
Introduction

The economic and financial crisis that swept through the world in 2008–09 shook us all hard. Until the fall of 2008, Russia appeared to be a safe haven with its steady, high growth rate of 7 percent a year and its massive international currency reserves, which peaked at \$598 billion in August 2008, the third largest in the world after China and Japan.

But by October 2008, it was clear that Russia had been hit hard. The Russian stock market plunged by no less than 80 percent from May to October 2008. In 2009 Russia's GDP fell by 8 percent, more than in any other economy of the Group of Twenty (G-20) largest economies in the world, though admittedly less than in Ukraine and the Baltic states.

Yet Russia's public finances and international financial balances have been very strong. We therefore prefer to speak of an economic crisis in Russia and not a financial crisis. Unlike many other countries, Russia is suffering not from major foreign debt or public debt but from too low economic growth. Will the precrisis high economic growth return, or has Russia hit a serious roadblock?

This second book from the Russia Balance Sheet project examines Russia's current dilemma. Why did Russia suffer so badly? What are the critical problems and bottlenecks and what opportunities are at hand? Did Russia just have bad luck, or has the global crisis revealed profound shortcomings that need be fixed?

To penetrate this conundrum, we the editors have chosen twelve major issues of importance for Russia's social and economic development: the current economic dilemma, impact of the economy on Russian politics, functioning of federalism, corruption and rule of law, role of high technology, climate change and energy efficiency, Gazprom, military reform,

foreign policy, foreign economic policy, the post-Soviet space, and US-Russia relations. In order to illuminate these issues, we chose the best Russian and American specialists on these topics that we could find. We conclude with our outlook for Russia.

In our first book, *The Russia Balance Sheet*, published in 2009, we selected eight themes: Russia's historical roots, political development after the end of the Soviet Union, Russia's economic revival, policy on oil and gas, international economic integration, challenges of demography and health, Russian attitudes toward the West, and Russia as a postimperial power. That book concluded with what a "reset" of US-Russia relations should amount to, while this book focuses on Russia's current challenges. We have followed up on some themes, such as economic policy, foreign economic policy, and foreign policy, but have largely selected different themes or angles.

The Arguments

Our basic question is, How serious has the global crisis been for Russia? Why did Russia see such a large decline in GDP in 2009? How profound is the impact of the crisis? Did it have such an effect that Russia may change its course?

In chapter 1, Sergei Guriev and Aleh Tsyvinski illustrate how strong the Russian economy looked before the crisis. Their main explanation for the sudden drop in GDP is the sharp fall in the oil price. They argue that economic policy during the peak of the crisis was adequate. Their main concern is the challenges that Russia faces after the economic crisis. Global growth is and will continue to be lower, and Russia suffers from its resource curse, which has constrained desired economic reforms. They argue for a renewal of structural economic reforms to improve economic efficiency and governance. Russia faces a choice between Brezhnev-era stagnation and difficult economic reforms that will build the foundation for faster economic growth.

Daniel Treisman presents his original view of Russian politics in chapter 2. He argues that Russian politics has been far more dependent on public opinion than is commonly understood. The Kremlin has persistently been a great consumer of opinion polls, which shows that the politicians care. The popularity of the presidents in power was determined by economic performance, over which they had little control. The ability of the president to enact and implement policies depended on the president's popularity. By contrast, changes in Russia's formal political institutions explain little about the varying ability of presidents to pursue their policies. The ideas of the president were effective only when the president was popular. The conclusion for the future is that worse economic performance

should reduce the popularity of the president and thus render him less effective as a policymaker. Yet, if the economy recovers quickly, political backlash might be limited.

In chapter 3, Ekaterina Zhuravskaya reviews federalism in Russia in light of global experiences and theory. Her exercise is remarkably fruitful. A large and complex country such as Russia needs a federal structure of government for its successful development. However, President Vladimir Putin's creation of a "strong political vertical" with the appointment of governors has created major problems, including inadequate provision of public goods, because of the absence of accountability of both regional and federal officials. Without a strong opposition and free media, the federal center cannot pursue efficient policies. Federalism without local elections can potentially work if the policy aims at economic growth and not provision of public goods, such as good education and health care, but Russia is too advanced for such a single-minded approach. The alternative to the political vertical is the building of strong national political parties, which can exercise accountability.

Timothy Frye studies corruption and rule of law in chapter 4 on the basis of his own enterprise surveys in 2000 and 2008. He identifies reducing corruption and strengthening the rule of law as the greatest modernization challenge that Russia faces. His results are rather depressing. He finds that businesspeople perceive that corruption has increased since 2000 and that the security of property rights has become more contingent on political connections. President Dmitri Medvedev has repeatedly exposed these conditions and called for improvements, but to date his record on reform is not very impressive, although he has initiated large personnel changes in the main villain, the Ministry of Interior. Frye concludes that strengthening the rule of law requires a leveling of the political playing field between the powerful and the powerless.

In chapter 5, Keith Crane and Artur Usanov analyze the role of high technology in the Russian economy. They establish that Russian high-technology products pertain to five major areas: software, nanotechnology, nuclear energy, aerospace, and armaments. They review the size, companies, and relative strength of these five industries. They give Russian software the highest rating; it is the only high-technology industry that consists of start-ups and is dominated by private enterprises. The other four industries are built around state-holding companies, with the last two belonging to the military industry, which is not in great shape. The general impression is that Russia is doing quite a lot in high technology, but overall this industry is strikingly limited, and its future prospects are not great since it is both poorly financed and stifled by state power.

Climate change and energy efficiency have become two major international themes in recent years, which Samuel Charap and Georgi Safonov discuss in chapter 6. Even though Russia has high energy intensity and is

the third largest emitter of carbon dioxide in the world after the United States and China, the Kremlin paid little attention to these issues until recently. Modernization of Russian industry has led to a sharp reduction in Russia's energy intensity, but much remains to be done. In 2010, President Medvedev has taken up this theme and given it new prominence in Russian policy. Russia still has unique opportunities to save energy, and the question is whether President Medvedev's recent statement really indicates a new beginning.

For the last two decades, Gazprom has been Russia's dominant corporation. In chapter 7, Anders Åslund reckons that Gazprom has entered a serious structural crisis. It has thrived on piping gas to the growing European gas market, but Europe is experiencing a large gas glut, which will last for several years. Expanded production of shale gas in the United States has suddenly made that country a larger gas producer than Russia and eliminated its need for liquefied natural gas, which instead is flooding the European market. The gas price is likely to decouple from the oil price and stay much lower. Europe is also likely to produce shale gas in multiple places. In addition, energy saving will reduce the demand for gas. So far, Gazprom has neglected both other markets and technologies. It was forced to cut production sharply in 2009 because of falling demand and also reduced its purchases from Central Asia and postponed the development of new fields. These challenges are severe and call for a new, more market-oriented, and diversified gas policy.

In one area, however, Russia has been pursuing radical reform, namely in the military, which Pavel K. Baev deals with in chapter 8. This reform is considered the greatest since the reforms after the Crimean War in the 1860s. The aim is to transform the Russian military from a mass tank army to well-equipped rapid deployment forces. The reform was initiated by Minister of Defense Anatoly Serdyukov in October 2008, who keeps it in his tight reins. The ideas of the reform are in line with modern military thinking, but the reformers are accidental and maintain great secrecy, while the officer corps offers solid resistance. The reform proposes to reduce the number of units, officers, and tanks of the army. Out of the current 22,000 tanks, only 2,000 will remain. Baev is skeptical that the reform will be successful because it is underfinanced, not very consistent, and encounters extraordinary opposition from the officers. In any case, the Russian military has already changed considerably.

Dmitri Trenin discusses the dilemma of Russian foreign policy—modernization or marginalization—in chapter 9. He emphasizes the importance of Russia's relative economic size for its foreign policy. Russia does not have sufficient resources to play the role of a superpower, but it still remains a significant power. A major policy of President Putin's second term (2004–08) was to abandon Russia's aspirations to join the West and instead build up an alternative center of power with former Soviet republics. However, Russia's economic resources are not sufficient for such a

policy. Instead, Moscow's priority should be to strengthen Russia's own economic, intellectual, and social potential and to develop its soft power. Russia's conventional forces, even if they are successfully reformed, will have only limited capacity, and the Russian defense industry has to be restructured. As Trenin concludes: "For Russia, the age of empire is definitely over, but postimperial adjustment continues."

In chapter 10, David Tarr and Natalya Volchkova deal with trade and foreign direct investment policy. They strongly argue why Russia needs to join the World Trade Organization (WTO). Their estimates for Russia's benefits are substantial: Russia would gain annually no less than 3.3 percent of its GDP in the medium term. The benefits to the global community, by contrast, would be small. The authors also contradict the common view that Russia is facing excessive demands from the WTO, showing that the demands are somewhat more lenient than has otherwise been the case. They see no particular advantage for Russia in establishing a customs union with Belarus and Kazakhstan. In the end, Tarr and Volchkova see Russia's choice of the WTO as the choice of an open economy and integration into the global economy.

One sphere of Russia's foreign policy has been the post-Soviet space, which Anders Åslund considers in chapter 11. His view is that Russia is largely contradicting its own interests in its policy toward these countries. It is attempting to develop closer relations with these countries than they desire and is therefore being perceived as a potential threat. In four areas, Russia has left its neighbors dissatisfied, namely territorial integrity, gas policy, trade policy, and financial assistance. Russian private foreign direct investment, however, has been remarkably large and noncontroversial. China has been expanding its role in Central Asia and Eastern Europe. Russia is no longer unchallenged, but it has no viable policy. Åslund suggests that Russia may as well dissolve the Commonwealth of Independent States and its suborganizations, since they apparently do not benefit but rather contradict Russia's national interests. Instead, Russia needs to convince its neighbors of its good intentions.

So what does all this mean for US-Russia relations? Andrew Kuchins concludes in chapter 12 that while US-Russia relations have undoubtedly improved in the first year of the Barack Obama administration, the relationship is constrained by an enduring mismatch in strategic outlooks in Washington and Moscow. More than 20 years after the Cold War, Russia still persists in arguing that the United States represents the greatest risk to its security. This deeply anachronistic assumption not only naturally places significant constraints on the bilateral relationship but also leads Moscow to pursue many foreign policies that seem at odds with its stated goals of economic modernization and prevent it from addressing the security challenges it actually faces.

The Russia Balance Sheet

This book is the second in a series from the three-year Russia Balance Sheet, a collaborative project of the Peterson Institute for International Economics (PIIE), the Center for Strategic and International Studies (CSIS), and the New Economic School in Moscow. In it we seek to address key questions about Russia's political and economic development and its foreign policy through a rigorous, multidisciplinary, and comprehensive approach. Our goal is to be factual, objective, and balanced, looking at Russia beyond the stereotypes.

The timing is right for such an effort. President Medvedev assumed office in Russia in May 2008 and President Obama did so in Washington in January 2009. The two countries have embarked on a third epoch in post-Soviet US-Russia relations, following the Yeltsin-Clinton and Putin-Bush periods. They have called this new phase a "reset," indicating both their dissatisfaction with the prior relations and the aspiration to achieve something better.

In 2008, the United States appeared to be in the doldrums and Russia on a new peak with all its oil wealth, but 2009 was equally cruel to both of them. This is a time of reconsideration and rethinking. Our conviction is that the United States and Russia need to understand each other, have substantial common interests, and had better handle their differences. But a big question is whether both governments will agree on that and actually move forward.

The US business community views Russia as one of the large emerging markets. It presents many challenges for trade and investment, but so do other large emerging markets such as Brazil, China, and India (with Russia, the so-called BRICs or the trillion-dollar club). It may be an exaggeration to call Russia a "normal country,"¹ but the American and international business communities do not view Russia as so different: They recognize it as both an important supplier and market, where all major global companies have to be present.

The US policy community remains preoccupied with the Russian nuclear arsenal. Their views were reinforced during the Putin years, when Russia became a centralized, authoritarian state as well as more aggressive in its foreign policy, but it does not necessarily mean that Russia has the economic or military muscle to pursue its old role of a great power.

We chose the title *The Russia Balance Sheet* for the first, overview book and the larger project to build on the brand name established by the very successful collaboration between CSIS and PIIE for the China Balance Sheet, launched in 2005 and broadly supported by the business and policy communities. The motivation for entitling this book *Russia after the Global*

1. Andrei Shleifer and Daniel Treisman, "A Normal Country," *Foreign Affairs* 83, no. 2 (2004): 20–38.

Economic Crisis stems from our view that economic drivers are crucial for Russia's future growth, and neither Russia's political system nor its foreign policy can be well understood without a firm grounding in its current economic realities, its goals, and the global economic system within which Russia operates. Russians not only are more prosperous than ever but are also more integrated into the global economy than ever before.

