

## **Russia in Mid-2011**

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### **Summary**

Russia's recovery from the global economic crisis has been slow, constrained by a number of structural problems, both economic and political. That the oil price continues to play an inordinately big role in Russia's economy is a symbol of these problems. Corruption, which has reached previously unheard-of levels, is a symptom, not the cause. Unless these fundamental factors change, Russia will not be able to start living up to its potential.

Russia's population exhibits elements of unease, but this is unlikely to lead to unrest. Society, until now squarely focused on the private space, is maturing and beginning to structure itself as groups of interests, which can manifest themselves in joint actions. This "reawakening" does not yet suggest mass opposition to the government's policies, but botched reforms—coupled with a sense that they are initiated by "thieves and swindlers"—could disrupt the social peace still reigning in Russia.

The start of a new political cycle in 2012 will be dominated by Prime Minister Vladimir Putin, whether he chooses to return to the presidency or not. Putin has vowed to almost double Russia's per capita GDP within a decade. To do that, he will need both to implement reforms and maintain firm political control. The political field will probably be expanded to include loyal liberals whose job will be to publicly make the case for reforms, carry them out, and possibly be blamed for them later.

Russia's foreign policy will continue to be guided by a desire to gain access to Western technology and expertise, which argues against confrontation or even serious political disagreement. At the same time, Russia will strive to establish itself as an independent strategic player with membership in many clubs, from the G8 to the BRICS (Brazil, Russia, India, China, and South Africa)—while building its own economic unit with a few post-Soviet states.

Traditionally Western-centric, Russia's foreign policy is now rediscovering an Asia-Pacific focus. A number of factors are behind this change: the need to develop eastern Russian territories between the Urals and the Pacific; the opportunity to use the rise of China toward that goal; the need to manage China's new might; and the opportunity to reach out to the advanced economies of Japan and South Korea, to name a few. Russia is not a European country; it is Euro-Pacific.

## The Economy: Underwhelming Recovery

After Russia pulled out of recession in Q2 2009, it initially witnessed almost twelve months of brisk growth. This growth ground to a halt in the summer of 2010, however. The worst drought in at least fifty years and a bad harvest—coupled with weak domestic demand and limited capacity to increase exports of raw materials—slowed down the economy. There are reasons to believe that actual GDP growth in 2010 was less than the 4 percent officially posted. In Q1 2011, the economy grew by an annualized rate of 4.2 percent, while industrial production and real income growth has slowed. Imports have risen, crowding out domestic production.

In Q1 2011, capital investment was down 1.5 percent year-on-year. One reason was a tax hike (from 14 percent to 34 percent), which hit small- and medium-sized enterprises (SMEs) particularly hard. The general investment climate, too, has continued to worsen. Toward the end of the four-year political cycle, political uncertainty resulted in a massive flight of capital, amounting to \$75 billion (5 percent of GDP) since August 2010.

Prospects for future growth are not promising. Russia's investment levels (21–22 percent) are well below what they should be for a developing economy (25–30 percent). The political necessity for new social expenditures and the decision to proceed with a sweeping defense modernization program reduce the funding available for infrastructure development, health care, science, and education. Under these conditions, growth can only be stimulated by short-term borrowing on the global financial market, which is likely to lead to overheating and a corporate debt crisis in the medium term.

Russia's dependence on the oil price is as strong as ever. Two-thirds of Russian exports and half of its federal budget revenues depend directly on the price of oil. The country's current economic model is only sustainable if the price of oil continues to climb, as it did from \$70 to \$100 per barrel within the last year. Should it stabilize, the budget will be immediately affected, and the macroeconomic situation will weaken.

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Russia's balance of payments surplus hit a record high in Q1 2011, as a result of the increase in the oil price. The Bank of Russia has substantially strengthened the ruble against the major currencies (by 15–20 percent), which led to growth in imports (by 40 percent in Q1 2011). Should the oil price plunge or even stabilize, this will inevitably lead to a financial crisis and the devaluation of the ruble.

## Russian Society: A Pre-Awakening

The effect of the economic crisis on Russia's population has been relatively mild: unemployment has held steady at around 7–8 percent. Still, Russian society today finds itself in a state of deep unease. In part, this is the result of a sluggish recovery: only 11 percent of Russians believe their economic welfare improved over the last year, and only 16 percent are optimistic about their prospects for the next year.

To a much larger extent, the causes of unease are political. While trust in President Dmitri Medvedev and Putin has recovered from its early spring lows, to 57.2 percent and 60.9 percent, respectively, it remains close to 10 percentage points below its 2010 highs.

Some 31 percent of respondents in a recent poll said they agreed with the characterization of the ruling United Russia (ER) Party as the “Party of Swindlers and Thieves,” a moniker thought up by the anti-corruption blogger Alexey Navalny. While dissatisfaction with the ER is perhaps unsurprising, what is remarkable is that nearly a third of Russians agree with Navalny's statement, while only 6 percent in the same survey said they were aware of Navalny himself.

It would be a mistake, however, to assume that unease would inevitably lead to unrest. To date, Russian citizens have shown themselves interested in and capable of successful mobilization on issues either of local importance (such as the Gazprom skyscraper in St. Petersburg or the Khimki Forest outside Moscow), or of relatively narrow group interest (such as motorist protests and labor strikes). But they have not mobilized in defense of high-profile individuals or of relatively abstract concepts, such as media freedom.

Navalny now finds himself the target of an evidently spurious criminal investigation, as well as a general campaign of harassment against both himself and his supporters. His influence—and the fact that the state has turned its machinery against him—also points clearly and convincingly to the growing power and influence of the Internet, in the context of an otherwise closely controlled electronic media space and the decline of the relatively free print media. Whether or not pressure against the country's best-known blogger provokes a public reaction will be telling for the future of state-society relations in Russia.

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Recent attacks on the blogs and online payment systems on which anti-corruption and other civil society projects rely represent a new foray by the government into an area that many among Russia's most dynamic (and young) citizens considered autonomous. It is a foray that essentially violates the tacit agreement between citizens and the government, under which citizens stayed out of politics and the government stayed out of citizens' private lives. And, as such, it has the potential to endow the local and secular protests that flare up from time to time with more political salience, bringing together different strata of society.

Putin's popularity—followed by the Putin-Medvedev “tandem”—was never based on a sense of constituency or accountability, so much as on a symbolic association with stability and a sense of consistent progress toward improved standards of living. That sense of progress is gone, and stability—of which Russia needs another decade, as Putin recently announced—is beginning to look like stagnation.

Sensing that, Putin is now promising another effort to nearly double the per capita GDP (from \$19,000 to \$35,000, in Purchasing Power Parity [PPP]) within the next ten years. Such progress, however, will require significant structural reforms, many of which are bound to be unpopular (some with elites, others with the population at large). Ironically, while abandonment of reforms during the “fat years” of the oil boom underwrote a certain acceptance of the current political system, a new round of reforms—and especially their botched implementation—may lead to intense dissatisfaction with and popular mobilization against the government's policies.

## Domestic Politics: Putin in Charge

The current four-year political cycle, which began in December 2007–March 2008 with the election of the fifth State Duma and the third president of the Russian Federation, is drawing to a close. The uncertainty about the name of the new president notwithstanding, Putin remains the paramount figure in Russian politics. He will decide whether to return to the Kremlin in the spring of 2012 and whether to re-appoint Medvedev to a second—and, this time, six-year—term, or to come up with a new name, which seems highly unlikely at this stage. Even though Putin's popularity has dipped recently, it is still sufficient, with the use of the power of the state, often referred to as “administrative resources,” to make sure that both the elite favor him and that he wins among the electorate.

The December 2011 parliamentary election may lead to some changes in the make-up of the Duma, though the present position of the Russian legislature as an instrument of executive authorities will remain unchanged. Putin seeks to bolster slipping support for his United Russia (ER) Party by organizing a “popular front.” Another Kremlin-backed party, A Just Russia (SR), has taken a blow from the ER, which was able to remove the SR leader from the position of

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speaker of the upper chamber of parliament. The two other parties represented in the Duma—the Communists (KPRF) and the Nationalists (LDPR)—will probably keep most of their seats.

A new entry to parliament may be the Right Cause (PD), a Kremlin-approved, pro-business liberal formation, now headed by the billionaire Mikhail Prokhorov. If the PD clears the 7 percent threshold to gain membership in parliament, this will mark a return of the liberals—or, rather, their loyalist wing—to the Russian parliament after an eight-year absence. On the other hand, opposition liberals, led by former Prime Minister Mikhail Kasyanov (PARNAS), are unlikely to even be registered as a party.

The slogan of modernization, launched by Medvedev in a 2009 article, has turned out to be too vague, and Medvedev's own position too weak, to generate a real drive for transformative change. The results thus far have been modest. Putin, meanwhile, acknowledges the need for technological improvements and even reform in several sectors, but not at the risk of losing political control. The ongoing Arab revolt, as well as the memory of Mikhail Gorbachev's *perestroika*, serve as compelling arguments to proceed cautiously while implementing long-stalled reforms, particularly those involving the pension and healthcare systems.

## Foreign Policy: What Follows the Reset?

Moscow's foreign policy has broadly followed the course charted in 2009–2010. This course, implemented by Medvedev and supported by Putin, sees foreign policy's main mission as assuring Russia's national security and providing external resources for technological modernization. The reset in Russian-American relations has been consolidated with the ratification of the New START agreement, expanding the northern transit route to Afghanistan across Russia, and the entry into force of the "123" agreement on U.S.-Russian nuclear energy cooperation. In December 2010, Medvedev attended the NATO Summit at Lisbon and, with Secretary General Anders Fogh Rasmussen, proclaimed a reset in Russia-NATO relations.

Russia's relations with the European Union profited from the improvement in U.S.-Russian relations. Moscow's main goal is to promote and develop "modernization partnerships" with the EU and "modernization alliances" with its key members. The aim is to gain access to the advanced technologies of Europe and to its market.

Moscow will, of course, continue its two-track approach to Europe, dealing simultaneously with the EU as a whole and its individual member states. In the latter category, Germany, France, Italy, and Spain—as well as several smaller countries—are long-time favorites, but efforts to reconcile with Poland have

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been a major new development. There are moves under way to “reset” relations with the UK, another EU member state traditionally skeptical of Russia.

Moscow’s decision to abstain from the UN Security Council (UNSC) vote imposing a no-fly zone over Libya—like its earlier support for sanctions against Iran (including canceling the sale of an air defense system) and the dramatic expansion of Afghanistan transit across Russia—are all products of the “reset.” Yet Moscow remains wary of the use of force—especially by the United States—in various conflicts, and insists on avoiding “mission creep” while implementing UNSC resolutions. Russia’s own attitude toward the Arab revolt has been reserved: Moscow has no allies among the embattled autocrats and relatively few (mostly commercial) interests in the area. It is more focused on the U.S. military response to the developments in the region than on the developments themselves.

In the past year, Russia has been able to consolidate somewhat its position in the post-Soviet neighborhood. Its Customs Union with Kazakhstan and Belarus, launched in 2010, is slowly becoming a reality. Belarus has been a laggard, but the rupture in Minsk’s relations with the EU following the post-election clampdown, and the severe financial crisis in Belarus, have sent Minsk begging for Moscow’s support—which is conditional on opening up the country’s economy for Russia-led privatization. By contrast, Moscow has been unable to attract Kiev into its orbit, even under the leadership of the “friendly” Viktor Yanukovich, as Ukrainians fear that excessive economic integration with Russia would limit their political independence.

On the frozen conflicts, Russia has demonstrated diplomatic activity over Transnistria, where conflict resolution is possible, and Nagorno-Karabakh, where the prospects for settlement are dim. However, the conflicts in Abkhazia and South Ossetia and relations with Georgia remain deadlocked, at least for the rest of Mikheil Saakashvili’s presidency. Tbilisi’s recent efforts to appeal to various ethnic groups in the volatile Russian North Caucasus and to promote their historical grievances against Russia irritate Moscow and have raised tensions to dangerous levels.

Russia’s post-reset agenda with the West is dominated by two issues: Ballistic Missile Defense (BMD) and entrance into the World Trade Organization (WTO). On BMD in Europe, a possible solution would allow for a degree of integration, at the level of data exchange and processing, and a degree of coordination at the level of firing systems. Moscow, however, needs guarantees that the future system will not have a capability against the Russian nuclear deterrent. If the project goes through, and Russia is part of it, it would amount to a game changer from residual adversity to strategic cooperation. If it fails, strategic adversity will linger, even though the conditions that brought it about have long been removed.

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On the issue of the WTO, if Russia again fails to accede, there is likely to be a pause for several years. From Moscow's perspective, the ball is in the West's court. After eighteen years of trying, the Russian government believes it has done all it needed to, and more. It still wants to complete the process, but cannot be expected to yield any serious economic concessions to the EU, or political ones to Georgia. On the other hand, Russian membership in the WTO would result in a degree of domestic pain and some acrimony between Russia and several of its trading partners.

On the whole, Russian foreign policy remains Western-centric, but the importance of China for Russia has definitely grown. In a way, the relationship has never been so good. In 2009, Rosneft and Transneft received \$25 billion worth of Chinese loans. That same year, Russia launched a regional development program for its Far Eastern provinces, which is linked to the needs of the neighboring northeastern region of China. In 2010, China overtook Germany as Russia's leading trading partner. In 2011, Russia started pumping oil to China along a new pipeline.

In strategic terms, Russia sees the United States and China as the world's two principal strategic players. Moscow is careful to avoid anything that the Chinese would find unfriendly or offensive. Still, China's assertive behavior in 2010 put Moscow on alert as to the potential long-term evolution of Beijing's foreign policy. To hedge its bets, Russia has continued strengthening its old strategic relationship with India, aims to nurture modernization alliance-type ties with South Korea, and seeks to revive its once-close links with Vietnam.

Even though Russo-Japanese political relations have worsened over the Southern Kuril Islands issue, Moscow has sought closer economic ties with Japan. It wants Japanese technology and investment, and is offering Tokyo access to its Siberian energy resources. The need to develop Siberia and Pacific Russia is looming ever larger as Moscow seeks to better integrate the country domestically and to integrate Russia itself, through its Pacific foothold, with the wider Asia-Pacific region. The 2012 Asia-Pacific Economic Cooperation (APEC) summit in Vladivostok serves as a flagship project geared to that dual objective. To sum up, Russia is in the process of identifying itself as a Euro-Pacific country.

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## **Russia's Energy Sector: Opportunities for Collaboration With the EU**

Recent growth trends in Russia's oil and gas sector disguise a fundamental problem. In 2010, oil production went up by 2.2 percent, setting a new post-Soviet record at 505 million tons. Gas output witnessed a major comeback following a turbulent year in 2009—after growing by 11 percent, gas production is back to its 2006 level, about 650 billion cubic meters (bcm).

But Russia's ability to maintain this trend is increasingly under challenge, as Soviet legacy fields (both for oil and gas) are in decline. Further growth hinges on Russia's ability to develop its next generation of oil and gas fields. This promises new opportunities for collaboration, though the scope and extent of that collaboration will depend primarily on two things: Russia's ability to launch and implement a major tax reform, and the leadership's decisiveness to overhaul a restrictive regime for foreign investors.

The EU and Russia do not seem to be close to resolving key sources of contention in their gas relations. First, the two sides maintain a very different conception of what should constitute an efficient and integrated European market. Gazprom continues to perceive the Third Energy Package as a wall erected to limit its penetration in Europe and as a source of a long-term investment risk. Second, the pipeline race between Nabucco and the South Stream is heating up. Third, the continuing lack of a mechanism for resolving gas disputes between EU members and Russia remains as an obstacle to a more constructive engagement.

Gazprom officials may feel that they are in a better bargaining position this year, though this position is far from guaranteed. On the one hand, the European gas market has tightened, which has occasionally led to spot-market prices that exceed Gazprom's long-term oil-indexed prices. The crisis in Japan this spring has also put additional pressure on international liquefied natural gas (LNG) supplies. Finally, Russia's domestic gas market is rapidly growing again. All of these developments indicate a potential growing competition over Russian gas exports. On the other hand, European companies will continue to exert pressure on Gazprom to revise their oil-indexed contracts, and Gazprom has an interest in helping them to avoid a financial predicament. Furthermore, the long-awaited Russian-Chinese gas export deal has yet to be signed, and key difficulties in their bilateral negotiations remain.

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