrial policy will have to be cancelled, there is also fewer sectoral biases against WTO membership. WTO accession, however, will be difficult, especially the relations to Georgia and Ukraine. However, Russia can trust other countries to push reluctant WTO countries to accept accession; WTO accession is viewed by key world powers as the most important commercial-policy priority. Russia will also have to accept its membership of the ECT and honor its commitments. This will be costly in the beginning, but is necessary if they are to be able to attract foreign investors in the energy sector.

Low energy prices hence would entail a development which is in Russia’s long-term interest. It is quite clear that the authoritarian style of economic management that emerged in Russia was a consequence of the energy boom. This is not to say that energy revenues were the sole factor behind this economic model - far from it. Moreover, not even a protracted recession will lead to a wholesale shift in Russia’s economic policy. But at a low growth trend Russia inevitably has to change some of its current practices. There is just not sufficient money around in Russia to pay for the past excesses and to keep inefficient producers alive. Hence, reforms are likely to come. But they will be incremental and will not aim at sweeping shifts.

In this scenario, Russia’s foreign policies in its near neighborhood will not become more benign. Russia will remain vocal. Its power in key countries such as Ukraine, Kazakhstan and Azerbaijan will remain strong as they too will have economic difficulties and will be less prone to investments aimed at diversifying away from Russia. Furthermore, Russia will continue to control energy prices in the FSU countries. However, Russia’s
capacity to influence decisions in its near abroad will be diminished due to Russia’s reduced financial clout and reluctance to deplete its reserves further. Potential military actions (e.g. new war in Georgia) cannot be ruled out, but will meet with tighter budget constraints and lower legitimacy at home (e.g. soldier’s mothers). China will gain even greater influence in Russia’s neighborhood (primarily Central Asia and possibly the South Caucasus). This is not to say that Russia’s assertiveness is only a reflection of its economic might. But it is beyond doubt that less revenue will make it difficult to finance its strategic geopolitical moves. It will have to become more humble and less imperial towards its neighbors.

EU exporters to Russia, in particular in Germany, will suffer from diminished trade with the EU’s third export destination. Sluggish oil prices, lower demand for gas, reduced exports, and investment could induce Russia’s privileged partners in the EU, such as Germany, to become more cooperative in potential coordinated moves to improve energy relations with Russia.

In this scenario any transfer of power might not be as straightforward as in the other scenarios. With the size of the pie decreasing the stakes become higher and the infighting within the elite is likely to become more ugly and its outcome less predictable, since the elite really has no means to conduct this struggle in an orderly fashion due to the lack of functioning formal institutions such as property rights, an independent judiciary, etc.

Due to the difficult economic situation Russia will not be able to uphold social spending, which will contribute to increasing popular discontent, which in turn threatens to destabilize society. The ruling elite can either chose to liberalize or to increase repression in an attempt to counter upheavals and protests. Should liberalization be chosen it is likely to be selective, but power will clearly be shifted towards the international community and foreign capital in this scenario compared to the first and second scenario. However, liberalization presupposes a minimum set of functioning state institutions for the system not to collapse (as in the beginning of the 1990s). Due to the nature of power in Russia which is informal and based on networks in combination with its weak state institutions, it is likely that the regime will consider it to risky to engage in piecemeal liberaliza-
tion out of risk of loosing control, power and economic wealth. Therefore the third scenario holds two different tracks: liberalization or increased repression.

Liberalization in the economic sector could open the door to liberalization in the political domain. Should the regime engage in repressive politics the Russian state is likely to enter into a political and identity crisis: ultranationalist groups are no more controlled, xenophobia is growing, Muslims have more and more legal and cultural claims, the Russian state has less leverage on the Northern Caucasus where the combination of smuggling and Islamism is growing, and on the Far East, which has decreasing relations with Moscow and is increasingly tied to Asian neighbors. There will be a real risk of decentralization of power in Russia. Russia will become even more unstable with severe effects on the economic development and risks finding itself in a dangerous downward spiral with low FDI and further economic stagnation as a result. Russia is losing its influence on the near abroad. China becomes the main partner of Central Asia. The SCO and CSTO structures are or dominated by China, either not functioning. Russia is obliged to negotiate more with the West. The West will be able to conduct its policy in Russia’s near abroad.
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