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Internal and External Impact of Russia's Economic Crisis

Jeffrey Mankoff

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Summary

Even though Russia's economy has returned to growth—on the back of higher oil prices—the financial crisis of 2008-09 will continue to reverberate across Russian politics and foreign policy. Domestically, the crisis has called into question the "social bargain" of the Putin years. It has also complicated President Dmitry Medvedev's push for economic liberalization and modernization. By restricting opportunities for rent-seeking among the various politically connected oligarchic factions, the crisis has exposed fissures within the elite. In terms of foreign policy, the crisis has limited the effectiveness of Russia's principal sources of leverage: energy resources, the military and foreign investment. If the worst is indeed over, much of the momentum for further reform is likely to dissipate, leaving Russia facing a recovery that is slower and less complete than that of other large industrial states (such as China and India). If there is to be a silver lining for Russia in the crisis, Moscow needs to push through the reforms needed to make Russia more attractive to foreign investors.

Introduction

While the global financial crisis that struck in mid-2008 has reverberated around the world, in few countries has the turmoil created greater uncertainty than in Russia. Russia has experienced many of the same dislocations as other developed countries in Europe, North America, and East Asia: collapsing demand, rising unemployment, a withering of credit, reduced exports, and rising debt. Russia's economy, which had been growing by around 7 percent per year before the crisis, shrank by more than 8 percent in 2009. After running budget surpluses every year since 2001, the state ran a budget deficit in 2009 equal to 6.3 percent of Gross Domestic Product (GDP). It is projected that the budget will remain in the red through 2012.[1]

By the start of 2010, many analysts believed that the worst was over, as oil prices climbed back to 80 US dollars per barrel and Russian GDP began growing again. Even if the economic indicators are beginning to turn around, the consequences of the crisis will be felt for some time to come. In particular, the effects of the downturn on politics and foreign policy have been more far-reaching in Russia than in other industrialized countries. Russia's government has not followed Latvia's or Iceland's into the abyss. However, the depth of Russia's crisis coupled with a system of governance in which political and economic power are fused to an unusual degree has called into question some of the basic assumptions about the nature of Russian politics and foreign policy. This leads to uncertainty over Russia's long-term development.

The Russian crisis has weakened the foundations upon which the semi-authoritarian, state-capitalist political system that emerged between 2000 and 2008 during the presidency of Vladimir Putin was built. The Putin years saw the emergence of a social contract in which the state guarantees a steadily rising standard of living for Russia's citizens in exchange for their political quiescence. At the elite level, the Putin years witnessed an end to the internecine conflict among competing oligarchic factions, which paralyzed Russia during much of the 1990s. This intra-oligarchic peace rests upon a different kind of bargain, one that guarantees various business clans access to particular streams of revenue as long as they toe the Kremlin's

[1] Russian Federal Ministry of Finances, Federal Law of 2 December 2009, No. 308-FZ "O federal'nom byudzhete na 2010 god i na planovyi period 2011 i 2012 godov" [On the Federal Budget for 2010 and Previsions for 2011-2012], <www1.minfin.ru/ru/budget/federal_budget/>.

political line, even as the state itself has become an increasingly significant economic player through the creation of a series of vast state corporations in sectors from energy to ship-building. For much of the past decade, Moscow sought to use a rising economic tide to buy off potential opposition to the semi-authoritarian, state-centric regime established by Putin and his allies.[2] With that tide having receded, the Kremlin's ability to reconcile the competing demands of the populace and the oligarchic elite with its own interest in preserving the political and economic status quo appears increasingly questionable, even if the worst of the crisis now appears to have passed.

The crisis has also hit the Kremlin's ability to get what it wants internationally. Lacking the geopolitical heft of the Soviet Union and the ideological appeal of Marxism-Leninism, modern Russia has had relatively few levers to influence others on the world stage. During the 1990s in particular, Russia discovered just how readily other countries felt they could ignore it—from the multiple rounds of NATO enlargement to Russia's inability to prevent the US-led military assault on Serbia in 1999. Even the other post-Soviet countries took advantage of Russia's decline to assert their strategic independence. As the Russian economy began growing at the beginning of the 2000s, Moscow quickly found its regional and global influence increasing as well, in part due to the massive influx of wealth it accumulated on the back of rising oil prices. Moscow used these funds to pay off its foreign debts, build up its military, and accumulate the world's third-largest store of foreign reserves, some of which it deployed abroad to underpin an increasingly assertive foreign policy. All these elements of Russia's international resurgence have suffered in the course of the crisis, forcing Moscow to reconsider some of the basic principles underpinning its recent foreign policy.

[2] See for instance D. Trenin, "Russia Redefines Itself and its Relations with the West," *Washington Quarterly*, Vol. 30, No. 2, spring 2007.

Origins and Depth of the Russian Crisis

While the global crisis has exacerbated Russia's economic difficulties, the origins of the Russian crisis are not entirely economic. Foreign investors began pulling out of Russia in the summer of 2008, following then-President Putin's clumsy threats against companies alleged to owe back taxes. The outflow accelerated in the aftermath of Russia's invasion of Georgia in August. By the end of 2008, over 130 billion US dollars had been pulled from the country, the largest annual figure since the government began compiling statistics on capital flows in the mid-1990s.[3] These outflows accelerated following the onset of the global financial crisis, touched off by the collapse of Lehman Brothers investment bank in September 2008.

Within Russia, the economic crisis has been moderately severe, and while the economy appeared to be gradually recovering by the end of 2009, the crisis exposed several structural weaknesses that could hold back Russian growth even after the worst has passed. While many Western countries as well as China, India, and Brazil appeared poised for a fairly rapid recovery in 2010, Russia's trajectory is likely to be much more gradual—absent a rapid upswing in global energy prices. Moreover, Russia still faces some fairly serious risks that could plunge the economy back into recession, notably a banking sector that has still not purged itself of bad loans and a high level of indebtedness across much of the private sector. During the first six months of the financial crisis, Russian banks' non-performing loans increased 240%; even by the end of 2009, fears of the crisis entering a second wave centered on concerns that banks' balance sheets had not been cleared of these loans.[4]

The Kremlin's intervention to cope with the crisis has been successful in preserving social peace and preventing a return to the worst moments of earlier crises, such as hyperinflation or widespread unemployment. The decision to accumulate large reserves during the boom years appears in particular to have paid off, and by deploying a fairly substantial stimulus package, the Russian government has managed to cushion the worst short-term consequences of the crisis.

[3] "Russia: A Record Year for Capital Flight," *EurasiaNet Daily Monitor*, 13 January 2009, <www.eurasianet.org/departments/briefs/eav011309e.shtml>.
[4] R. de Haas, "A Look at Non-Performing Loans: The Boomerang Effect," European Bank for Reconstruction and Development, 16 July 2009, <www.ebrdblog.com/2009/07/16/a-look-at-non-performing-loans-the-boomerang-effect/>.

Yet in moving to insulate the population from upheavals comparable those of the 1990s, the Kremlin has had to make a Faustian pact. By intervening to prop up a basically uncompetitive economic model, the Kremlin may well be setting the stage for slower growth in the future even as growth in the US, Europe, China, India and elsewhere picks up more rapidly once the acute phase of the crisis ends.

Overall, the Russian economy is set to contract by about 8.7 percent in 2009, a significantly worse performance than that turned in by most other developed countries.[5] The World Bank estimates that Russia's economy will return to (slow) growth in 2010, albeit from a fairly low post-crisis base. Credit remains tight, in part due to Russia's underdeveloped banking system. Consequently domestic demand has been slow to pick up, hampering Russia's recovery.

Moreover, Moscow has had to spend heavily out of its reserves to prop up ailing industries and expand social services to those thrown out of work or otherwise affected by the downturn. While Russia had accumulated the world's third largest store of foreign reserves in the years leading up to the crisis, it spent more than 400 billion US dollars during the initial months of the crisis, principally bailing out politically connected companies and defending the ruble. By early 2009, the Kremlin had adopted a somewhat more systematic approach, focusing on cutting interest rates while trying to limit deficit spending. About half that sum went to propping up industries hit by the crisis, including auto manufacturing, metallurgy, and the banking sector, and the defense industry. Another 200 billion US dollars in reserves was wiped out by the Central Bank's attempt to preserve the value of the ruble in the face of large-scale capital flight. While this policy prevented a repeat of the chaotic devaluation of 1998 and hence preserved short-term social stability, it forced Russia to rapidly spend its reserves. It also encouraged the recipients of government bailouts to use the money for currency speculation, rather than shoring up troubled businesses. Much of the spending came out of the country's Reserve Fund, set up to cushion the economy from potential shocks. Despite the gradual rise in oil prices to over 70 US dollars per barrel, which allowed Russia to make up some of the money spent out of the Reserve Fund, the need to continue applying fiscal stimulus means that the state forecasts the Reserve Fund will be exhausted during the course of 2010.[6]

The need for additional stimulus, coupled with a drop in tax receipts from the energy sector means that the government is confronting the necessity of running a budget deficit until at least 2012, after accumulating a yearly surplus since the beginning of the decade. The government has boosted spending on social welfare

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[5] See World Bank, *Russian Economic Report, From Rebound to Recovery?* No. 20, November 2009, p. 2-3, <http://siteresources.worldbank.org/INTRUSSIANFEDERATION/Resources/305499-1245838520910/rer20fulltext_eng.pdf>.

[6] Russian Ministry of Finance, *op. cit.* [1].

initiatives, including public works schemes, temporary employment, and paid furloughs for workers. After running a deficit of about 8.3 percent of GDP in 2009, the Ministry of Finance estimates that the deficit will remain at 6.8 percent in 2010 even as the economy returns to growth.

The record on employment is mixed. Official unemployment rose to 9.4 percent by February 2009 before gradually declining, well within the range of what countries like the US have experienced in the current crisis.[7] That said, the official statistics are somewhat misleading, because of the range of coping strategies that Russian companies and workers have developed over the years to deal with labor market uncertainty. Thus while unemployment *per se* is moderate and declining, official figures do not take into consideration a fairly substantial level of underemployment, such as reduced hours, unpaid furloughs (i.e. labor hoarding), and that bane of Russia in the 1990s: wage arrears. The World Bank calculates arrears in September 2009 as totaling 5.1 billion rubles (190 million US dollars), down from 8.8 billion rubles at the end of May, but still 70 percent above the level of a year previously.[8] The impact of both unemployment and underemployment is, furthermore, concentrated in particular industries that have been hit especially hard during the crisis, including metallurgy, construction, and manufacturing. Many marginal workers who have been laid off have also stopped looking for new jobs, while several hundred thousand migrant workers from Central Asia and the Caucasus have returned home and thus are not counted in official unemployment figures.[9]

One particularly difficult legacy for Russia has been the uneven geographic impact of the crisis. While the major urban centers of Moscow and St. Petersburg have weathered the storm relatively well, heavy industrial regions such as the Urals, as well as medium-sized cities lacking the concentrated wealth of the two capitals but nonetheless connected to the global supply chain have been especially hard hit.[10] The areas causing the most concern for the Kremlin, though are the roughly 460 so-called *monogoroda*, or single-factory towns, which grew up in the Soviet period around single "town-forming" (*gradoobrazuyushchii*) enterprises, which are often no longer globally competitive. Given the danger of social unrest should one or more these enterprises shut down, the Kremlin and regional authorities have sought to keep them open at all costs. They have pumped in large amounts of budgetary funds to keep loss-making,

[7] State Statistics Committee, "Zanyatost' i bezrabotitsa v oktyabre 2009 goda" [Employment and Unemployment in October 2009], <www.gks.ru/bgd/regl/b09_01/IssWWW.exe/Stg/d10/3-2.htm>.

[8] World Bank, *Russian Economic Report*, *op. cit.* [5], p. 5.

[9] International Crisis Group, "Central Asia: Migrants and the Economic Crisis," *Asia Report*, No. 183, 5 January 2010. Of course, many of these migrants worked in the informal economy in the first place and would not have been counted in Russia's official employment figures.

[10] See N. Zubarevich, "The Crisis in Regional Perspective," *Pro et Contra*, Vol. 12, No. 5-6, September-December 2008.

uncompetitive factories open, even at the cost of preventing restructuring that could enhance the country's competitiveness in the longer term.[11]

During the first stage of the crisis, the state came under enormous pressure to use its reserves to bail out a wide variety of politically connected firms. As in the West, large sums were transferred to failing industrial enterprises and major banks. The most notorious recipient of bailout funds has been automaker AvtoVAZ, which employs over 100,000 workers and held debt of over 2 billion US dollars. To keep AvtoVAZ running, Prime Minister Putin promised to inject more then 1.7 billion US dollars into the company in the fall of 2009, despite opposition from the Finance Ministry, which argued there was little sense pouring such sums into a company that had not demonstrated the ability to produce a competitive product.[12] Similarly, the aluminum conglomerate Rusal was quietly bailed out by the Kremlin after Putin had publicly upbraided its owner, the oligarch Oleg Deripaska, on television for idling his firm's operations in the *monogorod* of Pikalevo. In Russia such industrial bailouts are perilous, more so than in the West, because they act as an obstacle to the process of "creative destruction" that, in macroeconomic terms, is needed to make Russia's industrial sector more competitive. At the same time, the bailout money also enabled recipients to engage in various types of activities that do nothing to boost competitiveness, such as paying out shareholder dividends and speculating against the currency.

While the impact of the crisis on the *monogoroda* has received the most attention, other regions of the Russian Federation have suffered badly as well, above all the North Caucasus. After a period of relative calm, this area has once again reverted to a state of latent anarchy. Unemployment in the North Caucasus republic of Ingushetia was estimated at 57 percent at the start of 2009, while output had fallen by more than 25 percent over the previous six months.[13] This economic despair feeds the insurgency creeping through the North Caucasus. A few days before he was nearly assassinated by a suicide bomber in September 2009, Ingush President Yunus-Bek Yevkurov warned that the insurgency was spreading because "the republic's inhabitants see how officials are building fancy mansions and driving cars on the roads even as more than half of Ingushetia's able-bodied inhabitants are unemployed."[14]

[11] S. Wagstyl, "Smelt Down," *Financial Times*, 7 August 2009.
[12] RIA-Novosti, "AvtoVAZ Carmaker Could Get Additional State Support—Putin," 3 December 2009.
[13] L. Fuller, "Russian President Calls For Emergency Measures in Ingushetia," Radio Free Europe/Radio Liberty (RFE/RL), 21 January 2009.
[14] I. Plugaterëv, "Krizis obostryaet terroristicheskie ugrozy" [The Crisis Sharpens Terrorist Threats], *Nezavisimaya Gazeta*, 3 July 2009. <http://nvo.ng.ru/spforces/2009-07-03/1_terror.html>.

The Impact of the Crisis on Russian Domestic Politics

Despite these problems, outside the North Caucasus, the danger of social unrest stemming from the economic crisis seems relatively limited for the time being. The greater danger comes from concerns about the elite's cohesiveness in the face of declining revenues and an increasing push (at least rhetorically) by President Dmitry Medvedev to reduce the state's role and open up the Russian economy to greater competition. During the Putin years, Russia increasingly moved toward a kind of hybrid state-capitalism in which a selected cadre of leading officials (many of them, like Putin, *siloviki* or veterans of the security services) took up seats on the boards of key companies. This included Medvedev himself, who was Chairman of Gazprom's board of directors before being tabbed as Putin's successor. In contrast to the oligarchs of the 1990s, this new political-economic elite used its political connections to amass wealth, rather than the inverse. Though portraying themselves as ensuring that major corporations acted in the interests of the state, these officials frequently took advantage of their position to amass great personal wealth at the expense of the companies they were charged with overseeing.[15] Nor have all of the old oligarchs disappeared, leaving Russia's major industrial sectors with a mix of politically connected private firms and massive state-owned conglomerates, most of which are fonts of corruption and (at times) instruments for implementing state policy. Leading officials have acknowledged the seriousness of the problem, and indeed Medvedev has made fighting corruption one of the centerpieces of his reform program, so far to little avail.[16]

With the downturn, the stability of this system appears more precarious, especially with the added uncertainty connected to the end of President Medvedev's first term in 2012. Though Medvedev is nominally the leading figure in the state, Prime Minister Putin has been instrumental in regulating conflicts among the various bureaucratic-oligarchic factions comprising the so-called "Kremlin Inc." apparatus that has dominated Russian business and politics for much of the past decade. Whether the system could function in its current form without Putin playing such a mediating role

[15] See P. Baker and S. Glasser, *Kremlin Rising: Vladimir Putin's Russia and the End of the Revolution*, Washington DC, Potomac Books, 2007, p. 351-353.
[16] News Conference of Presidential Aide Vladislav Surkov, Deputy Head of the Presidential Administration, Press Conference at the July 2006 G-8 St. Petersburg Summit, <www.en.g8russia.ru/news/20060704/1168817.html>.

remains a major question; during the uncertainty surrounding the 2008 presidential election, a clash broke out between competing factions (known at the time as the "war of the *siloviki*"). The relatively smooth succession from Putin to Medvedev, along with Putin's decision to remain onstage as prime minister helped prevent this clash from developing into a serious threat to stability. However, the political uncertainty surrounding the end of Medvedev's first term, compounded by diminished revenues could easily lead to a more serious falling out among the various bureaucratic-oligarchic factions.

The crisis, coupled with worries about the elite's cohesiveness, has created a dilemma. Medvedev and his allies, notably the cabinet officials charged with economic policy (Minister of Finance Aleksey Kudrin, Minister of Economic Development Elvira Nabiullina, and First Deputy Prime Minister Igor Shuvalov) have committed themselves to a program of economic modernization as the only path to restoring Russia's long-term competitiveness and hence its international power and prestige. Yet such a program cannot succeed without upsetting the existing power structure and threatening to cause wider instability at the top.

Under the watchword "modernization," Medvedev has used the crisis to promote the idea of weaning Russia from its reliance on state corporations and the sale of natural resources in favor of creating an economy based on innovation and high technology. In his article "Forward Russia!" and in a series of speeches (including his annual address to the Federal Assembly in November 2009) Medvedev argued that Russia's resource-dependence was "shameful," since it condemned the country to the role of a raw materials supplier to the more developed world.[17] To overcome this backwardness, Medvedev has called for reform of the legal system to battle Russia's pervasive "legal nihilism," breaking up the state corporations, and focusing on the development of high technology industries.

While Medvedev's rhetorical assault on Russia's hidebound economic structure has been consistent and forceful, actual reform has been sparse. The basic problem is that the intertwined nature of Russia's political and economic elite means that targeting the economic oligarchy would also constitute an assault on the state-capitalist political system bequeathed by Putin. Several figures close to Putin, notably Deputy Prime Minister Igor Sechin, appear to have lined up behind efforts to preserve the status quo, calling for the government to continue spending from its reserves, taking advantage of the crisis to seize a larger stake in key industrial sectors. Putin himself has given mixed signals, while leaving his protégé Medvedev

[17] D. Medvedev, "Rossiya, vperëd!" [Russia, forward!], *Gazeta.ru*, 10 September 2009; D. Medvedev, "Poslanie Federal'nomu Sobraniyu Rossiiskoi Federatsii," [Presidential Address to the Federal Assembly of the Russian Federation], 12 November 2009, <http://eng.kremlin.ru/speeches/2009/11/12/1321_type70029type82912_222702.shtml>.

to serve as the public face for the modernization campaign. Given the potential for an assault on the bureaucratic-oligarchic elite to set off a destabilizing scramble for resources, Medvedev is unlikely to succeed without strong backing from Putin himself.

One major bellwether for the success of Medvedev's campaign will be the fate of the state corporations. These conglomerates—including arms exporter Rostekhnologii, nanotechnology firm Rosnano, and Olimpstroi, in charge of constructing facilities for the 2014 Sochi Olympics, as well as the energy giants Gazprom and Rosneft—were established or strengthened during Putin's presidency as a means of enhancing the state's control of key sectors of the economy, and at least incidentally to provide a revenue stream for favored state officials. These firms have proven much less effective in terms of adding value to the Russian economy than the private sector, which still accounts for 65% of Russia's GDP, despite the state's continually growing presence in the economy since Putin's accession in 2000.[18]

Few state firms are profitable, and many are deeply indebted, in part as a result of foreign loans taken out to pay for currency speculation. Many of them also enable corruption, as their overseers engage in large-scale asset-stripping. In the early stages of the crisis, the Kremlin also encouraged some of these firms to take on even more debt in order to buy out failing rivals at risk of foreign takeovers. Similarly, the state bailed out selected, politically connected private companies from the state treasury to prevent the seizure of their assets by foreign creditors. Many firms appear to have siphoned off such bailout money to pay dividends, without resolving their debts—which collectively amounted to 294 billion US dollars at the start of July 2009.[19] In Russia, such debts practically never result in companies undergoing bankruptcy proceedings; they merely continue to lose money.

Medvedev has called for the state corporations to be gradually wound down and transferred to private ownership. Since many of these firms are controlled by important political players—many of them *siloviki*—true privatization would also disrupt the existing political constellation. Of course, privatization could also be done in a way that preserves many features of the existing system, much as in the early 1990s when privatization was often used as a cover for managers to seize control of their companies.[20] Also uncertain is whether foreigners will be allowed to participate in privatization, and which companies will actually be privatized; the pressure to maintain state control of firms in "strategic" sectors of the economy, such as

[18] European Bank for Reconstruction and Development, Economic Statistics and Forecasts: Russia, 2009, <www.ebrd.com/country/sector/econo/stats/russia.pdf>.
[19] "Razoblachenie oligarkhov" [Revelations about Oligarchs], *Izvestia*, 17 August 2009, <www.izvestia.ru/economic/article3131891/>.
[20] See M. Goldman, *The Piratization of Russia: Russian Reform Goes Awry*, London, Routledge, 2007, p. 103-104.

state oil major Rosneft (which now produces around 44 percent of Russia's oil), is intense.

The depth and duration of the crisis will likely have a significant influence on the eventual success of Medvedev's plans for reform, and hence on the fate of Russia's state-capitalist political system. On the one hand, a serious and prolonged crisis—particularly if other major economies return to growth sooner—would expose the underlying flaws of the Russian state-capitalist system and create immense pressure for reform (though at the same time raising the prospect of the state losing control of the process, as happened under Mikhail Gorbachev in the late 1980s). On the other hand, should international oil prices return to the exponential growth of the pre-crisis years, Russia could weather the economic storm with minimal political damage. Under this scenario, the Kremlin would find itself under far less pressure to engage in wholesale reform that could well prove destabilizing, thereby limiting Russia's longer-term development prospects.

The Impact on the Crisis on Russian Foreign Policy

The impact of the crisis on Russia's foreign policy is in many ways hard to predict. President Medvedev has argued that the crisis must put to rest the fantasy that Russia is an island of stability in a turbulent world, and that the impressive economic recovery of the past decade allowed Moscow to act as an independent pole in an increasingly multipolar world. Indeed, Medvedev argued in his annual address to parliament that Russia could no longer afford to base its foreign policy on "nostalgia and prejudice." Instead, the success of Russian foreign policy should be judged on its contribution to Russia's development.[21] As with many of Medvedev's statements, however, foreign observers wonder about the substance behind the rhetoric.

The impact of the crisis has been felt most clearly in Russia's relations with its post-Soviet neighbors. Most CIS countries have suffered from the crisis even more than Russia, but at the same time have taken advantage of Russia's reduced leverage to seek enhanced ties with both Western countries and China. In terms of Russia's policy toward Europe and the US, the crisis has thus far had less direct impact. To be sure, the economic pain Russia has suffered over the past year and a half has forced Moscow to confront the reality of economic interdependence, particularly with regard to the EU. Relations with the US have become less fraught as well, though given the lack of economic ties between Russia and the US, the cautious warming appears driven as much by new US President Barack Obama's determination to place relations with Moscow on a more predictable footing. With the partial exception of negotiations on a treaty to further reduce nuclear weapons (Moscow can not afford to maintain parity with the US at current levels), the crisis *per se* does not appear to have had a major impact on relations with Washington. That being said, by reducing—for the time being—Russian intervention in the affairs of its post-Soviet neighbors, the downturn has sidelined one of the most intractable issues in relations between Moscow and the West.

Prior to the onset of the crisis, many Russian officials had argued that, thanks to its oil wealth and general lack of integration with the global economy, Russia would remain insulated from financial turmoil in the developed countries of the West. As the crisis

[21] D. Medvedev, "Poslanie Federal'nomu Sobraniyu," *op. cit.* [17].

unfolded in the last months of 2008, however, it became clear that Russia was acutely vulnerable, in part because the downturn led to rapidly diminishing demand for Russia's major export commodities—above all oil and gas. Falling energy demand caused the market capitalization of Russia's largest companies to drop precipitously—especially that of natural gas monopoly Gazprom, which plunged from the world's fourth largest company in 2008 to only the 36th largest in 2009.[22] Given the Russian economy's dependence on energy sales, the plummeting price for oil and gas resulting from sharply lower demand in Europe further weakened Russia's market power, and hence too its leverage with consumers. It also strengthened the hand of those, such as Shuvalov and Nabiullina, arguing for Russia to pursue membership in the World Trade Organization, after a brief interlude when Moscow announced that it would seek to join the WTO in tandem with its Customs Union partners Belarus and Kazakhstan, which are much further from concluding negotiations with the organization.

At the same time, a supply glut and lower prices have undermined Russia's ability to use energy as a lever to influence European foreign policy. Following Gazprom's decision to cut off gas supplies to Ukraine (and hence to European customers further downstream) in January 2009, the EU has managed to make real progress in limiting its vulnerability to future supply cuts. Brussels has committed funds to modernize Ukraine's energy sector and increasingly moved toward adopting a common approach to energy security. The Europeans are also building more terminals for liquefied natural gas (LNG) and actively pursuing deals for pipeline gas from a number of Middle Eastern and North African countries. At the same time, the outflow of foreign capital from Russia in the course of the crisis (foreign direct investment plummeted by more than 45 percent in the first six months of 2009) coupled with the continuing credit crunch in Russia itself, has imperiled the modernization agenda championed by President Medvedev.[23] Under the circumstances, the EU, which is already by far Russia's largest trade partner, is the most likely source of new investment in the Russian economy. This development potentially lays the foundation for improved cooperation between Russia and Europe, and gives the Europeans some leverage to press Moscow for further economic liberalization.

The drop in European demand for oil and gas created another foreign policy quandary for Russian leaders: at the height of the global boom in early 2008, Gazprom had signed a series of long-term contracts with Central Asian energy producers (notably Turkmenistan) promising to pay them "European prices" for gas fed into the Russian pipeline system. The price agreed in these contracts,

[22] "Global 500 2009," *Financial Times*, 29 May 2009, <http://www.ft.com/reports/ft500-2009>.
[23] "Ob inostrannykh investitsiyakh v I polugodii 2009 goda," State Statistics Committee of the Russian Federation, <www.gks.ru/bgd/free/b04_03/IssWWW.exe/Stg/d03/159inv20.htm>.

in the neighborhood of 230 US dollars per thousand cubic meters (tcm), was several times what the Central Asian producers had previously received. Moscow and Gazprom agreed to the higher prices on the basis of a calculation that global energy prices would continue their inexorable rise, and to reduce the incentive for Central Asian states to sign commercial energy deals with European companies that would undermine Moscow's dominant position in the region.[24]

Previously, Gazprom had taken advantage of its position as a near monopsonist for Central Asian gas—apart from a small pipeline to Iran, all of Turkmenistan's gas sales on the international market went via Russian-controlled pipelines—to pay Ashgabat a fraction of the price paid by end users in Europe. Meanwhile, Turkmenistan was utterly dependent on Russia to market its gas outside the former Soviet Union, and hence to earn hard currency. Moscow took advantage of this dependency to ensure Ashgabat's foreign policy was closely aligned with Russian interests.[25]

The drop in energy demand led the price of European gas to fall dramatically. Stuck with the long-term take-or-pay contracts it had signed before prices fell, Gazprom was left paying the Turkmen far more than it could recoup from its sales in Europe. In April 2009, the main pipeline between Turkmenistan and Russia mysteriously exploded. Ashgabat blamed Gazprom for unilaterally reducing the amount of gas it was taking from the pipeline in violation of its contract; without the gas being drawn from the pipeline, pressure accumulated until the pipe burst. As of January 2010, the pipeline had still not been repaired, and relations between Ashgabat and Moscow remained frigid.

Always an idiosyncratic international actor, Turkmenistan stepped up its courtship of European companies to invest in its upstream and became increasingly receptive to Western overtures to participate in the Nabucco pipeline project that would bring gas from the Caspian basin to Europe via the South Caucasus and Turkey, bypassing Russia.[26] In the meantime, a new gas pipeline from Turkmenistan to China opened in December 2009, further reducing Russian leverage over Ashgabat, even if gas sales to Russia and Europe eventually recover. While Turkmenistan is the main beneficiary, the other Central Asian energy producers have increased leverage vis-à-vis Moscow too. Even though Moscow and Ashgabat finally agreed in December 2009 to resume gas sales, the months-long cut off has already had long-lasting effects both by encouraging

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[24] D. Bochkarev, "'European' Gas Prices: Implications of Gazprom's Strategic Engagement with Central Asia," *Pipeline and Gas Journal*, Vol. 236, No. 6, June 2009, <http://pipelineandgasjournal.com/%E2%80%9CEuropean%E2%80%9D-gas-prices-implications-gazprom%E2%80%99s-strategic-engagement-central-asia>.
[25] A.N. Stuhlberg, *Well Oiled Diplomacy: Strategic Manipulation and Russia's Energy Statecraft in Eurasia*, Albany NY, SUNY Press, 2007, p. 99-115.
[26] M. Denison, "The EU and Central Asia: Commercializing the Energy Relationship," EUCAM Working Papers, 23 July 2009, <www.ceps.be/book/eu-and-central-asia-commercialising-energy-relationship>.

contacts between Turkmenistan's government and Western energy companies, and by providing an example for other energy producing states of the dangers of excessive reliance on Moscow.

The crisis will affect Russian foreign policy in other ways as well. The military, which during the boom years became accustomed to yearly funding increases, will have to confront a period of renewed austerity.[27] This austerity comes at a bad time: the war with Georgia in August 2008 exposed a number of shortcomings that the infusion of cash during the Putin years had failed to stem. In particular, the Russian armed forces were slow to react and struggled to mount combined operations, even against a much weaker foe. Even though the war was ultimately successful, the military's less than impressive showing strengthened the conviction among Russia's political leaders that reform had to be accelerated. In this way the war provided momentum for implementing a scheme to downsize and modernize the army that experts had been discussing since the 1990s.

In essence, to deal with the kind of threats it confronts in the contemporary world, the Russian military needs to move away from the conscription-based mass army of the 20th century to a smaller, more mobile, and more professional force. Yet because such a fundamental re-conceptualization of the military's structure and goals would require significant downsizing, the officer corps has been strongly opposed to the reform. Anatoly Serdyukov, a one-time furniture salesman, was named Minister of Defense by Putin in 2007 largely because of the perceived necessity of having a non-military figure overseeing the reform efforts. With strong backing from both Putin and Medvedev, Serdyukov has been doggedly pursuing his program of transformation. However, lack of funding has imperiled these efforts, because of the need to provide social support (including housing) for laid off officers.

Moscow, meanwhile, insists that spending on military procurement will not be affected by the crisis as it seeks to both upgrade the conventional forces in the aftermath of the Georgia conflict and maintain a sufficient strategic deterrence capability—though whether it can actually afford to do so remains uncertain.

Meanwhile, the Russian navy is also encountering problems. Difficulties with the new *Bulava* submarine-launched ballistic missile (which has failed the majority of its operational tests), delays in procuring new ships, and the mounting obsolescence of much of the existing fleet have created major difficulties for the navy. Given the lack of resources and decline of the military-industrial complex since the Soviet days, these developments may be difficult to reverse.[28] The struggles of the military and military-industrial complex have

[27] Russia's yearly military spending increased by double-digit percentages starting in 2003. J. Mankoff, *Russian Foreign Policy: The Return of Great Power Politics*, Lanham MD, Rowman & Littlefield, 2009, p. 34-35.
[28] I. Kramnik, "Russian Navy's Days Could be Numbered," *RIA-Novosti*, 11 December 2009.

given the Kremlin a powerful incentive to avoid the risk of further military conflicts, especially while the fate of the Serdyukov-Medvedev reforms remains uncertain.

An additional crisis-related constraint on Russian foreign policy has to do with the state's diminished ability to use financial incentives to keep its post-Soviet neighbors in line. Even though many of the other post-Soviet states have been hit even harder by the crisis than Russia itself, Moscow's ability to take advantage of its neighbors' problems has been significantly diminished. Its reduced influence is especially visible relative to that of China, whose economy will continue to grow rapidly even as Russia struggles. Not only has Russia's pre-eminent position in the Central Asian energy sector been challenged by the opening of the new gas pipeline from Turkmenistan to China, but post-Soviet states from Moldova to Kyrgyzstan have achieved greater foreign policy flexibility as Russian handouts have diminished. In many cases, China has moved in with financial assistance and investment to countries that have traditionally looked to Russia. Beijing, for instance extended a 1 billion US dollar credit to Moldova, twice as much as Moscow had promised (and so far failed) to deliver.

Particularly in Central Asia, China and Russia are increasingly at odds as both seek resources and economic opportunities. Chinese investment has been flowing into Central Asia at an impressive rate, particularly in the energy, mining and construction sectors. Even before the financial crisis, Chinese companies (especially state-owned energy companies) were in a position to outbid their Russian rivals for stakes in the Central Asian upstream, while Chinese capital has flowed into infrastructure and real estate across the region. This influx of Chinese money is changing the region's economic geography to Russia's disadvantage. China's involvement in Central Asia is, moreover, driven heavily by commercial considerations, while Russia's has a much more overt political subtext. For instance, Moscow has exerted heavy pressure on its Central Asian allies to recognize the independence of South Ossetia and Abkhazia. Even though a significant number of Central Asians resent what they see as Chinese investment that does not trickle down to ordinary people, Beijing's lighter hand and deeper pockets give it an important long-term advantage in what is increasingly a competitive relationship with Moscow in the region.

The evidence of the former Soviet republics' reduced deference to Moscow is already visible. Uzbekistan, always mercurial, has been especially active in loosening its connection to Russia, making a point in July 2009 of announcing that it would not join the Collective Security Treaty Organization's (CSTO) rapid reaction force, which is being set up on Russian initiative, while Tashkent is seeking once again to improve security and economic cooperation with the West. Kyrgyzstan, meanwhile, balked on its decision to expel US forces from their base at Manas, long a Russian priority. The decision came after Moscow failed to deliver the entire 2.15 billion US dollar loan it had promised Bishkek in the spring of 2009 and the US agreed to increased rent payments for the base. Even Belarus, long Russia's closest ally in the former Soviet Union, boycotted a CSTO summit in the summer of 2009 and has started pursuing rapprochement with Europe in response to Moscow's diminished ability to prop up the Belarusian economy.

In the long-run, it is less the US than China that will benefit from the diminution of Russia's financial influence, especially in Central Asia. Even before the crisis hit, Chinese companies were making significant inroads into the Central Asian states. Chinese energy companies have bought up stakes in Central Asian production sites, often by paying a significant premium that their Russian competitors (including a heavily indebted Gazprom) could not match. In recent years, Chinese companies have played a central role in non-energy sectors as well, including mining, retail and construction. As China has weathered the global downturn far better than Russia, its influence in Central Asia is set to increase even more rapidly in the near future (though, in the long run, resentment at China's outsized role in the economies of the Central Asian states may come back to haunt Beijing).

Conclusion

For the Western powers, the challenges are manifold. On the one hand, Russia's economic difficulties have made it less capable of pursuing the energy-fueled mercantilism of the recent past. To restore competitiveness in the medium term, Russia needs to attract foreign capital, both to the energy sector (where output is declining) and to the new innovation-based sectors Medvedev is promoting as the central component of Russia's long-term development. If it wants to attract new foreign investment, Russia will need to address some of the risk factors exposed in the course of the crisis and integrate more deeply with the world economy—for example by finally joining the WTO. At the same time, Russia's need to return to international credit markets provides potential creditors with leverage that they can use to promote reform of the judiciary and tackle corruption. The Western powers are also in a stronger position vis-à-vis Russia on account of the (probably temporary) decline in European demand for gas, which has reduced Russia's market power and called into question the entire concept of Russia as an "energy superpower." If the Europeans can take advantage of the opportunity in particular to improve the liquidity of their own gas markets, and develop alternate sources of supply, they will find themselves less vulnerable to Russian pressure once the crisis ends.

Whether Moscow will become more tractable on foreign policy issues of overriding importance for the United States is less certain. Certainly Russia's position to dictate to its neighbors, for instance on the question of US troops' access to facilities in Central Asia, is much reduced. It is certainly possible that, in light of its changed economic circumstances, Moscow's calculations about the threat to its interests posed by US forces in Central Asia will change and Russia will seek a more collaborative approach. The seeming success of US-Russian negotiations on replacing the START-I treaty offers another glimmer of hope, with Moscow apparently calculating that the cost of maintaining a large nuclear arsenal in the context of an evolving strategic relationship with the United States is excessive. It would be naïve though for the West to ignore the alternate possibility: that the downturn will ultimately make Russia more likely to manufacture or profit from instability around its borders as a means of rallying public support.

For the US and EU, the main task is to keep the path for Russia's economic integration open while at the same time creating incentives that discourage Moscow from using its neighbors' difficulties as an excuse to foster instability. That means promoting greater economic cooperation between Russia and Western countries (especially the US, which has very little economic interaction with Russia), while also remaining engaged in the post-Soviet space to help Russia's neighbors cope with the crisis as well. Economic interdependence can help create a community of interests and over time help promote closer political ties. Economic integration, including working to finish the process of bringing Russia into the WTO, also helps by establishing an agreed set of rules and procedures that can create confidence on the part of the foreign investors that Russia will need to follow through on Medvedev's call for modernization. Finally, Russia's need to access international capital markets over the next few years gives the West leverage to press Russia to clean up corruption and strengthen the rule of law.

It is Russia's own neighborhood that will provide the real test of whether the crisis will contribute to resolving some of the major concerns connected to Russia's recent foreign policy. In recent years, the most serious clashes between Russia and the Western powers have been connected in one way or another to developments in and around the CIS, from the "colored revolutions" to the war in Georgia. For the "reset" in relations proclaimed by US President Barack Obama to truly take hold, Russia will have to adopt a less confrontational posture toward its post-Soviet neighbors. In some ways, the overall landscape is more promising now that it has been in recent years, not only because Russia's capacity for intervention in its neighborhood has been reduced by the crisis, but because the question of further NATO expansion has been shelved for the time being. Still, some of the fundamental issues at stake in the CIS remain unresolved, from securing energy transit across Ukraine (and Belarus) to the fate of South Ossetia and Abkhazia. Given that Russia's neighbors have in many cases suffered even more from the crisis than has Russia itself, the temptation certainly exists for Moscow to take advantage of its neighbors' problems to pursue unilateral gains regardless of its own difficulties. At the start of 2010 Moscow and Minsk were at odds over oil duties while the Ukrainian presidential election threatened to touch off a new crisis drawing in Russia and the Western powers on opposite sides. Another energy cut-off affecting Europe or a renewed crisis in Ukraine could easily de-rail the "reset" and set back the process of Russia's integration with Europe.

Such an outcome would likely aggravate foreign investors' concerns about placing their money in Russia, undermining prospects for the kind of economic modernization being touted by Medvedev. To be sure, Russia's economy will likely grow in 2010 (the World Bank anticipates GDP growth of about 3.2 percent), but from a much reduced base and mostly on the back of higher oil prices.[29] So far, despite Medvedev's exhortations, little has been done to place Russia's economy on a more sustainable base. An early end to the

[29] World Bank, *op. cit.* [5], p. 2-3.

crisis, moreover, will lessen the pressure to actually implement such a far-reaching overhaul. Obviously the success of Medvedev's modernization agenda depends above all on decisions that will be made in Moscow. The West can only encourage Russia to act in mutually beneficial ways. To do that, it will first have to demonstrate its credibility as an interlocutor, above all by getting its own economic house in order and on the path to recovery.