Abstract:
Since the discovery of vast amounts of natural resources, especially energy resources, in Russia, Russian policy has changed in many respects. Russia has shaped its economic policy around the use and sale of energy resources, and has used its resource wealth to shape domestic and international policies. I argue that Russia’s current dependence on energy resources to support economic development and foreign policy positions may limit its future policy implications. This paper examines Russia’s unique political and economic situation with regard to energy.
Widespread energy dependence has come to characterize the modern world, creating an international community which is at the mercy of natural resource supplies and prices. Not only are states which rely upon energy imports to power their industrial, commercial and residential sectors dependent upon energy resources, but many of the nations which produce energy have become dependent upon energy markets as the backbones of their economies. Nations which fit into the latter category include Russia, Libya, Nigeria, Venezuela, and several Middle Eastern nations. While the level of dependence has differed from nation to nation, all of these nations have at some point in their recent history found that taking advantage of the large energy reserves available to them provided a successful way to jumpstart their economies and begin their transition into the developed world, a path along which many of them are still travelling. This thesis examines the efficacy of Russian dependence on energy resources as a source of long-term economic and foreign policy. I argue that Russia’s current dependence on energy resources to support economic development and foreign policy positions may limit its future policy options.

In order to examine the relationship between Russian energy and Russian economic and foreign policy it will first be helpful to develop a classification of Russia in terms of political and economic development. This classification will help to place Russia in context with other nations and allow for comparisons to other nations which have energy resources. Any discussion of a nation in the international community should be carried out with an understanding of the type of nation being discussed, such a classification helps to clarify the amount of influence and credibility the nation will
have relative to other nations. The classification of Russia will help to explain the differences between its relations with the Western world and its relations with its developing neighbors.

Next, I discuss Russia’s energy resource policies. First the domestic arena is examined with regard to Russia’s energy dependence. Discussion then moves on to listing factors that contribute to and arise from Russia’s energy dependence. These topics include institutional problems within Russian political and social structures, the complicated state-firm relationship between the Russian government and state-owned natural gas giant Gazprom, and the existence of a consumption subsidy system for natural gas sales within Russia. These issues are intricately related, with factors and problems arising from each directly affecting the others. The existence of widespread corruption and tendencies towards state control within Russian society and government directly relate to the control of Gazprom by the state and the intense regulation of energy prices and foreign investment. Similarly, government involvement in the energy markets through state-owned firms like Gazprom increase the likelihood that foreign investment will be stalled and that assistance in the form of tax-breaks and subsidies will be given to producers.

Finally, foreign policy will be taken into consideration. Russian foreign policy is a complex subject, so to look at it in a way which suggests that energy is the most important or influential factor in determining Russian foreign policy would be misleading, but an attempt will be made to look at Russian foreign policy in terms of Russia’s energy resource endowment and energy security concerns. Russia’s foreign
policy is examined by region, even though many policies and issues do overlap, and will focus on the three regions which have the most effect on, or interaction with, Russia’s energy policy - the Post-Soviet and Caspian Basin states, Western Europe, and Asia.

Russia: A Classification

In order successfully to consider the efficacy of Russian policy decisions it is necessary to define Russia’s position within the international community, a subject which has been contested by many scholars and experts. While Russians would like to consider their nation to be developed and stable, economic and political evidence would seem to dispute this image. Russia has yet to meet many of the criteria which are widely considered to be characteristic of political and economic development. In order to determine Russia’s development status, a set of guidelines must be developed.

Before getting into specific measures of development and political stability it is useful to look at a list of common characteristics of developing nations in order to see which are and are not applicable to Russia. In his introductory text on the economics of developing nations Michael Todaro finds that developing nations or economies are characterized by:

1. Low levels of living, characterized by low incomes, high inequality, poor health and inadequate education; 2. Low levels of productivity; 3. High rates of population growth and dependency burdens; 4. High and rising levels of unemployment and underemployment; 5. Substantial dependence on agricultural and primary producer exports; 6. Prevalence of imperfect markets and limited information; 7. Dominance, dependence and vulnerability in international relations

An examination of these characteristics reveals that many are applicable to Russia within the past decade. Although Russia’s position is now improving, the Russia of the 1990s was characterized by low standards of living; inadequate education and healthcare; high rates of unemployment; imperfect markets; and vulnerability in the international community following the collapse of the Soviet Union. Today’s Russia is still plagued by problems with its markets, including critical energy markets, dependency on energy exports, high inequality, with the lowest 10% of the population consuming less than 1.9% of national consumption, a high inflation rate of 11.8% in 2007 and the residual effects of some of the other characteristics. It is also important to note that several of these characteristics do not apply to the case of Russia. Most notably, Russia is far from having a high rate of population growth, in fact the population of Russia is diminishing due to the fact that the mortality rate is higher than the birth rate. Russia’s current rate of population growth is -0.484%, a bad sign for Russian labor markets in the long-run, although it may help to contain the unemployment problem as the current youth enter the work force. Education is less of a problem now than it was immediately after the fall of the Soviet Union, with the CIA World Factbook reporting that over 99% of citizens over the age of 15 can both read and write. With these characteristics outlined it is now possible to consider more concrete standards for determining the economic status of a nation.

In order to determine Russia’s economic status, standards described by Todaro will be utilized and considered with respect to data from outside sources. Todaro explains that economists have traditionally used development to refer to the “capacity
of a national government... to generate and sustain an annual increase in its gross national product (GNP).”² He goes on to explain that it is also common to look at increases in gross domestic product (GDP) or the rate of growth of per capita GNP to look at the ability of a nation to increase output more quickly than its population is growing. Growth rates of 5 to 7% have traditionally been associated with developing nations, particularly if the growth is following a period in which the economy was stagnant or static. According to statistics from the CIA Worldbook, in 2007 Russia achieved an 8.1% growth in GDP and a per capita GDP of $14,600, compared to the threshold for a developed nation, which is pegged at $10,000 per capita. Inflation rose to 11.9% in 2007, compared to 2006 when Russia was able to maintain an inflation rate of 9.7%, falling below 10% for the first time in the past ten years. The unemployment rate fell to 5.9%, although underemployment was still a considerable problem.³ While Russia has managed to keep up its GDP growth and has a per capita GDP which is within developed levels, the high rates of inflation and unemployment, especially considering the problem of underemployment and the fact that energy, metals and timber account for over 80% of Russian exports and 32% of government revenues, is troubling.

Finally, it is possible to look at the transition index used by the European Bank for Reconstruction and Development in order to determine the success that a nation has had in developing a free market economy. The EBRD ranks nations on a scale of 0 to 1, where 0 equals no market economy and 1 is a normal Western market economy. From 1992 to 1995 the EBRD ranked Russia between a 0.5 and 0.7, which is considered an

² Todaro, pg. 13.
intermediary market economy then in 1996, Russia was ranked at 0.7, a full-fledged market economy, and has fluctuated between 0.7 and 0.8 ever since. After considering all of these factors, with weight upon the growth in GDP, per capita GDP, and the level of freedom in the market economy, for the purposes of this paper, Russia will be considered as a nation characterized by a developed market economy. This classification is strongly qualified, however, by Russian dependence upon resource markets, the relatively closed status of Russian markets as noted by indices such as the Global Competitiveness Index and the Index of Economic Freedom (see Table 1 below), and the inflation and unemployment concerns noted above. Although Russia has been somewhat successful in economic development, there are still obstacles to be faced.

It is also possible to look at what are traditionally considered to be social and political measures of stability and development, although they certainly play into some economic measures as well. These indicators include the literacy rate, provision of housing and food, health conditions including the infant mortality rate, the Human Development Index, the Corruption Perception Index, and the Environmental Sustainability Index. Table 1 below lists Russia’s results from several of these indicators, which give a less-than-rosy perspective on the state of Russian economic and political freedoms.

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Table 1: Indices of Political and Economic Indicators

<table>
<thead>
<tr>
<th>INDEX/COMPARISON NAME</th>
<th>SCORE</th>
<th>SCALE</th>
<th>COUNTRY RANK</th>
<th># OF NATIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Index of Economic Freedom (The Heritage Foundation &amp; WSJ)</td>
<td>49.9</td>
<td>0 - 100 (100= max. free)</td>
<td>134</td>
<td>163</td>
</tr>
<tr>
<td>Global Competitiveness Index (World Economic Forum)</td>
<td>4.19</td>
<td>0 - 60 (60= max comp.)</td>
<td>58</td>
<td>131</td>
</tr>
<tr>
<td>Worldwide Governance Indicators-Regulatory Quality (Worldbank)</td>
<td>-0.45</td>
<td>-2.5 - +2.5</td>
<td>33.7 Percentile</td>
<td>100 Percentile</td>
</tr>
<tr>
<td>WGI- Political Stability (Worldbank)</td>
<td>-0.74</td>
<td>-2.5 - +2.5</td>
<td>23.6 Percentile</td>
<td>100 Percentile</td>
</tr>
<tr>
<td>WGI- Control of Corruption (Worldbank)</td>
<td>-0.76</td>
<td>-2.5 - +2.5</td>
<td>24.3 Percentile</td>
<td>100 Percentile</td>
</tr>
<tr>
<td>WGI- Government Effectiveness (Worldbank)</td>
<td>-0.43</td>
<td>-2.5 - +2.5</td>
<td>37.9 Percentile</td>
<td>100 Percentile</td>
</tr>
<tr>
<td>Corruption Perception Index (Transparency International)</td>
<td>2.1-2.6</td>
<td>0-10 (10= least corrupt)</td>
<td>143</td>
<td>180</td>
</tr>
<tr>
<td>Human Development Index (United Nations Development Program)</td>
<td>0.802</td>
<td>0-1 (1= most develop)</td>
<td>67</td>
<td>177</td>
</tr>
</tbody>
</table>

Both the Human Development Index and the Corruption Perception Index are indicators in which Russia does not fare well, scoring 67th out of 177 nations on the HDI in 2007, placing it within the high scoring range, but below nations including Croatia, Latvia, Bulgaria, the United Arab Emirates and Romania. Transparency International, a non-profit organization which commissions the Corruption Perception Index (CPI), found that in 2007 Russia scored between a 2.1 and 2.6 on a scale of 0-10, with 0 being most corrupt, ranking Russia at 143 out of 180 nations. Russia scored below both developed and developing nations on the CPI, including the United Kingdom, the United States, Latvia, Romania, Mexico and Saudi Arabia. Although the CPI only represents how

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corrupt the population perceives a nation to be, the score tends to be fairly representative of reality, as suggested by the similar results listed in Table 1 for the Worldwide Governance Indicators- Control of Corruption Index, and, especially when viewed in conjunction with other WGI indices, can be interpreted as evidence of political instability in Russia. Russia also scores within the ‘developing’ and ‘transitional’ ranges many other indicators, explaining why Russia has traditionally been categorized as a transitional democracy. Perhaps the biggest factor in this categorization is the lack of government transparency and widespread corruption since the fall of the Soviet Union.

Despite Russia’s desire to be seen as a member of the Western developed world, and despite the major strides which have been made to achieve competitive rates of GDP growth and economic freedom, much of the evidence is too contradictory and flimsy to be given too much weight. While Russia can be considered a developed market economy in terms of its rate of growth, the problems plaguing the freedom of its markets and the limited allowance of foreign investment tend to undermine this classification. Similarly, the corruption which characterizes the Russian government and the lack of government transparency in creating and implementing policy prevent Russia from being classified as a full fledged democracy and complicate Russia’s relations with the Western World. A further complication of Russia’s relations with the outside world, both economic and political, is the idea of Russian energy dependence. Russia has become dependent on energy for economic stability as well as for a source of negotiating and bargaining power in the international community. The ramifications of Russian energy dependence are examined below.
Energy Dependence: A Risky Game

Today’s Russia finds itself in a complex situation. Current energy prices and world energy demand are high enough to encourage Russian energy producers to focus on natural gas and oil production and for the government to allow energy to make up a large percentage of its revenue. But in the event that energy prices were to fall or the rest of the world were to turn to an alternative and more sustainable form of energy, the Russian economy would find itself in a downward spiral which would be almost impossible to prevent or reverse. The technology exists to make this transition, as evidenced by Brazilian success in reducing oil dependence, it would only be a matter of adapting and implementing the technology and expanding production of sustainable fuels like those developed from switch grass and sugar cane. Unfortunately for Russia, the ability to transform existing industries to an alternative fuel is likely to be achievable much more quickly than the creation or resurrection of industry in Russia. Currently, Russia finds itself in a position where over 80 percent of its export activity can be characterized as resource-based, consisting of natural gas and oil along with some timber and metals exports. These same resources account for 32 percent of government revenue.8

Russian preference for producing oil and natural gas over manufacturing labor intensive goods can be explained relatively simply through the use of basic international trade theory. One of the most basic theories of economic behavior is the idea of comparative advantage, whereby an entity produces the good which it can produce at a

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lower opportunity cost relative to other members of its market. In international trade theory, this condition is expressed through the Heckscher-Ohlin Theory, which states that a nation will have a comparative advantage in and export the good that uses the country’s abundant factor of production (capital, labor, natural resources, etc.) intensively. In the case of Russia, the abundant factor of production is comprised of natural resources, particularly energy resources. This relationship can be more completely explained by the Rybczynski Theory, which states that at a constant relative price ratio for goods, an increase in the endowment of one of the factors of production causes an increase in the production of the good that uses that factor intensively and causes a decrease in the production of the other good.

Although the theory is expressed in simple terms, as if it were possible to assume that a nation would only be producing two goods between which it could shift production, the Rybczynski Theory is a good explanation of the decision made during the era of the Soviet Union to shift the focus of the Soviet economy from labor intensive goods such as manufactured and agricultural products to energy. The discovery of vast supplies of energy resources throughout the Soviet Union and its territories, given the rapidly growing international demand for energy, posed a very lucrative opportunity for the Soviet economy and government. During the era of Soviet central planning this transformation of the economy did not require the interest of independent firms, rather the government was able to develop plans for an energy infrastructure and then had only to move labor from previous markets to the construction of infrastructure and later to the extraction and refining of oil and natural gas.
In this sense, the current state of energy dependence in Russia is simply a residual of the energy resource endowment discovered during the Soviet Union. The Rybczynski Theory is sometimes referred to as Dutch Disease, and is also used to describe the idea of a “resource curse.” The term Dutch Disease refers to the discovery of offshore natural gas in the Netherlands during the 1970s, around the same time that energy resources were being discovered in the Soviet Union. In the Netherlands, the discovery and extraction of these resources attracted resources which had previously been employed in the production of other goods, leading to a decline in some other industries. The problem continued to deepen as the natural gas market grew and world demand increased, making it more difficult for other industries to attract capital and resources. As the production of other goods fell, the Netherlands found itself increasingly dependent upon natural gas and at greater risk in the event of a fall in price or demand. The situation in the Netherlands closely parallels that in Russia, where the discovery of energy resources shifted resources from manufacturing industries to the energy markets. The attempts by the Russian government to keep industry alive, as described previously, have only exacerbated the dependence situation.

While it would be in Russia’s best interests to continue to fast track further industrialization, the Heckscher-Ohlin and Rybczynski Theories explain why acceleration is not likely. Russia still has a comparative advantage in energy resources over the majority of the world and a considerable endowment of energy resources, it is unlikely that any significant shifts away from energy as a primary source of GDP will take place before depletion is within sight. The lifespan of Russian energy resources is unknown,
with estimates for the lifespan of known and accessible crude oil reserves to production ratio ranging from 20 to 30 years and estimates ranging from 70 to 90 years for accessible natural gas, without consideration of additional reserves yet to be found. In this light, it is possible that Russian policy could favor energy over industry for many years to come, making the potential for price and demand related crises even greater.

The current level of dependence upon energy resources in Russia makes it important that Russia continue to diversify its economy. Anders Aslund points out several positive signs that the Russian economy is beginning to diversify sufficiently, primarily that Russian “GDP is increasing by almost 7 percent a year, while the value of Russian energy produced has increased by 1 to 2 percent a year since 2005,” indicating that other industries are beginning to account for larger portions of Russian GDP. This analysis is most likely accurate, because while energy prices on the world markets are high, in which case a 1 to 2 percent increase could mean a large chunk of Russian GDP, Russian domestic energy prices are low enough to counter much of the effect of export revenue. This trend is a good sign for the future of Russia’s economy, but must continue in order for Russia to reach the level of other developed nations.

The growth of Russian GDP as the result of industries other than energy may signal the beginning of the end for Russia’s resource curse. While energy resources still make up a large portion of GDP, other industries are beginning to come into their own and attract the resources necessary to stimulate growth. As alluded to above, at the current international prices natural gas and oil have the potential to bring in enormous

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9 Aslund, pg. 265.
amounts of revenue, but the low price of natural gas within Russia, as will be discussed below, tends to negate the export revenue. Since Russia has been dependent upon energy resources to stimulate economic growth in the past, it is a positive sign that nearly one quarter of Russia’s economic growth can be accounted for by diversification of capital into what were most likely under-invested industries.

The most dangerous aspect of Russian dependence upon energy resources for such large portions of its GDP and government revenue is the potential for volatility within energy markets. Energy markets can be volatile for many reasons, the most dangerous of which for Russia would be a fall in price like that of the 1980s, or a drop in international demand, which would in turn cause international prices to fall. It is interesting that Russia chose to remain dependent upon energy resources following the fall of the Soviet Union, given the price war which the Soviet Union suffered through in the 1980s. There are multiple possible explanations for this fall in oil price, the most realistic of which is that the discovery of new oil resources in non-OPEC nations following the oil crises of the 1970s caused an exponential increase in the production of oil, forcing the price down. An alternative argument claims that Middle Eastern nations increased their production of oil during this period, as discussed by Kenneth Deffeyes,\(^\text{10}\) which pushed down the price of oil and lowered oil revenue for other nations. Data provided by the U.S. Energy Information Administration proves that total OPEC production fell steadily from 30.58 million barrels of oil per day in 1979 all the way to

\(^{10}\) Kenneth Deffeyes. *Beyond Oil: The View from Hubbert’s Peak.* (New York: Hill and Wang, 2005.)
16.18 in 1985,\textsuperscript{11} as OPEC nations attempted to lower production and push up the price, so as to increase oil revenue. This data supports the original theory of the fall in prices, and seems to indicate that while certain OPEC producers may have attempted to increase production significantly, the general OPEC consensus was to attempt to raise price. Regardless of the explanation behind the price drop, the price of oil happened to fall below the marginal cost of production for the Soviet Union, and the nation suffered in terms of lost GDP and government revenue for several years before prices stabilized. Although the price war was not successful in forcing the Soviet Union out of the energy industry, some experts have attempted to list the energy crisis as a causal factor in the fall of the Soviet Union.\textsuperscript{12} Regardless of the reality of this relationship between the energy crisis and the fall of the Soviet Union, the price drop and the resulting economic shock should have had a significant impact on Russian energy policy.

One of the most interesting results of this drop in price is the fact that Russia, as the successor to the Soviet Union, chose to continue a pattern of energy preference in light of this crisis, perhaps yet another testament to the power of the factor endowment theories discussed previously. Given the current price level, which has risen from $30/barrel of oil in 2005 to approximately $100/barrel in early 2008, it is unlikely that any nation, Middle Eastern or otherwise, would be willing to forego such enormous revenue in order to force other nations from the market, but during the 1990s when

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Russia was reorganizing and restructuring itself, such a crisis could have been a possibility.

The second danger listed above deals with changes in the international demand for energy which would affect the price of energy resources. These two dangers, both of which deal with a drop in price, are closely related, but the causal factors between the falls in price are key. While a dramatic fall in demand is not likely in the short-run, Russia must face the possibility that its trading partners may soon begin to follow the example of Brazil and begin to develop and utilize more sustainable energy sources. In fact, in 2006 the European Union announced its unwillingness to remain dependent upon Russian energy supplies in the long-run. An editorial in the European economic journal *Euromoney* put this sentiment into words, saying that

Western Europe’s strategy is therefore two-pronged: active measures to reduce energy dependency, coupled with political measures designed to tell Moscow that the more it tries to put the squeeze on the West, the higher the price Moscow itself will have to pay for this.13

For many reasons, Western Europe has decided that remaining dependent upon a nation which has acted without concern for the input and reactions of its trading partners in the past, as was the case with the Ukrainian conflict in 2004 (discussed below), is an undesirable situation. The same article went on to mention the debates going on in several nations regarding the feasibility of turning to nuclear or other energy sources.14 While these are not solutions which will have an effect in the short run, Western nations have considered political actions to encourage Russia to back down its

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14 *Euromoney*
energy-related agenda. Western nations did, in fact, place troops within Georgia and Azerbaijan, a natural gas transit country and producer respectively, in order to prevent Russian pressure from causing their collapse (although the troops in Georgia are now being withdrawn), and the United States even began to consider the possibility of admitting Ukraine as a NATO member.\textsuperscript{15} While these policies may serve to constrain Russian influence and force Russia to consider its own dependence on energy resources, it would also cause great tension between Russia and the West by effectively ending Russian power in nations which it still considers to be within its sphere of influence.

The fact that natural resources account for such a large portion of government revenue is also troubling, but only in light of a potential drop in world energy prices as discussed above. While the CIA, as mentioned above, lists natural resources as accounting for 32 percent of government revenue, the World Bank in 2004 found that energy alone accounted for 63 percent of Russian exports and about 50 percent of government revenue, explained by the fact that the marginal tax rate on oil in 2005 was 88 percent.\textsuperscript{16} As Aslund points out, this overdependence on oil tax revenue not only places Russian state finances in danger in the event of a fall in oil prices, but it also deters energy, particularly oil, companies from investing in further production and development and prevents the government from paying sufficient attention from other sectors of the economy because it is primarily funded by energy revenues. Gazprom is subject to different government relations, as a result of its status as a primarily state-owned entity and due to the tax breaks which it receives from the government for

\textsuperscript{15} Euromoney
\textsuperscript{16} Aslund pg. 271
providing domestic energy at low costs. Russia has attempted to make up for the 
dependence of the Russian government upon such a volatile source of revenue through 
its creation of the Stabilization Fund, a device which has been very successful thus far. 
The Stabilization Fund is the Russian version of a rainy day fund, and with any luck it will 
prove sufficient to bail the Russian government out of a repeat of the 1980 price crisis. 
The Stabilization Fund will continue to grow as long as Russia produces energy, 
furthering the ability of Russia to bail itself out of trouble.

Russian energy policy poses many questions for the future of the nation’s 
economy, including, for how long is it optimal or viable for Russia to remain so reliant 
upon energy resources? This question is not meant to suggest that Russia should 
abandon its pursuit of energy revenue, but only that in a world which is evolving 
towards alternative fuel sources, it is vital that Russia develop its other industries to the 
point where they comprise the bulk of Russian economic strength. In this way Russia 
will find itself prepared for either of two eventualities: the day when non-sustainable 
fuels are no longer needed or the day when the depletion of the Russian energy 
endowment is realized.

In order to further examine the efficacy of Russian energy policy it is necessary 
to look more carefully at some of the factors which have influenced the situation of 
energy dependence which Russia finds itself in now and at some of the policies which 
have arisen from such dependence. The factors considered will include the role of 
corruption in increasing government control of energy resources and the role of energy 
resources in encouraging further corrupt activities; the role of the state-owned natural
gas company Gazprom and its relationship to the state via Russia’s ‘virtual economy’; and the government regulated pricing of domestic natural gas sales through subsidies, and tax breaks.

**Domestic Policy Crisis**

Within the domestic arena, Russia has made many policy decisions and has numerous problems which may need to be addressed before the nation can reach its true potential. These problems include a lack of efficient and transparent democracy, as exemplified by the Corruption Perceptions Index, the existence of a state owned monopoly which tends to exclude outside firms and investment (Gazprom), the Russian ‘virtual economy’, and a dual pricing scheme which has resulted in Russian domestic energy prices that are lower than both the international price and the marginal cost of production.

**Institutional Dilemma**

In recent years domestic policy in Russia has begun to raise eyebrows regarding just how free from influence and corruption the decision making process in Russia truly is. The Putin era has added fuel to the fire, with the most recent controversy being the likely appointment of President Vladimir Putin as Prime Minister after the presidency is handed down to a handpicked protégé, Dmitri Medvedev. The amount of influence which Putin and certain special interest groups, especially energy and manufacturing entities, have in the government and the amount of control which the government has
over the media has raised eyebrows and caused many observers to question the transparency of the Russian government.

As mentioned previously, Russia ranks quite low each year in terms of the Corruption Perceptions Index, but a perception of corruption alone is not proof that democracy has failed in Russia. Anders Aslund, in an attempt to explore why capitalism seems to be thriving in Russia while democracy is not, uses the Freedom House ratings of democracy, defined as civil and political rights. He finds that Freedom House has rated the degree of freedom in Russia as having fallen from ‘partially free’ in 1992 and 1993 to ‘not free’ in 2004 through the present. Similarly, the Worldwide Governance Indicators, referred to above and listed in Table 1, rank Russia consistently within the lower percentiles of the international community, with no indicator, of political or economic basis, reaching higher than the 34th percentile. This decline in the degree of democracy or freedom in Russia, and consistently low ranking in numerous other indices, has led Aslund and other scholars to begin classifying Russia as being in a state of ‘mild authoritarianism.’ Given the apparently backward progress of Russian democracy, this classification may be justified.

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17 Aslund, pg. 278.
18 It is interesting here to note that much research has been done on democratization which could be applicable but will not be discussed in depth here. There are two distinct schools of thought regarding Russian democratization, one of which takes the pessimistic point of view that Russia has been moving steadily backwards in terms of democracy since the fall of the Soviet Union, and the second taking a more hopeful perspective in assuming that Russian institutions and policies are still in a state of transition and that policymakers will eventually be able to contain the influence of outside participants and control corruption, allowing stable democratic institutions and processes to take root. It is also often accepted that one precursor to stable democracy is a settled and stable free market, which is still developing in Russia. Anders Aslund is only one author to discuss the subject of Russian democracy, and there are certainly a number of scholars who would take issue with his conclusion that democracy has failed in Russia. It is also interesting to note that a 2005 work by Steven Fish names the existence of oil reserves in Russia as one of the three most significant factors leading to the backtracking of Russian democracy,
The consequences of such corruption and ‘authoritarianism’ on Russia’s political, social, and economic life is nearly immeasurable. Corruption in Russia has become widespread, with many officials and politicians demanding and receiving bribes as payment for their services or support. This is especially apparent when politicians or producers are involved. The influence of an interest group in the Russian legislature can be seen as being closely linked to the group’s ability to provide perks or support for legislators. There have been arguments made which would tie the existence of corruption to the Russian energy endowment. In 2005 a political scientist named Steven Fish argued that the presence of energy resources under the control of the state encouraged corruption among government officials because energy tends to be such a valuable commodity, and officials have been able to make profit off of the desire by firms and individuals to invest in and profit from these resources. Fish also argues that the existence of such a valuable and vast resource base masked “the need for industrialization and development in other sectors of the Russian economy,”19 essentially the same argument as was made previously during the discussion of the Rybczynski Theory and Russian energy dependence.

The problem of corruption is one which has become deeply entrenched within Russian political life and social structure, and it will take a lot for the Russian political

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19 Aslund, pg. 271.
structure to move away from such a widespread tendency. If Fish’s argument that corruption has been in part caused by the state control of energy resources, then one option at the disposal of the Russian government to control corruption may be to begin the privatization of state-owned energy enterprises like Gazprom and Rosneft. In fact, such privatization has already begun within the Russian electricity industry, with the *New York Times* reporting that the process for the privatization of United Energy Systems (UES), the state-owned electricity giant is almost complete.\textsuperscript{20} In light of such discussion of the impact of state-owned energy industries upon the political and social institutions in Russia, it is logical to now introduce a discussion of Gazprom in order to explain its relationship to the Russian government. As this discussion develops it is important to note that a similar relationship exists between the Russian government and Rosneft, the state-owned oil giant, and at least until recently a nearly identical relationship existed with respect to UES.

Gazprom: A State-Controlled Monopoly

Despite Russian attempts to develop a strong, liberal market economy since the fall of the Soviet Union in the 1990’s, Russia’s largest markets remain under the control of state-owned companies. In 2006 the *International Herald Tribune* reported that the Russian parliament had “passed a law that grants exclusive rights to export natural gas”

to Gazprom. Already the world’s largest gas company, this law was proof of Russian intentions to maintain control over their energy markets. Although the law has not been as successful as Gazprom may have hoped in terms of making it the only firm with export rights, the close relationship between Gazprom and the Russian government was made quite apparent. While European nations have attempted to accept the power of the state-owned entity, relations with the United States regarding Russia’s energy sector have been strained, with the Bush administration repeatedly attempting to pressure the Russian government to open the energy market to competition. A member of the pro-Kremlin United Russia Party was quoted as having told the media that “when one efficient operator is appointed, the state will keep the situation under control... Private-sector development...would ‘destabilize’ Russian energy export markets.” It is not obvious though that the current situation in Russia is stable or under control. In fact, it can be argued that the domestic market is inefficiently priced and produced, while export markets are used as a foreign policy instrument.

Following the fall of the Soviet Union, the natural gas and oil industries in Russia were separate, with the entire natural gas industry being controlled by Gazprom. The oil industry on the other hand was comprised of thirteen companies, which eventually merged and privatized into eight. Because the two industries were so separate organizationally, the oil companies were not able to do anything but burn natural gas which they encountered in the process of drilling for oil, and it wasn’t until Gazprom

22 Kramer
proved to be incapable of producing enough natural gas that oil companies and independent natural gas companies were allowed to enter the industry. Even after the introduction of independent producers Gazprom continues to produce a dominant percentage of Russia’s natural gas, claiming 87.22% of the market in 2004.23

Gazprom’s large share of the market, in conjunction with government support and shaping of its policies, make it a virtual monopoly, and it has done everything possible to maintain that position of power. A monopoly is generally characterized as a single firm market, where the single firm has influence over the price and the ability to keep competition from entering its market. Although Gazprom is no longer the only firm in the Russian natural gas market, its large market share means that it continues to have the power to dictate price to other firms, and its connection with the government has proven useful in the prevention of investment projects by independent companies. These factors will be used to justify the classification and discussion of Gazprom as a monopoly throughout the remainder of this paper.

Gazprom has used its relationship with the Russian government several times to attempt to prevent investments planned by foreign investors, or to shape the project in such a way that it would benefit Gazprom economically. In the fall of 2006, the progress of a Royal Dutch Shell project off the coast of Eastern Siberia was threatened by the Russian government for ‘environmental shortcomings.’ Gazprom was reported to be interested in the progress, attempting to negotiate for 25 percent of the consortium and a blocking vote on the board. A New York Times article on the conflict quoted the

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23 Information for historical overview courtesy of Russian Analytical Digest 1 (June 2006): 8.
research director for Russian and Caspian energy at Cambridge Energy Research Associates as saying “It looks like Shell received an invitation to the negotiating table, under the point of a gun.”\textsuperscript{24} This conflict, along with similar ones, between Gazprom and the Russian government, on the one hand, and foreign investors, on the other, has served to create tension between companies and nations which would be interested in investing in Russian energy infrastructure.

Similarly, Gazprom’s tendency to turn toward the government in order to resolve problems of natural gas debt, and the seemingly political decision to cut off gas shipments to Ukraine in January 2006 in order to compel payment have raised questions within the international community, especially Europe, which relies on Russia for about one quarter of its natural gas imports, regarding the reliability of Russia and Gazprom as an energy supplier. While these international conflicts will be considered in depth during the regional examination of Russian foreign relations, the close relationship between the government and the leadership of Gazprom only adds to the distrust of Russian energy supply by Western nations. Russia has not yet found its way back onto solid ground in terms of relations with the rest of the world in many ways, and its somewhat unpredictable policies make the rest of the world view it as a risk in terms of being a trading partner.

Aleksei Salmin rather succinctly explained the state-producer relationship in Russia when he wrote that “despite the seeming disagreements between the largest Russian energy-producing corporations and the state, the corporations have, in reality,

\textsuperscript{24}Andrew E. Kramer. “Gazprom Reaps the Benefit of Friends in the Kremlin.” \textit{The International Herald Tribune}. September 22, 2006.
become one of the most efficient instruments of Russian foreign policy.”\textsuperscript{25} Russia is certainly not the first nation to run state-owned or controlled energy corporations, although the closeness between the government and the board of directors, which has a deputy prime minister as its chairman and numerous other government officials sitting on the board, is often seen in the West as limiting the potential of the firm to act in a way which would be economically efficient in terms of price and quantity of production and supply.

There is also another way to consider the relationship between Gazprom, and other state-owned industries, and the Russian government. The idea of Russia's ‘virtual economy’ was developed by Clifford G. Gaddy and Barry W. Ickes in a book published in 2002. Gaddy and Ickes define their ‘virtual economy’ as the “outcome of agents’ adapting their behavior to an environment that threatens their survival.”\textsuperscript{26} What Gaddy and Ickes are trying to explain is the fact that many of the heavy industries of the Soviet Union failed to act in a way predicted by economic theory. In effect, after the fall of the Soviet Union, these industries failed to adjust in order to become compatible with a liberal market economy. Instead, these industries maintained the majority of their structure from the centrally planned Soviet economy. Unfortunately for Russia, a lack of interest in investment in industry, for reasons which could be associated with the resource curse examined previously, whereby a large endowment in one factor of production attracts the investment which was previously associated with industries


which are intensive in other factors of production, prevented the development of these industries into new efficient market entities.

Instead of finding ways to reallocate capital to these industries in order to make them more efficient and capable of functioning in a market economy, the Russian government assisted these industries in creating their ‘virtual economy.’ The industries involved in this ‘virtual economy’ have, generally speaking, degenerated into mere shadows of the manufacturing powerhouses that they were during the Soviet Union, primarily as a result of lack of investment. It is possible to travel through Russia and see old warehouses and manufacturing plants which have been turned into greenhouses which now specialize in growing mushrooms and vegetables. These industries have devolved to the point of almost complete inefficiency, but the Russians have developed a system to keep them functional so as not to lose the jobs which they provide.

The system which was developed by the Russians and explained by Gaddy and Ickes consists of three primary entities: the largely state-owned energy and railroad companies which Gaddy and Ickes name the ‘Fat Boys’; the industries in need of life support; and the Russian government. In order to keep the industries alive, the Russian government developed a system of tax breaks and subsidies intended to entice the Fat Boys to provide energy and transportation to the failing industries at a price low enough that they could afford it. One such subsidy is the granting of access to foreign markets, rather than a direct cash transfer. The tax breaks and subsidies were intended to cover the lost revenue costs of the Fat Boys, and although the incentives were not able to cover the complete cost of the lower price, it was close enough that when combined
with pressure from the state, the majority shareholder for all of the Fat Boys (primarily Gazprom, the railroads and UES, although the upcoming privatization of UES will complicate the ‘virtual economy’ relationship considerably), the Fat Boys agreed to play by the new rules. In return for the cheap energy and transportation that the floundering industries receive, they provide much needed jobs to the Russian citizenry, as well as providing cheap goods to the Russian government and sometimes providing public goods such as schools to their local communities. This relationship is summed up in Figure 1 below.

The Russian ‘virtual economy’ can be viewed as a form of market failure. Not only is the Russian government implementing tax breaks and subsidies to lower the price of domestic energy and transportation, but the problem is exacerbated by the fact that the lower prices are being utilized to support industries which are failing and which would be better off if left to market forces, which would either attract investment to renew the industries or allow them to collapse and be replaced by more efficient industries. By using access to foreign markets as a form of subsidy, Russia has further complicated the problem by giving the government even more control over the market and making Russian energy firms less profitable than their foreign counterparts, because the profits which foreign energy producers are able to count as pure revenue must be used by Russian firms to cover for the profits that they lose in domestic transactions.
In summary, there are two ways in which the relationship between Gazprom and the Russian government can be considered. First is the more traditional approach, Gazprom as a monopoly, a majority of which happens to be owned by the state, second is the ‘virtual economy’ approach, wherein Gazprom is not simply a monopoly which happens to be owned by the state, but where Gazprom is also a major player in a scheme devised by the Russian government to keep failing industries alive to preserve jobs. In either scenario, Gazprom and the other state-owned energy corporation play a large role in the domestic and foreign policy of Russia, with the ability to prevent foreign investment, influence price, and to sustain or allow industries to fail. In the next section the phenomenon of Russian domestic energy pricing will be explored. The fact that lower energy prices are charged in Russia is addressed explicitly in the ‘virtual economy’
model, however in the original model where Gazprom is simply a monopoly there is no assumption of lower prices. This is because the charging of lower domestic prices is not a natural product of the model, rather it is the result of a combination of political factors, which will now be explored in depth.

A Dual Pricing Scheme for Natural Gas

Traditional macroeconomic theory suggests that when a nation opens itself up to international trade, domestic prices for goods will rise to the international price level. There are instances in which this does not happen, however, and these instances are generally considered to be a form of market failure and are widely criticized by the majority of the international community. These discrepancies between the international and domestic price can be generically categorized as dual pricing schemes, more specifically these schemes include subsidies: import, export or consumption; tariffs; and taxes or tax breaks, among others.

The subject of Russian dual pricing has become a controversial subject in light of Russia’s desire to become a World Trade Organization member country. Many current member countries argue that the dual pricing scheme is a form of an export subsidy for Russian energy exporters, a policy which would further prevent Russian accession to the WTO. Russian officials have countered this argument by stating that “dual energy pricing is an export subsidy only if the energy embodied in exported goods is priced

lower than domestic energy.” As the Russian officials are quick to point out, this is not the case. Russian exporters are charging a higher price for their exports, rather than receiving an export subsidy it could be argued that domestic consumers are receiving a subsidy for the energy that they consume. As David Tarr and Peter Thomson of the World Bank explain in their article exploring the merits of dual pricing, while subsidies to particular industries are forbidden by WTO policy, there is no explicit rule which forbids dual pricing on such a large scale. In other words, although Russian energy producers had to cease charging fertilizer producers lower prices for energy, effectively creating a consumption subsidy for fertilizer producers, the WTO does not explicitly forbid Russia from charging lower prices to all consumers of natural gas.

If the objections made by Russian officials are ignored, however, and the policies are looked at through the lens of economic theory, the policies seem to reflect a form of a consumption subsidy. Consumption subsidies, as defined by Michael Todaro, are “direct government policies to keep the price of essential [goods] low.” Consumption subsidies are commonly seen in developing and transitional economies where the government is attempting to keep the prices of food within the reach of its population. The Russian policies for keeping energy prices low fit into this category, as Daniel Dudek, Alexander Golub and Elena Strukova explain in their article exploring the dual pricing policy in Russia. Dudek, et al., quote a study conducted by the OECD between 1996 and 1998 in which “energy subsidies were defined as any policy or measure that keeps the

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28 Tarr, pg. 1176.
29 Todaro, pg. 175
price of energy below the market level." The authors also relate Russian policy to the classification of subsidies published in 2000 by Von Moltke et al., saying that Russian policies have fallen within two categories, which include:

- energy-related services provided by the government at less than full cost—a direct investment in energy infrastructure; and...
- the regulation of the energy sector—demand guarantees, price controls, and market access restrictions (Von Moltke, p. 24).

The subsidies which have been put in place by the Russian government have lowered the price of Russian natural gas to the point that in 2003, the cost of natural gas in Germany was over five times higher than the same gas in Russia. Not only are Russian prices much lower than the price of natural gas on the world market, but the price is also lower than the marginal cost of producing and transporting the gas, in both the short-run and the long-run as will be illustrated below.

The consequences of setting price below marginal cost are more severe than they may seem at first glance. Generally speaking, a low price would lead producers to supply less of a good, but in this case the government is providing a consumption subsidy in the form of tax breaks (as described in the discussion of Gaddy and Ickes’ ‘virtual economy’ above) to the gas companies in order to keep prices low in conjunction with regulations regarding how high price may rise. This inefficiency is not mitigated by the supply of enough gas to reach the demand curve, not only are producers of natural gas failing to cover their costs, but there is also still huge shortage.

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31 Dudek pg. 1660
32 Tarr pg. 1180.
in supply. The inefficiencies created by this relationship will now be explored in greater detail.

Some of the explanations which are commonly given to explain this discrepancy in pricing are not quite sufficient to offset the economic problems which are caused by such a policy. While some have argued that the explanation lies in the fact that Gazprom acts as a monopolist in the Russian energy markets and is therefore able to price its products as it wishes, this argument has no basis in economic theory. Even a monopoly has as its primary goal the maximization of profit. Figure 2 below compares the graphical representation of a typical monopoly to that of a firm acting in the manner of Gazprom through the depiction of the demand, marginal revenue and marginal cost curves for a monopoly. As illustrated below, the typical monopoly produces the quantity at which marginal cost is equal to marginal revenue (Qm), and it sets price where that quantity is located on the demand curve (Pm). In this way the monopoly is able to maximize its total profit and it charges the highest price that the market is willing to pay, not simply whatever price it wants to charge. Gazprom is represented by the points PG and QG on the graph, it seems clear that Gazprom is setting price at whatever point the government leads it to through the consumption subsidies, whether those subsidies, made up of tax breaks and access to foreign markets, are able to completely cover the difference between marginal cost and domestic price is unclear. The Russian allowance of access to foreign markets as a subsidy can be viewed as making up for the remainder of this difference, but it must be remembered that there is still a loss of revenue between what Gazprom could have earned at Pm and what it will earn,
essentially meaning that there is an opportunity cost of the ‘virtual economy’ system. Some commentators have suggested that the tax breaks which have been made public do not appear to cover this difference, and that Gazprom may be relying on the additional revenue which they receive in the international market, which would be similar to that of a typical monopoly, to cover the additional costs of domestic production.

Figure 2

Gazprom’s actions in the domestic market simply cannot be explained by the theories of monopoly. Gazprom has been consistently charging a price for natural gas in Russia which is not only below the price which consumers would be willing to pay, but which is also below the marginal cost of producing that quantity of natural gas. Gazprom is not seeking to maximize profit, the primary goal of a firm, or even to cover its costs, rather it appears to be attempting to maximize the volume of its sales-
although it has not expanded its production to the level which demand would sustain at the subsidy price. Price is determined not by demand or marginal cost, in fact the price which Russia charged for natural gas in 2003 was less than half of the marginal cost of production, the only explanation for which are the regulations and subsidies which have been imposed by the Russian government. Economic theory is not able to explain the reasoning behind such high consumption subsidies for natural gas, it can only explain the effect and potential dangers of such policies on the energy market. Any realistic explanation of these policies must be based in the politics behind the government’s choice to institute such subsidies.

There are two dominant theories regarding the reasoning behind the Russian consumption subsidies for natural gas. The first theory, developed by Gaddy and Ickes and described during the description of Gazprom, explains the tax breaks which comprise the structure of the subsidies as being a part of a cycle which hopes to sustain industries which are viewed as necessary because they provide jobs to Russia’s unemployed. The second theory was developed in a 2005 article by three economists, Dudek, Golub and Strukova. While Tarr and Thomsen had brushed upon the idea of promoting natural gas over the burning of coal as one objective of the dual pricing policy, Dudek, et al., spent a large portion of their paper explaining what they term Russia’s ‘gasification policy.’ They explain that the Russian policy of promoting the use of natural gas over the burning of coal for environmental purposes began in the 1970s and has continued since, stemming from Russian social concerns over the dangerous air quality in many Russian regions which resulted from the burning of coal. Dudek, et al.,
conclude that “it becomes clear that gasification is an explicit social policy undertaken in Russia... designed to address a number of social issues, including environmental considerations.”

Despite their acceptance of Russian gasification policy, Dudek, et al., come to a conclusion which is similar to that of Tarr, Thomsen and other experts on the subject, that Russian natural gas prices must rise. Given conventional theory which would suggest that a cleaner and more efficient fuel should cost more than a ‘dirty’ fuel such as coal; the fact that Russia’s growing market economy and supposed dedication to the ideals of free trade; and the slow but steady introduction of natural gas producers more independent than Gazprom which would like to charge higher prices, it is inevitable that natural gas prices should continue to rise at least until they reach the point of covering the marginal costs of production.

In order to justify the discontinuation of such consumption subsidies Russia could consider other forms of gasification policies, such as placing taxes on the use of ‘dirty’ fuels such as coal which inhibit the use of coal without requiring the use of consumption subsidies and regulations to keep natural gas prices so low. There are also better ways to encourage the creation of jobs and development of industry than to subsidize cheap energy sales to and give tax breaks to inefficient remnant firms from the Soviet era. It is not that Russia is the only nation which charges a different price for domestic natural gas than for that which it exports, but that Russia is currently one of the few nations where the discrepancy is so large. The elimination of such subsidies

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33 Dudek pg. 1664
34 Dudek pg. 1663, 1665
would help to stem objections to Russian ascension to the WTO and allow for easier integration of the Russian economy into world markets, as well as helping Russia to achieve the image that it desires as a stable and reliable trading partner.

In international relations theory, it has long been accepted that domestic policy and foreign policy are interrelated, in fact that foreign policy may stem directly from domestic policies. This relationship has been extensively explored through the field of linkage politics, which seeks primarily to determine exactly where the ties between foreign and domestic policy lie. This relationship has traditionally been explored by theorists like Jonathan Wilkenfeld in his text *Conflict Behavior & Linkage Politics*\(^{35}\) and James N. Rosenau in texts such as *Domestic Sources of Foreign Policy.*\(^{36}\) This linkage has also been explored in texts which relate more explicitly to the subject of Russian foreign policy, as explored by Robert H. Donaldson and Joseph L. Nogee in the third edition of their text *The Foreign Policy of Russia: Changing Systems, Enduring Interests,* more specifically in the fifth chapter, which is titled “Domestic Factors in the Making of Russia’s Foreign Policy.”\(^{37}\)

The linkage between foreign and domestic policy in the terms of this discussion would seem to be obvious. On all levels discussed there is an aspect which, either directly affects Russia’s policy choices, or affects the ability of Russia to attain the ends which it desires. Everything from corruption and Russia’s classification as a developed economy with some market failures and a transitional democracy, which fit into the


latter category, to Russia’s decision to keep energy markets under state control, which clearly fits into the first category for its implication on foreign investment, can be related to Russian foreign policy. It is certainly true that Russian foreign policy is the result of a complex compilation of numerous desires and concerns, which include energy security, military security, a return to a position of global power, the maintenance of influence within Eastern Europe, and to provide a source of balance to American hegemony, among others. But it is possible to consider Russian foreign policy with energy security and policy as a primary focus, and that is what will be discussed in the next section.

The Impact of Energy on Russian Foreign Relations

Since the fall of the Soviet Union, Russia’s foreign policy has been the result of a nation attempting to assert itself. During the Cold War, the Soviet Union was seen as a superpower, not because it had the economic, social or political power to be a superpower, but because it had the military might to claim the position. The 1990’s were a time of transition for Russia. Political institutions had to be reestablished; a market economy was semi-successfully created from the remains of the centrally planned Soviet economy; decisions about how to select officials and elected officials had to be made; and the remains of the Soviet bureaucracy, military and intelligence services had to be dealt with, all while keeping up an appearance of strength and calm to the outside world. Unfortunately for Russia, one thing that did not transfer from the Soviet Union to the Russian Federation was superpower status. The new leadership in
Russia found itself with only a few positions of true influence left: a permanent seat on the United Nations Security Council, continued influence in the Post-Soviet states, membership in the nuclear club, and an endowment of energy resources in demand by the rest of the world.

The rest of the world was in for a surprise following the collapse; the nation which they had both feared and respected was struggling with a failed economy, home to an impoverished citizenry, internally riven by Chechnya’s desire to secede, and in disbelief over its loss of power, identity and territory. What the rest of the world did not expect was to become dependent upon Russia’s energy resources. The data in Table 2 below shows the percent of natural gas that the European nations import from Russia. The figures in the table indicate a strong dependence on Russian natural gas for a number of European nations, both Eastern and Western. This dependence ranges from complete or 100% dependence on Russia to partial dependence of around 20%. This dependence illustrates the importance of Russian/European relations.

Table 2 Europe: Natural Gas Imports

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage</th>
</tr>
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<tbody>
<tr>
<td>GERMANY</td>
<td>43%</td>
</tr>
<tr>
<td>FRANCE</td>
<td>24%</td>
</tr>
<tr>
<td>SPAIN</td>
<td></td>
</tr>
<tr>
<td>PORTUGAL</td>
<td></td>
</tr>
<tr>
<td>ITALY</td>
<td>31%</td>
</tr>
<tr>
<td>BRITAIN</td>
<td></td>
</tr>
<tr>
<td>IRELAND</td>
<td></td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td></td>
</tr>
<tr>
<td>BELGIUM</td>
<td></td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td></td>
</tr>
<tr>
<td>AUSTRIA</td>
<td>75%</td>
</tr>
<tr>
<td>CZECH REP.</td>
<td>76%</td>
</tr>
<tr>
<td>POLAND</td>
<td>62%</td>
</tr>
<tr>
<td>SLOVAKIA</td>
<td>100%</td>
</tr>
<tr>
<td>TURKEY</td>
<td>100%</td>
</tr>
<tr>
<td>GREECE</td>
<td>81%</td>
</tr>
<tr>
<td>UKRAINE</td>
<td>53%</td>
</tr>
<tr>
<td>BELARUS</td>
<td>100%</td>
</tr>
<tr>
<td>LITHUANIA</td>
<td>100%</td>
</tr>
<tr>
<td>HUNGARY</td>
<td>80%</td>
</tr>
<tr>
<td>SWITZERLAND</td>
<td>20%</td>
</tr>
<tr>
<td>SWEDEN</td>
<td></td>
</tr>
<tr>
<td>LATVIA</td>
<td>100%</td>
</tr>
<tr>
<td>ESTONIA</td>
<td>100%</td>
</tr>
<tr>
<td>ROMANIA</td>
<td>100%</td>
</tr>
<tr>
<td>BULGARIA</td>
<td>100%</td>
</tr>
<tr>
<td>FINLAND</td>
<td>100%</td>
</tr>
</tbody>
</table>


While Russia’s energy resources supplied the nation with the ability to pick its economy up out of the gutter and with a bargaining chip for the outside world, the use of that bargaining chip has cost Russia in terms of its relationships with many of its trading partners. The effects and consequences of Russian energy-politik will be explored in this section, focusing first on Russian relations with the member countries of the Commonwealth of Independent States, then moving on to its relations with the Western world and finally touching upon the prospects for Russian energy relations in Asia, particularly China.

Russia’s relations with the outside world since the fall of the Soviet Union can be read in many ways, but in many ways its relations have been designed to provide a sense of security. Largely driven by this desire for security, both physical and economic, Russia has resisted foreign investment, attempted to steer clear of conflict and worked to increase its sphere of influence in any way possible, often through a combination of economic and political relations.

Russia and the CIS and Caspian States

Russian relations with the Commonwealth of Independent States have been tense since the collapse of the Soviet Union. While Russian policymakers continue to view the CIS as a part of its sphere of influence, the nations themselves tend to desire a shift away from the control of the Russian federation. Russian relations with the region are essential, as its most lucrative gas and oil pipelines to Western Europe run through the region and a number of the CIS member states have considerable energy resources
of their own. In order to discuss the CIS in depth it is important to define the boundaries of the region, this paper will define the CIS as Belarus, Ukraine, Moldova, Georgia, Armenia, Azerbaijan, Turkmenistan (now only an associate member), Uzbekistan, Kazakhstan, Tajikistan, and Kyrgyzstan. Similarly, discussion which refers to the Caspian Basin states is referring to Azerbaijan, Iran, Kazakhstan, Russia and Turkmenistan. While discussion here may touch upon issues which affect all of these nations, the focus here will be on nations which have either more influential or more confrontational relations with Russia, primarily Georgia, Belarus and Ukraine.

Russian relations with nations in this region have been strained since the 1990s, a result of Russia’s transition from central authority to neighbor. During the era of the Soviet Union, pipelines were built through several member nations of the CIS, primarily Belarus and Ukraine, through which the Soviet Union could transport oil and natural gas to its client states. These pipelines are still being used today for lack of a better route through which to transport the resources, but several issues have arisen as a result. Two of these conflicts have proven to be problematic for Russian relations both within the region as well as with Western powers. For Russia, the continued use of pipelines which traverse these Post-Soviet states is becoming an issue of energy security. This section will focus on the explanation of interactions and conflicts as they affect relations with Russia’s neighbors, while the next section will explore Western reactions to such conflicts.

One way in which Russia has attempted to increase its sphere of influence into the Post Soviet states has been by providing them with natural gas and crude oil at
prices below the international price, although not nearly so cheaply as available domestically. In light of international pressure to raise domestic energy prices and cut subsidies and other price cutting instruments, Russia chose to begin its price reform within the CIS rather than domestically, although Russia has finally begun to raise natural gas prices for industrial consumers slightly. The change in Russia’s pricing policy towards its neighbors, which began slowly and quietly in 2005, was met with resistance and disapproval.

In January 2006, Gazprom shut off natural gas deliveries to Ukraine, reportedly as the result of an ongoing price dispute between the natural gas giant and Ukrainian leaders. Russia told the media that the shut off was a strategic decision made to encourage repayment of Ukrainian natural gas debt, an ongoing problem which the two nations had been debating over for several years. Russia’s use of its energy power to encourage repayment was a strategic decision. It is generally in the best interest of a nation to use its strengths to achieve its goals, but in this case the rest of the world, both within the region and in the West, viewed the action as heavy handed and inappropriately severe. There are international institutions (such as the World Bank and International Monetary Fund) which are designed to help developing nations pay off debt until they have reached a state where they can cover their debt themselves, it would perhaps have been in the best interest of Russia to have attempted to seek resolution through such an institution before shutting off natural gas shipments. While Gazprom leaders and Russian officials insisted that the action was driven by nothing more than the desire to secure the highest possible returns for their energy sales,
Western perceptions and portrayals of the conflict seemed skeptical of the truthfulness of these claims, seeming to suspect a deeper political explanation for the action.\textsuperscript{39}

A similar conflict occurred again in 2007 when Russian officials shut down crude oil exports to Belarus as the result of a dispute over fuel subsidies and “illegal siphoning of oil from the main pipeline that carries Russian crude oil to Europe.”\textsuperscript{40} According to an article in a Canadian newspaper, the conflict began when Gazprom demanded a doubling of the price which Belarus had been paying for Russian gas only shortly before an announcement by Russian officials that duty free sales of crude oil to Belarus would be coming to an end as a way to eliminate what they described as a $3.5 billion (U.S.) subsidy. In other words, not only was Russia doubling the price of its natural gas exports to Belarus, an uncommon action for Russia in light of its standing policy to provide the Post Soviet states with inexpensive energy, but it was also ending the subsidies which had essentially been making Byelorussian consumption of Russian oil possible. Belarus responded to the Russian actions by announcing that it would be imposing a new transit fee on Russian shipments of crude oil through its territory, and when Russia refused to pay the fee, Belarus began to take oil from the Russian pipelines in lieu of a direct payment.\textsuperscript{41} Russia reacted quickly to prevent further appropriation by shutting off oil shipments.


\textsuperscript{40} Guy Chazan, Gregory L. White and Marc Champion. “Moscow’s move to shut pipeline chills Europe; Oil rift with Belarus renews questions about Russia’s reliability as a supplier.” \textit{The Globe and Mail(Canada)}: 9 January 2007.

\textsuperscript{41} Chazan, ibid.
The price conflicts referred to above are both related to the decision made by Russia in 2005 to end energy subsidies to Post-Soviet nations. Prior to 2005, Russia had been supplying the Post-Soviet states with energy priced only slightly higher than the price of its highly subsidized domestic energy. While the price hike will be healthy for the relations of Russia and the nations of the region in the long run, the policy reversal has caused tensions in the short run. Jeronim Perovic, an analyst for the Russian Analytical Digest, explains that the price hike will eventually stabilize relations based on market principles, but in the short run it has caused the CIS member nations to look elsewhere for energy supplies. Some of Russia’s neighbors, particularly Kazakhstan, have turned inward for natural gas, preferring to consume their own product rather than pay the new Russian prices. Perovic goes on to explain that Russia has also switched policy in terms of buying energy from the CIS energy producers, agreeing to buy gas at prices which are much higher than ever before. The willingness of Russia to accept an additional cost, rather than simply passing on costs to its trading partners has limited the scope of the disagreements between Russia and its neighbors, at least those with energy resources of their own. These changes in policy should help to stem future conflict regarding the way that Russia perceives and handles relations with respect to energy markets, treating them with the same considerations it would any foreign nation rather than as part of a Russian empire.

*Russia and the West*

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42 Perovic 2007, pg. 3.
43 Perovic 2007, pg. 3.
Relations between Russia and the Western world have been somewhat strained since the fall of the Soviet Union, perhaps as a residual effect of the Cold War, and although Europe is Russia’s most important trading partner in terms of revenue, misunderstandings and misperceptions have marred the interactions between the two. As discussed previously in the paper, Western Europe depends on Russia for approximately one quarter of its energy imports, not nearly as high as the Middle Eastern nations, but still a sizable chunk of European demand. As developed industrial nations, European demand for energy is relatively inelastic, or unresponsive to small changes in price, with the possible exception of France, which relies on nuclear power for over half of its energy. It would require a large price hike before demand in Europe would begin to fall. The relative inelasticity of demand in Europe makes its dependency on Russian energy supplies all the more dangerous in the eyes of the European nations, and actions by the Russian government and suppliers such as those described in the previous section tend to make the leaders of Western nations worry about the reliability of Russia as an energy-supplying nation.

European reactions to the price conflicts between Russia, Ukraine and Belarus were rather strong. While Russia did not perceive its decisions to shut off energy shipments to the two nations as involving its Western trading partners, the Europeans could not believe that Russia would make such an aggressive move without first consulting its European customers who always paid their bills on time. Similarly, the Russian move came at a time when the international environment was charged against
Russia as a result of Western perceptions of the nation as increasingly authoritarian.\textsuperscript{44} The Western media even went so far as to portray the Ukrainian shut off as “a politically motivated action and ‘punishment’ from the Kremlin for the country’s ‘Orange Revolution’ of 2004.”\textsuperscript{45} While this reaction is rather extreme, it is certain that the actions did make the Europeans begin looking to sources outside of Russia for energy supplies.

The Ukrainian conflict was a source of major discussion at a May 2006 Russian-European Union summit in Sochi. European officials at the summit advocated the European Energy Charter, an agreement intended to broaden access to Russian energy supplies and transit, but Russia showed no interest in ratifying the charter, instead maintaining a hard line and demanding concessions in exchange for ratification.\textsuperscript{46} Reactions following the Russian conflict with Belarus were similar, with the Polish deputy economy minister stating that “This shows us once again that arguments among various countries of the Soviet Union, between suppliers and transit countries, mean that from our perspective, these deliveries are unreliable,” referring to the fact that the shut down in Belarus also halted deliveries to Poland and Germany and slowed flows to Hungary, Slovakia and the Czech Republic.\textsuperscript{47} Russian attempts to force solutions in CIS disputes have served primarily to cause rifts between itself and its European trading partners, a region in which Russia cannot afford to lose favor.

\textsuperscript{45} Perovic pg. 2.
\textsuperscript{46} Editorial. “Russian energy security.” \textit{Oil and Gas Journal}. October 9, 2006.
\textsuperscript{47} Chazan 2007.
Russia has also done itself a disservice in terms of Western relations through its disinterest in foreign investment. European companies have shown great interest in developing Russian energy resources, but Gazprom and the Russian government have effectively blocked or stalled nearly all of these projects since 2004. Much of this can be related back to Gazprom’s position as a near-monopoly with the backing of the government to help prevent competition from entering its market. As mentioned in the previous discussion of Gazprom, the Russian government has even gone so far as to attempt to pass legislation which would have made Gazprom the only firm with rights to export Russian natural gas. This law would have effectively ended foreign interest in developing the natural gas production capabilities in Russia, as domestic prices are not high enough to draw competition into the market, Gazprom is in fact losing money in the domestic natural gas market.

In September of 2006 the New York Times reported that the Russian government had threatened to halt work at the Royal Dutch Shell natural gas production site on Sakhalin Island, prevented three tanker shipments from leaving an Exxon Mobil terminal also located on Sakhalin Island and threatened to withdraw the license of Total of France to operate an oil field in Siberia.48 These actions all took place within the span of a single week, and were the broadest moves which had been taken against foreign investment during either of President Putin’s terms in office. As alluded to previously, Gazprom played a role in the actions taken against investment on Sakhalin Island, desiring a portion of the revenue to be earned there and the power to hold a veto over

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what could be done on the island. Gazprom has been attempting to expand its share of natural gas production in Siberia. In 2006 the company had already forced one of BP’s joint ventures to give up its export rights from the Kovytka gas field near the Chinese border and was in buyout negotiations with three Russian operators of another BP joint venture in Siberia.49

In an article on Russia’s energy relations with the West, Amy Myers Jaffe and Robert Manning point out the fact that Russia views diminished control over its exports to be a source of insecurity,50 which may help to further explain Russia’s repeated actions to maintain Gazprom’s control of natural gas exports. And the fact that the allowance of foreign investment in the Russian energy markets, with foreign firms constructing new infrastructure and more efficient pipelines, would bring in large amounts of government revenue, especially in light of the high taxes placed upon oil production, seems to have little impact on Russian willingness to welcome investment. The continued lockout of foreign firms by the Russian government will have few, if any, positive effects on relations with the Western world.

Russian prevention of foreign investment in natural gas and oil revenue seems to be foolish in many aspects. While Russia has been able to save impressive amounts of money in its Stabilization Fund as the result of energy revenue, it would seem that Russia would want to welcome investors willing to pay for the improvements and expansions in energy infrastructure which Russia so desperately needs and desires. If

improvements were the only form of investment to be made, an argument could be made for Gazprom and the government attempting to cover the costs on their own in order to keep their corner on the market, but with numerous new pipeline plans in the works it is only reasonable for Russia to allow foreign investors to bring in foreign capital to fund the projects. Not only would foreign investment release Gazprom and the government from some of the financial burden, but it would also prevent more Russian resources from being consumed by the energy industry, freeing up capital to be invested in the manufacturing industries which are still in the process of developing. In this sense, foreign investment is important for Russia’s long-run economic health, and the loss of control over a portion of the energy market is a short-run problem whose cost will be outweighed by the long-run benefits.

Myers-Jaffe and Manning are certainly not the first or the only analysts to attempt to explain Russian energy policy as a security issue. As previously alluded to, the security of energy supplies is one of the primary concerns of every nation which consumes or produces energy. Given worldwide dependence on energy, a failure in terms of energy security would be disastrous, meaning that attempts to secure energy supplies are high on the priority lists of both Russia and the EU. Such a failure in energy security could include resources being placed in jeopardy by the exporter, a fear on the part of the EU given distrust of Russia, or whereby energy supplies could be siphoned off or tainted by a transport nation, as Russia fears from the CIS nations.

In 2005 an article was published in Government and Opposition by a scholar named Debra Johnson that explores the EU-Russian link in terms of energy security. In
this article she outlines the security issues which she believes will be the most important in the long-run provision of energy resources for sale in the international market, stating that “In the twenty-first century, security concerns will be exacerbated by two factors-demand-side developments and by the spread of energy security risks not only to oil but to other fuels.” Johnson is essentially stating that it is not necessarily the suppliers which will be a security risk as they have been in the past, like the Middle Eastern suppliers during the 1970s, but rather it will be the growing demand for oil and natural gas by rapidly expanding economies such as China and India that will create long-run energy supply problems. For the EU this should be a huge concern. Not having enough energy reserves to sustain themselves long-term European nations must accelerate their attempts to increase energy efficiency and conservation at the same time as they attempt to develop alternative sources of renewable fuel.

The European nations have begun to move towards diversification away from dependence upon Russian natural gas and oil, especially in light of the growing cooperation between Russia and China, which may have caused even more discord between Russia and the European nations. At the same time as the Europeans are attempting to diversify away from Russian energy, Gazprom has begun focusing on Europe as its largest market. While there is huge potential for Russia to sell energy to China, assuming that the two nations can come to agreements over technical issues, in the short- and even medium-run, Europe remains Russia’s largest and most profitable market. A European diversification strategy will only complicate relations further,

although in the long-run it may help to spur Russian development of other industries. In the absence of greater cooperation on the part of Russia in terms of foreign investment projects, which would help to reassure the Europeans that Russia is acting in ways which are more reliable and stable, it is unlikely that the Europeans will abandon their diversification strategies, whether they involve looking to Africa for natural gas supplies or developing and implementing renewable fuel sources.

Russia and Asia

Russia and the Asian nations have often had a relationship which can possibly be characterized as primarily disinterested. Although there have been historical interactions between Russia and China, Russia and Japan, the Soviet Union and China, and the Soviet Union with nations such as North Korea and North Vietnam, the region seems to hold little attraction for Russia. It may seem strange that Russia would show so little interest in a region with which it shares thousands of miles of borders and potential energy reserves, but Russia has traditionally preferred to interact with the nations of the West. This preference could very well be grounded in historical and prejudicial feelings towards Asia which have, until recent years, been quite prevalent in Russia. The discussion here will focus on China and Japan, the two nations with the greatest prospects for energy cooperation in Asia. China is desirable due to its insatiable appetite for energy supplies, while Japan has very few resources of its own, but lots of money to invest in the development of Russian energy and infrastructure should Russia become more willing to allow foreign investment.
Relations between China and Russia, the two largest nations which can be considered a part of Asia, have long been tense and troubled. Since the Mongol invasions of Eastern Russia in the 13th Century, cultural fears and stereotypes have exacerbated otherwise potentially beneficial relations on both sides of Siberia. The Cold War could have been a turning point, with both nations turning to Communism as their political system, but differences in ideology and disagreements between national leaders prevented the relationship from reaching its full potential. More recently additional factors have affected the relationship, as changes in Russian mindset have relaxed the traditional stereotypes felt towards the Chinese, as fears regarding American hegemony have led the two nations to act as allies, and as China’s need for energy and Russia’s ability to provide at least part of those energy resources steer the two nations towards greater cooperation.

The factor which has the greatest impact here is the role that energy cooperation plays in shaping Sino-Russian economic and foreign relations. For Russia, as an energy producing nation, China is a very attractive potential trading partner, currently the world’s fastest growing economy and the world’s largest consumer of energy resources. China is a nation in constant search of stable and reliable partners from whom it can import the large quantities of energy resources that it needs to support its growing economy and population. As a neighboring nation with the capability to build a pipeline directly into China, Russia is an attractive possibility as one of China’s energy suppliers, although both nations have alternatives to choose between. The possibility of a long-lasting energy partnership between the two has numerous
implications for both their foreign relations policies and the policies and atmosphere of the international community. It is likely that some form of agreement will be reached, but the extent and comprehensiveness of that agreement is yet to be seen.

The idea of energy relations permeates nearly all considerations of Sino-Russian relations. In fact, nearly all recent analyses of Russian-Chinese relations take into account some factor of energy cooperation, either in terms of the potential partnership between the two, the energy security problems which could arise from a Russian pipeline cutting through China or other Asian nations, or the energy crisis which could be caused by the continued growth of China’s energy needs. The latter would be cause for a crisis throughout the world, although the increased demand would mean higher prices and demand for energy producing nations such as Russia.

One of the most positive signs in terms of Sino-Russian energy cooperation is the increased discussion of Chinese investment in Russian energy and infrastructure in recent years. Since 2005, despite some setbacks, both Russia and China have begun to push for a greater relationship. In fact, 2006 was named the “Year of Russia in China,” with President Vladimir V. Putin traveling to China to celebrate the anticipation of expanded relations between the two neighbors. Although much of the celebrating was anticipatory, the “Year of Russia in China” celebration did give birth to some hopeful signs for the expansion of cooperation between the two nations. In On March 27, 2006 the Chinese news agency Zhongguo Xinwen She reported that Putin and Chinese President Hu Jintao had signed a “Sino-Russian Joint Statement” which announced that Russia and China would “adopt a multifaceted strategy in the realm of energy
cooperation." This new strategy would not only include an expansion of Russian energy exports to China, but also support for attempts to explore and invest in energy resources and engagement in other areas of energy resource extraction, including processing and transmission. While all signs looked good in terms of the potential for further expansion of Sino-Russian cooperation, fruition of such agreements is still years away from realization.

In May 2006, Nodari A. Simonia published an article in the *Asia-Pacific Review* about the growing role of Russia in Asia-Pacific region. Although Simonia examines multiple factors which help to explain both the success and the interest of Russia in the region, one of the most prominent explanations is Russian desire for new and expanded export markets for oil and natural gas. Simonia discusses the improved ability of Russia to trade with nations in Asia as having benefited from the absorption of Rosneft as a state-owned energy company, creating a source of competition for Gazprom in Siberia and the Far East. Simonia also lists several expected Russian export figures to China, stating that the expected export figures for oil in 2006 was approximately nine million tons, while in total by 2010 China will have imported a total of 48.5 million tons of oil from Russia. The latter figure refers to imports of oil which have already been paid for at a price of US $6 billion. This figure does not exclude the possibility that China may import more oil from Russia, but it is a promise that China will import at least 48.5 million tons of oil between 2007 and 2010. This is only a portion of the energy

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54 Simonia pg. 26.
relationship between the two nations, as it does not take into account any transactions regarding Chinese purchases of Russian natural gas, but it provides an expectation for a continued energy relationship between the two nations for a minimum of the next several years.

In the Fall 2006 issue of *East Asia* Kent E. Calder explored China’s response to energy insecurity. Calder considers the relationship between China and Russia in terms of both historical and current context, beginning with the energy shortage which was precipitated by the Sino-Soviet split of 1960. One result of this split was a China which was extremely dependent upon the Soviet Union, an adversary, for a large portion of its energy imports.\(^55\) This helps to explain both China’s current reluctance to become reliant upon foreign nations for its energy security as well as the relatively small portion of oil imports which come from Russia and Kazakhstan, currently only about 12% of China’s total imports.\(^56\) China has shown little interest in increasing the proportion of oil imported from Russia and Kazakhstan without having some form of large-scale energy production agreement in place. Similarly, while Russia rose to the place of fifth-largest oil-importer to China in 2004, Gazprom’s treatment of the Ukraine, Belarus and other Central Asian and Eastern European nations along with Russia’s hardnosed bargaining techniques with China and Japan have made further cooperation difficult.\(^57\) Calder concludes his discussion by taking the position that “a deepening energy relationship between the two giants of Eurasia, China and Russia, is both natural and virtually

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\(^{56}\) Calder pg. 56.

\(^{57}\) Calder pg. 56.
inevitable, barring severe geopolitical conflict. The relationship envisioned by Calder is one driven by energy-sector cooperation, with China as an energy dependent nation and Russia as a neighbor with the ability to produce oil at low cost. The idea that Sino-Russian cooperation is inevitable is one that has been taken by numerous scholars, including Yu Bin, but there has been very little fruition of this relationship. Although Russia and China routinely discuss possible investment deals, there is rarely a significant agreement, rather the two nations continue to celebrate a relationship that has not yet been realized.

One of the most contentious issues related to Sino-Russian energy relations is the ability of the two nations to come to an agreement regarding the pipeline which has been discussed since the 1990’s. In 2007, Yu Bin published a paper titled “The Search for a Normal Relationship: China and Russia Into the 21st Century” which explored the future of relations between Russia and China on many levels, including the possibility of future energy cooperation. In 2003, Russia opted against building a single pipeline to China, preferring the possibility of building a pipeline which would provide access to a diverse number of energy consumers. Yu Bin concluded that Russia and China should be able to come to an agreement regarding energy partnership based on the principles of supply and demand. Because Russia is the second-largest oil producing nation in the world and China has a seemingly unending desire for oil, the two are natural trading partners. The inability of China and Russia to come to an agreement over the location

58 Calder pg. 61.
and existence of this pipeline could be seen as reluctance on the part of Russia to focus on China and Asia rather than Europe in terms of trading partners. Despite the fact that Russian views towards Asia are shifting, the ability to make a complete turn-around in policy is a long and tedious process. Similarly, the apparent preference of the Russian government for a pipeline that would provide access to a diverse group of nations over one leading directly into China is a sign that Russia is looking for energy security by choosing to avoid over-reliance upon China for energy exports, interesting since China’s demand for energy is so great.

The July 2007 issue of the *Russian Analytical Digest* examines the relationship between China and Russia with respect to energy cooperation. In an article regarding Russian resurgence in Asia, Gilbert Rozman, a professor of sociology at Princeton University, concludes that Russia’s “unilateral pursuit of security, total control over energy resources, and renewed influence in Central Asia and North Korea has added an element of wariness” in Beijing, Tokyo and Pyongyang. Rozman also briefly discusses the Chinese point of view regarding energy more specifically, stating that the unlikelihood that Russia will pursue a pipeline through China as opposed to a pipeline to the Pacific Coast with the ability to service nearly all of Asia and the West Coast of America has led China to look for alternative producers of energy. Again, the apparent preference of Russia for a pipeline able to provide a diversity of consumers is evidence of Russian unwillingness to become dependent upon Chinese purchases of oil and natural gas. This information seems to be evidence that the stalemate between Russia

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and China in terms of further energy cooperation appears to be continuing, as more recent data shows very few changes in the position of either nation.

There is relatively little literature or data relating to Russo-Japanese relations, perhaps because very little progress has been made in attempting to open investment and trade between the two nations. Some observers, including Gilbert Rozman of Princeton, have attempted to tie the lack of relations between the two nations to the preoccupation with the return of the four islands lost to the Soviet Union during WWII on the part of the Japanese.⁶¹ Although the Japanese may be interested in the construction of a pipe-line to the Pacific, the lack of interest shown by the Russians, coupled with complications of several other investment attempts and the four islands issue seems to be preventing any meaningful relations between the two nations.

One source of contention between the two nations has been the Russian reversal of the Sakhalin Project in September 2006. When the Russians pulled the environmental permit on a project worth $20 billion, a project in which the Japanese firms Mitsui and Mitsubishi owned a 45 percent share, the Japanese reacted quickly.⁶² The incident goes to show that it is not only nations in Western Europe that Russia tends to upset through its refusal to allow foreign investment in its energy markets. Similarly, Russian reversal of promised projects is causing it further problems, primarily through causing nations such as Japan to lose interest in Russia as a trading partner for many of

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⁶¹ Rozman, ibid. pg. 4.
the same reasons as Western Europe is concerned, because Russian policies and actions do not reflect Russian claims of reliability.

The potential for Russian energy cooperation in Asia is huge, although it would require Russia to make a huge shift in its current policy of preferring relations with Europe to those with Asia. The prospects for energy trade with China are potentially greater than those with Europe, particularly if Russia were willing to build a pipeline to China, which would both assure China of Russian commitment to the relationship and make the process of transportation much easier. Russia must become willing to compromise in order to move forward in terms of trade and investment no matter what market it chooses to pursue.

**Conclusions and Policy Implications**

After an examination of Russian energy dependence and foreign policy from a number of perspectives it is possible to make several conclusions. The factors which help to determine Russian energy policy are numerous and inseparable. Russia’s desire to provide jobs for its people has led it to enact policies which support inefficient industries and provide subsidies to energy giants in order to encourage them to provide energy to such industries at unsustainably low prices. The subsidies provided largely consist of allowing access to foreign markets, creating a large gap between the price charged domestically and that charged in the foreign markets. This price gap creates a problem for Russia in terms of foreign relations, in that Western nations find the discrepancy troubling, a sign of Russian instability or unreliability, and Russia’s neighbors
resent the fact that Russia is raising the price it charges them without a parallel increase in Russian domestic prices.

Russian dependence on energy has placed it in a precarious situation. The rest of the world is in the process of looking for alternative sources of energy, with nations like France and Brazil already having begun the transition, and there are signs that Russia has already reached its peak in terms of oil production. An article in *Financial Times* in April 2008 quoted a Russian energy executive as saying that "the period of intense oil production (growth) is over."\(^{63}\) The next day, the *Wall Street Journal* echoed these fears, quoting statistics from the International Energy Agency which show that "Russian oil production in the first quarter declined for the first time in a decade" and stating that "Russian oil executives are gloomy about keeping production steady, let alone increasing output."\(^{64}\) The peak oil fear is one which has been realized in several other oil producing nations, notably Mexico and Turkey, and which exemplifies one reason that Russia should begin to focus on diversification.

The conclusions reached in this paper have clear domestic and foreign policy implications. First, in light of the potential for medium- and long-run volatility of energy markets, the diversification and industrialization of the Russian economy is necessary. In this way Russia will be able to protect itself from potentially disabling economic disturbances when energy prices begin to fall due to a demand side shift or the depletion of Russian energy resources is realized. Second, the existence of the Russian ‘virtual economy’ is an extremely inefficient form of employment, and the subsidies and

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tax breaks supporting the system should be reconsidered. The allowance of those markets to either self-correct or selfimplode will prove much more beneficial in the long-run, especially if Russia can find more efficient ways to encourage investment in industrialization and development. Third, closely related to the issue of the ‘virtual economy,’ Russia must allow its energy market prices to at least rise to the point where marginal revenue equals marginal cost. The existence of consumption subsidies which encourage inefficient uses for Russian energy have no economic value, and will not improve until prices are released from their artificially low level. The fact that Russia allows access to foreign markets as a form of subsidy only complicates the problem; in a free market firms would have the ability to sell their goods in foreign markets regardless, Russian energy firms remain worse off than their foreign counterparts regardless of this subsidy.

The foreign policy implications are just as essential. First, it is important that Russia recognize that its trading partners in Western Europe are on edge and are watching every move that Russia makes, whether it directly involves them or not. Western Europe already has its doubts about the stability of Russia as a trading partner, and Russia should be careful not to exacerbate the situation further. Second, continued refusal and postponement of foreign investment proposals will haunt Russia in the long-run in both economic and foreign relations terms. Finally, and perhaps most significant in the short term, in light of Western Europe’s attempts to diversify the supply of their energy resources, Russia should seek to do the same with respect to diversifying its
consumer states. In the event of such a diversification strategy the most probable trading partner for Russia to turn to is China.

This paper has sought to explore the efficacy of Russia’s energy policy in terms of its foreign policy and economic effects. One possible conclusion after consideration of these issues is that Russian energy policy is profitable in the short-run, but unsustainable in the long-run. Without a more comprehensive and active diversification and industrialization policy, Russia will find itself in a dangerous position in the event of the development of alternative fuel sources or a fall in oil prices caused by the discovery and access of additional oil fields like that of the 1980s.

The outlook for Russia is not all grim however. Russia does have the Stabilization Fund set up to provide a safety net for the government in the event of a crisis, and investment in non-energy industries has been growing significantly. It is still unknown what effect the handoff of the government from Vladimir Putin to Dmitri Medvedev will have on Russian policy, for although he has been championed as a liberal, his policy preferences are yet unknown. There is a chance that Medvedev will introduce significant policy changes, but with Putin as Prime Minister, the influence of the current administration will likely be felt for the duration of Medvedev’s term in office. The tide has begun to shift in Russia, with energy executives and analysts beginning to recognize that Russian energy could be nearing its peak and that dependence on oil could prove fatal for the Russian economy without diversification. The recognition of these issues could be the first step towards a sustainable policy for Russia.
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