

**Statement before the Senate Foreign Relations Committee**

***“PROSPECTS FOR ENGAGEMENT WITH  
RUSSIA”***

A Statement by

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Last month in Munich Vice President Biden talked about “pressing the reset button in US-Russia relations.” While the State Department was challenged to find the correct translation of “reset button,” those of us in the Russia-watching community have been debating whether such a button exists, and if so, what “pressing” it might really mean. The analogy that Vice President Biden used a month ago at the Munich security conference is not perfect, since there is too much toxic waste under the bridge of U.S.-Russian relations to be cleaned up over night. But the sentiment implies that there is a real opportunity for the Obama Administration to improve relations with Russia, and with this I very much agree.

A good part of the rationale is simply that relations had reached such a low point, lower than any point in at least two decades, in the wake of the Georgia war last year, that there was virtually only one direction the relationship could go before igniting a new Cold War or worse. I also sensed in the Fall/Winter the development of a solid consensus in the center of the US political spectrum that it was imperative for the incoming Obama administration to develop a more constructive relationship with Moscow, in order to address more effectively a number of pressing security challenges including Afghanistan, the Iranian nuclear program, and nuclear security more broadly, among other issues.

In addition, the global situation has drastically changed in ways that probably have altered the calculations in the Kremlin. Russia had been on an extraordinary economic roll for the past decade that saw their GDP grow by more than eight times. Simultaneously they perceived US power to be ebbing as we became mired in the Iraq and Afghanistan wars and our economy began to flounder with the sub-prime problems, foreshadowing the global financial crisis. Most likely they overestimated their strength as well as our weakness, but Russian economic hubris has been rocked as the crisis has hit them extremely hard, revealing their vulnerabilities as well as deep integration with the global economy. For the first time in years I think there is a greater sense in Moscow that Russia needs better relations with the United States and the West more broadly.

### **Economic Factors Key to Unraveling the Russian Riddle**

Russia is notoriously difficult to comprehend, as many famous observers far smarter than I have noted over the years. My personal favorite is from Will Rogers, “Russia is a country that no matter what you say about it, it’s true.” My argument today is that is that understanding Russia’s economic circumstances as well as its articulated goals hold the answer today to the eternal question “Whither Russia?”

2008 was the most contentious year in Russian-Western relations since the collapse of the Soviet Union. From differences over Kosovo, NATO enlargement, and missile defense in the spring to the Georgia war

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Note: Much of this testimony derives from two recent reports which I co-authored: Samuel Charap and Andrew C. Kuchins, *Economic Whiplash in Russia: An Opportunity for U.S.-Russian Commercial Relations?*, (Washington DC: Center for Strategic and International Studies, February 2009) and Anders Aslund, and Andrew C. Kuchins, *Pressing the Reset Button in U.S.-Russia Relations*, (Washington DC, Peterson Institute for International Economics, March 2009. See these reports for a comprehensive set of specific policy recommendations regarding U.S.-Russia relations.

in August to concluding the year and opening the new one with another gas war between Russia and Ukraine, tensions and differences escalated. Yet while political relations continued to worsen, economic integration between Russia and the West continued to deepen and widen as trade and investment volumes reached all time highs. In the summer of 2008 the Russian government published a long report detailing Russia's economic goals to the year 2020. The most striking finding in that report is that Europe especially, and the West more broadly, would be far and away the most important partners for Russia to achieve their best-case growth scenarios in the coming twelve years. The current trends of deepening economic integration amidst worsening political relations did not seem sustainable in the summer of 2008, and now after the war in Georgia and the impact of the economic crisis they seem even less so. Dmitri Medvedev was inaugurated as Russia's new president in May, later in the month the Russian stock market hit its all-time high, and in July the oil price peaked at \$147/per barrel. The Russian government had more money than it knew what to do with as foreign currency reserves peaked at nearly \$600 billion with another \$200 billion in two funds that were formally the Stabilization Fund. The Russian GDP (in nominal dollar terms) had increased by a factor of eight in less than a decade, and the report on Russia's strategic economic goals to 2020 called for similar growth levels that would ultimately make Russia the fifth largest economy in the world and the largest in Europe. Our friends in the Kremlin talked about Russia possibly being a "safe haven" or "island of stability" as the impact of the US mortgage crisis widened to the global economy.

But how quickly things change. Russia's economic hubris has been smashed, as their economy in the last few months has been amongst the hardest hit of large emerging markets. The Russian stock market has lost about 70% of its value since its peak (worst performance of all large emerging market economies). It is estimated the Russian Central Bank spent about \$200 billion—first defending the ruble, and then allowing gradual devaluation, until the ruble eventually dropped 50% against the US dollar. Most prognoses for economic performance in 2009 predict negative growth, and because of ruble devaluation, the nominal dollar GDP is likely to drop 20-25% after averaging more than 25% growth for nearly a decade. The Moscow-based investment bank Troika Dialog, for example, calls for a drop in nominal dollar GDP from nearly \$1.67 trillion in 2008 to \$1.25 trillion in 2009—and Troika's prognostications are relatively more optimistic than most.

After a decade of budget surpluses, the Russian government is anticipating a deficit of 5-10% in 2009 and the possibility of deficit in 2010 and 2011. In the fall, Russian enterprises began major layoffs and the unemployment rate will likely exceed 10% this year. After a decade of dramatically reducing the poverty level, Russia will likely see it increase once more, from 12% to 15% according to the most recent World Bank projections. There is growing concern about the potential social impact in one-company towns with massive layoffs resulting from shutdowns of their major local enterprise.

All national economies are struggling to adjust to the deepest global slump in several generations, but the drastic change in momentum for policymakers in Moscow is especially stark and challenging. Since so many millions of Russians have benefitted from the economic prosperity of the past decade, the impact of the current crisis affects a far greater percentage of the population than the last economic crisis in 1998.

Vladimir Putin's vaunted "vertical of power" will be tested like never before as the prospects for social unrest and even bankruptcy are ever more possible, if the slump endures for more than 12-18 months.

### **Foreign Policy Implications of the Economic Downturn**

It is important that US policymakers understand the implications of this unprecedented economic whiplash. The crisis could have a major impact on Russia's external behavior, and therefore US interests. As of this writing, many analysts have already concluded that the crisis will spur a new period of aggressiveness in Moscow's external stance.<sup>1</sup> Most agree with Dmitri Simes's maxim that "In Russia, hard times normally produce hard lines."<sup>2</sup>

Thus far the crisis has indeed correlated with assertiveness in Russian foreign policy. For example, Russia has engaged in a highly destructive "gas war" with Ukraine, at one point going so far as to completely cut off deliveries to Europe, which caused rationing in some countries that are completely dependent on Russian gas, such as Bulgaria. The recent announcement that Kyrgyzstan would close the US base at Manas under apparent Russian pressure would also indicate a more assertive line. Moscow seems at least in part motivated by a revanchist instinct to keep its "near abroad" under tighter political control. Despite these assertive moves, it is too early to draw definitive conclusions about the future trajectory of Russian policy. History provides evidence that economic downturns in Russia have corresponded with periods of greater cooperation. Economic stagnation in the late 1980s was associated with the end of the Cold War, and the contraction of the 1990s correlated with an accommodating foreign policy under Boris Yeltsin. Since the first oil crisis in the early 1970s, there has been a powerful correlation between a high oil price environment and a more assertive and aggressive Soviet or Russian foreign policy. This dynamic corresponds to the later Brezhnev years and the Putin period, especially since 2003. Although nothing is predetermined, this historical perspective suggests that the current economic downturn could push Russia towards a more cooperative stance vis-à-vis the West, especially in terms of economic cooperation. Just nine months ago when oil was over \$140 per barrel, Moscow had fewer incentives to engage with the West on economic issues. Russia was such an attractive market that it did not need to make an effort to lure Western investors; money flowed into its markets regardless of its policies. Its economy grew at a rapid clip despite the stagnation of the economic reform agenda and it no longer needed financing from international institutions to ensure fiscal health. In short, Russia's boom provided little incentive to reach out to the West.

With its economy in deep trouble and oil under \$50, this situation has significantly changed. Clearly economic troubles are not exclusive to Russia, but the whiplash factor has altered the incentive structure to perhaps a greater degree than in many other countries. Recovery from the crisis could require a

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<sup>1</sup> E.g., Clifford G. Gaddy and Barry W. Ickes, "Putin's Third Way," *The National Interest*, January 21, 2009, <http://www.nationalinterest.org/PrinterFriendly.aspx?id=20496> and Leon Aron, "Russia's Woes Spell Trouble for the US," *Wall Street Journal*, December 31, 2008.

<sup>2</sup> Dimitri K. Simes, "Uncertainty in Moscow," *The National Interest*, December 24, 2008, <http://www.nationalinterest.org/Article.aspx?id=20468>.

considerably more economic engagement with the West than the boom did. In sharp contrast to the pre-crisis period, Russia may now need resources that only international, and particularly Western, investors, institutions and trading partners can provide. This is a potentially powerful incentive for pursuing greater cooperation. Three examples illustrate the point.

First, since its budget appears likely to run a large deficit this year, Moscow may need to turn to international lenders to shore up its fiscal position, especially if its stabilization funds and foreign currency reserves continue to be depleted at such a rapid clip. After having paid off virtually all its debts to other states and international financial institutions ahead of schedule in the first few years of this decade – a move intended both to prevent incoming oil and gas revenues from spurring inflation and to increase geopolitical freedom of maneuver – Russia could now once again turn to international markets and lenders for credits. According to the World Bank, Russia will be forced to do so if oil prices average below \$30 for the year.<sup>3</sup>

Second, Russia's stock market can only recover if foreign, and particularly Western, investors return.<sup>4</sup> The massive expansion of Russia's market over the course of the period from 1998 to mid-2008 was to a significant extent driven by Western investors. Many Russian firms held IPOs in London and New York, some listing directly on Western exchanges. After the "ring fence" that prevented foreigners from trading in its shares on the Russian market was lifted in December 2005 and the government consolidated its 51% stake, leaving the remainder to be purchased by private investors, Gazprom rapidly became one of the most desirable stocks in emerging markets. In May 2008, its market capitalization peaked at \$315 billion, making it the third largest company by market cap in the world. In this period, Russia was viewed as one of the most attractive emerging markets. Portfolio foreign investment stood at \$4.2 billion in 2007, a 31.8% increase from the previous year.<sup>5</sup>

The economic circumstances that allowed the Russian government to interfere in the market with impunity are long gone. In the context of the current economic crisis and the bottoming out of the RTS at around 500 points (compared to its high of approximately 2500 points in May 2008), Russia needs to attract foreign, and particularly Western, investors back to the market. Without a return of foreign capital, the Russian market is unlikely to recover in the medium term. Even if oil prices increase significantly, investors have little money to spend, and if Russia remains a risky investment they will be loath to spend it there.

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<sup>3</sup> "Vsemirnyi bank ponizhaet protsenty," *Vzglyad*, December 19, 2008, <http://vz.ru/economy/2008/12/19/240207.html>. Russian officials claim that their stabilization funds will be adequate to cover budgetary shortfalls for 2009-2011. Courtney Weaver, "Oil Funds Will Cover Shortfalls for 3 Years," *Moscow Times*, February 4, 2009, <http://www.moscowtimes.ru/article/600/42/374225.htm>.

<sup>4</sup> If oil prices remain low, domestic investors alone will be too cash-poor to return the market to its previous levels. Gaddy and Ickes, "Putin's Third Way."

<sup>5</sup> Interfax, February 2, 2008.

Third, Russian corporations and financial institutions need to refinance loans obtained from Western lenders. Russian firms obtained nearly \$500 billion in private credits in the years of plenty leading up to the crisis.<sup>6</sup> UBS estimates that around 40% of that went to the energy sector, mostly to Gazprom and Rosneft.<sup>7</sup> Western lenders competed fiercely with one another to finance Russian companies' rapid expansion, tempted by the impressive cash flows on their balance sheets.

When the value of collateralized assets sank as investors fled the Russian stock market over the summer of 2008, Russian companies scrambled to make their (dollar-denominated) repayment schedules. Credit dried up fast and margin calls on 10 of the 25 wealthiest owners of large private companies forced even more asset sell-offs. As one brokerage house put it, "Russia has a solvency problem. Simply put, in August Moscow was flooded with international bankers competing to provide funding to Russian entities. By October, the only financiers visiting were those trying to get their money back."<sup>8</sup> In addition to cash shortage problems, Russian corporations will face difficulties refinancing as a result of the global credit crunch. Russian firms have about \$130 billion in debt coming due in 2009, more than double the total owed by the governments and companies of Brazil, India and China combined.<sup>9</sup>

### **Domestic Economic and Political Impact of Downturn**

Evidence since the first oil crisis in 1973 also suggests that periods of low international oil prices and/or economic downturns in Russia correlate with greater incentives for structural economic reform and political pluralization. The crash of the oil price in 1986 took place shortly after Mikhail Gorbachev assumed leadership of the Soviet Union. The dramatic drop in hydrocarbon revenues starkly revealed all the structural deficiencies of the Soviet economy. The rapidly eroding balance sheet clearly made the imperative of reform far more urgent—it is hard to imagine that Gorbachev would have embarked on such a radical set of reforms absent impending sense of economic crisis.<sup>10</sup>

At least in the short-term, or however long this global recession lasts, the Russians will feel far more economically constrained than in the recent halcyon years. Even when global demand begins to recover, Russia will be competing for investment with all economies whose assets have dramatically declined in value, as opposed to ten years ago when Russia was more unique as a large emerging market with undervalued assets.

The second major difference the Russians will face is that for the near and mid-term, prospects for production growth of oil and gas resources are grim. Particularly in the oil sector after the financial crash in 1998, Russian oil companies, led by Yukos at the time, achieved remarkably rapid growth in

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<sup>6</sup> Gaddy and Ickes, "Putin's Third Way."

<sup>7</sup> Ben Aris, "RUSSIA 2009: Paused before a rally," *Business New Europe*, December 20, 2008, [http://www.businessneweurope.eu/story1414/RUSSIA\\_2009\\_paused\\_button\\_pushed](http://www.businessneweurope.eu/story1414/RUSSIA_2009_paused_button_pushed).

<sup>8</sup> Renaissance Capital, "2009 Outlook: What's Next," December 16, 2008, p. 8.

<sup>9</sup> World Bank, "Russia Economic Report," no. 17, November 2008, p. 15. <http://www.bloomberg.com/apps/news?pid=20601109&sid=aM71GKiXdzZ8&refer=home>

<sup>10</sup> Andrew C. Kuchins, *Alternative Futures for Russia to 2017*, (Washington DC: Center for Strategic and International Studies, 2007).



production with application of modern technologies to old Soviet wells. That feat cannot be repeated, and future production will have to come from new greenfields in geologically and climatically challenging conditions that could be the most expensive and complicated projects in history.

Russia has reached the end of the road in resource-based development and catch-up growth, but it remains only semi modernized and highly vulnerable to external circumstances beyond its control, primarily the oil price. About 85 percent of its exports are based on energy and commodities such as metals and chemicals. With the exception of the arms industry, Russia's manufacturing has largely failed to develop because of an adverse business climate (widespread corruption and onerous state intervention) and a lack of comparative advantages outside of the commodity sector.

The global financial crisis has hit Russia hard. As commodity prices have fallen sharply, the status quo is not a viable option. Russia cannot continue to depend to such an extent on its resource wealth, which is vulnerable to cycles of booms and busts. No other large emerging market or developed economy is so dependent on a single volatile factor (the oil price) as is Russia.

Sustaining economic growth for the country's increasingly prosperous population will have a direct influence on popular support for the government. A recent study by Daniel Treisman, a political scientist at UCLA, found that the popularity of Russian presidents "closely followed perceptions of economic performance, which, in turn, reflected objective economic indicators." Thus the presidential approval rating depends on the Russian people's sense of material well-being; "most other factors"—such as the war in Chechnya, in the case of Putin in 1999—"had only marginal, temporary effects."<sup>11</sup>

Russia faces two starkly different choices for its economy. One option is to continue the current course toward increased state control and renationalization, which would result in economic domination by large monopolistic state corporations. In that case, the country would have little need for the WTO and increasing isolationism would be the natural outcome. Russia's economic growth, however, would probably wither, because such a system breeds stagnation.

The alternative would be to return to the liberal economic reform agenda that Putin abandoned in 2003. Indeed, then-presidential candidate Dmitri Medvedev's February 15, 2008, speech in Krasnoyarsk called for the revival of such a program.<sup>12</sup> In his speech in Davos on January 28, 2009, Putin further stated: "The crisis has exposed the challenges we have. They are: an excessive orientation of exports towards natural resources and, of the economy as a whole, a weak financial market. There is a greater demand for the

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<sup>11</sup> Daniel Treisman, "The Popularity of Russian Presidents," presentation at the Frontiers of Political Economics conference, New Economic School, Moscow, May 30–31, 2008.

<sup>12</sup> Transcript of the speech of the first deputy chairman of the Government of Russia, Dmitri Medvedev, at the 5th Krasnoyarsk economic forum "Russia 2008-2020. Management of Growth", February 15, 2008. (Stenogramma vystupleniya Pervogo zamestitelia Predsedatelya Pravitelstva Rossiya Dmitriya Medvedeva na V Krasnoyarskom ekonomicheskome forume "Rossiya 2008-2020. Upravleniye rostom") Available at <http://www.rost.ru> (Accessed on February 9, 2009).

development of basic structures...”<sup>13</sup> Major elements of such a policy would be the control of corruption, deregulation of the domestic economy, and the reinforcement of private property rights. Such an economic choice would most likely accompany political liberalization and enhanced international integration.

### Whither Russia?

My view since the collapse of the Soviet Union has been and remains that in the long term, Russia’s strategic economic and security interests lie in closer partnership with the West—not to the exclusion of its important interests in constructive relations with China, India, Iran, and many other countries to its East and South. Historically, culturally, economically, demographically, Russia has and continues to lean strongly to its roots as a European great power.

Another telling data point from the Russia 2020 strategy supports this conclusion. Even in the best-case innovation scenario that calls for average 7% annual growth and a more diversified economy, Russia’s share of global GDP would rise from only 2.5% of global GDP today to about 4% in 2020. Russia will not have the financial or human resources to wage any kind of new Cold War and contest US power around the globe as it did for most of the second half of the last century. The Soviet Union’s excessive militarization of its economy and society to support its overreaching global confrontation with the United States was a major cause of its collapse, and this lesson is not lost on most of the current Russian elites. And it would also seem that Russia’s genuine security challenges are principally to its South in the form radical Islamic groups supporting terrorist and oppositionist activities in its neighborhood as well as in the Northern Caucasus, the most vulnerable and unstable region of Russia. Longer term, there is tremendous insecurity about the rapid rise of China to its East. Russia may not have been thrilled with the notion of “junior partnership” with Washington, but a subordinate role to Beijing is far less palatable.

So why have we failed to establish a firmer partnership with Russia over the past generation? There is lots of fault to go around, and certainly our own unipolar hubris in the wake of the great victory of the Cold War played a considerable role. As for Russia, while many observers have been quick to label Putin’s Russia as “neo-imperial,” fundamentally the Russians are still dealing with collapse of empire and post-imperial syndrome. The Soviet Union was the last empire to collapse, and like many empires before them, it will certainly take more than one generation for Russia to fully adapt to its post-imperial status. As then Deputy Secretary of State Strobe Talbott wisely advised more than a decade ago, we need to have “strategic patience” with Russia.

Russia’s heavy dependence on energy exports also contributes to its contradictory tendencies. For the last near decade, Russia has defied modernization theory in that its democratic institutions have weakened

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<sup>13</sup> “Putin’s Speech at Davos World Economic Forum,” *Russia Today*, January 28, 2009, [www.russiatoday.com/news](http://www.russiatoday.com/news) (accessed on February 2, 2009).



as its people have become considerably more prosperous. Social scientists point to a \$10,000/year income as the point at which most developing countries become more democratic. The oil and gas income dependency is probably the factor that makes Russia an outlier.

### **Caveats**

While I am reasonably confident about the broader framework of my argument, there are two important near-term caveats. First, there is the danger that the Kremlin may not be able to react quickly or effectively enough to the growing social and political impact of an extended downturn, especially if there is a second wave of dramatic difficulties this year or next. While one may fault the Russian leadership for being in denial for too long or spending too much of its reserves on defending the ruble, their response has been broadly in line with what other national governments are doing with stimulus packages and other measures, and some economic indicators such as the value of the ruble and the Russian stock market have stabilized. Still, there is considerable potential for greater hardship and social unrest that may invite a tougher crackdown in response that could be accompanied by greater international isolation. This would short-circuit any “reset button” in US-Russia relations for a time.

The second caveat concerns differences over our policies towards Russia’s near neighbors. While Russia has been harder hit than many developed and large emerging market economies, many of its neighbors have been harder hit which may be increasing Russia’s leverage with them. Already we see signs of this with Ukraine and Kyrgyzstan early this year. Tougher economic conditions may increase Moscow’s incentives to control oil and gas production and transport infrastructure with its neighbors. Conflict between Washington and Moscow over the post-Soviet space will likely continue to be the most volatile set of issues in the bilateral relationship as well as with and within Europe. We are unlikely to see European consensus over Russia policy any time soon.

### **Conclusion**

I believe we have an important opportunity to turn around US-Russian relations. Despite lingering revanchist tendencies, Moscow harbors powerful motivations to improve its ties with the United States and the West to both enhance its security and facilitate its economic development. Russian leaders wish to be seen in public on an equal footing with global leaders, especially the US president. Furthermore, and more importantly, they understand that Russia cannot afford to fall back into another long-term confrontation with the West: Integration with the West remains Russia’s best chance to develop and reach its ambitious target of becoming the fifth largest economy in the world by 2020.

For the United States, the motivation for closer cooperation with Russia is grounded in the reality that the world’s most pressing energy and security challenges cannot be addressed effectively without Moscow’s cooperation and trust. This is most obvious in the realm of nuclear nonproliferation and European security.

In conclusion, my final caveat is that rebuilding trust and reaching concrete agreements about cooperation will not be easy, and we must beware of overly high expectations lest we be disappointed as we were with

two previous opportunities to improve ties with Russia: after the collapse of the Soviet Union in 1991-92 and after 9/11 in 2001. The powerful Cold War legacies have now been overlaid with nearly two decades of mutual disappointment in Russia and the United States. Even in areas that we presumably share broadly common goals such as promoting nuclear security, stabilizing Afghanistan, restoring global economic growth and order, and expanding economic and trade ties, the going will be tough. Strong leadership and support in the Congress will be essential as well as firm presidential leadership supported by a well-organized bureaucracy in the executive branch.