

Executive Summary Background

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Russia's Economic Crisis and U.S.–Russia Relations: Troubled Times Ahead

Ariel Cohen, Ph.D., and Richard E. Ericson, Ph.D.

As the Obama Administration embarks on a major readjustment of U.S. policy toward Russia, U.S. policymakers need to understand how the economic crisis is influencing Russia's foreign and domestic policies, and thereby affects U.S. interests. Much of Russia's assertiveness and adventurism in recent years floated on a bubble of expensive oil and natural gas exports.

As Russian leaders realize their country's economic weakness, the Administration should deny Russia economic benefits if Russia pursues anti-American policies or refuses to enact the needed policy changes, especially on Iran. At the same time, the U.S. should devise incentives that facilitate Russia's integration into global markets and promote policies in sync with U.S. goals. Unilateral concessions by the Obama Administration will not work, whereas pursuit of mutual strategic and economic interests is possible. Specifically, the U.S. should work with its European allies to diversify their energy supplies, to defeat Russian hopes of black-mailing Europe into further strategic concessions, to block Russian weapons and sales to Iran and Venezuela, and to oppose Russia's attempt to reestablish its hegemony in the "near abroad."

Russia's falling economic performance has dampened some aspects of the revisionist rhetoric, but has not drastically changed Russia's foreign policy narrative, which remains decidedly anti-status quo and implicitly anti-American. Recent increases in oil prices ensure the continuity of this policy

thrust. Unless the Kremlin significantly reorients its foreign and security policy priorities, the Obama Administration's attempt to "reset" U.S.–Russian relations may fail.

The Russian Economic Crisis and Foreign Policy. Since summer 2008, the Russian economy has undergone a major meltdown, largely due to the global financial crisis. The crisis caused a significant decline in oil and gas revenues, the principal source of income for the Russian economy and government. Beginning in the fall of 2008, the financial resources for Russia's assertive foreign and defense policy dwindled, with Russia's massive hard currency reserves declining from about \$600 billion to about \$400 billion. However, economic growth resumed in the second quarter of 2009 before the reserves were exhausted.

Yet during the current crisis, Russia has continued to voice strong grievances against the West and demanded changes in key international economic and European security institutions.

This paper, in its entirety, can be found at:
www.heritage.org/research/RussiaandEurasia/bg2333.cfm

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The U.S. Policy Conundrum. The United States has used economic levers to deal with Russia for more than 70 years with mixed results until Ronald Reagan won a decisive geo-economic victory over the decrepit Soviet system. Today, U.S. interests in Russia include:

- Stopping or at least slowing Russia's slide toward a state capitalist model, which makes externally aggressive authoritarianism more viable;
- Encouraging Russia to develop more transparent business practices, which will attract American business and help Russia's candidacy for membership in the World Trade Organization (WTO); and
- Increasing Russia's integration into the global economy.

The U.S. is interested in demonstrating to the Russian leaders that their current policies could lead toward imperial overstretch and isolation. Offensive Russian priorities—including support of Iran and Venezuela; building military bases in Central Asia, the Caucasus, and the Middle East; and ambitious pipeline projects—could prove economically unviable. In the long term, they could become unsustainable liabilities that impoverish the Russian people.

What the U.S. Should Do. It is in long-term U.S. and Russian interests for Russia to abandon its revisionist rhetoric and policies and to join the community of market economies. Moscow could become a more viable U.S. partner if it demilitarized its foreign policy and refocused on economic modernization and international integration. However, such a shift will require profound changes within Russia. To this end, the U.S. should offer incentives for changes that facilitate Russia's integration into global markets and disincentives for anti-American or destabilizing policies. Specifically, the U.S. should:

- Work with key European governments to address their overreliance on Russian gas;
- Support diversification of energy transportation routes in Eurasia;

- Cooperate with Western governments to track and prosecute Russian state and oligarch money laundering activities, corruption, and unfair competition practices;
- Place conditions on Russian borrowing from international financial institutions;
- Encourage Russia to deepen its economic reforms and diversify its economy;
- Make the rule of law and good governance litmus tests in developing U.S.–Russian economic relations;
- Support Russian membership in the WTO and OECD if it opens its economy and implements transparency, rule-of-law, and anti-corruption measures; and
- Repeal the Jackson–Vanick Amendment.

Conclusion. The economic crisis has selectively toned down Russia's rhetoric, but has not sufficiently changed the basic priorities of the top Russian national leadership.

When dealing with Russia, the U.S. should staunchly protect its national security and foreign policy interests. This is not the time for counterproductive, unilateral concessions, which may cause further Russian recalcitrance. Yet by increasing Russia's stake in the global economic pie it is likely that its rulers may emphasize the economic agenda over the 19th century-style expansionism. This is an option that Congress and the Obama Administration should pursue while driving a hard bargain on vital national security priorities.

—Ariel Cohen, Ph.D., is Senior Research Fellow in Russian and Eurasian Studies and International Energy Security in the Douglas and Sarah Allison Center for Foreign Policy Studies, a division of the Kathryn and Shelby Cullom Davis Institute for International Studies, at The Heritage Foundation. Richard E. Ericson, Ph.D., is Chair of the Department of Economics at the East Carolina University and former Director of the Harriman Institute at Columbia University. The authors thank Daniella Markheim and Ted R. Bromund, colleagues at The Heritage Foundation, for their review of and contributions to this paper.

Background

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Russia's Economic Crisis and U.S.–Russia Relations: Troubled Times Ahead

Ariel Cohen, Ph.D., and Richard E. Ericson, Ph.D.

Abstract: *Russia's revenues from oil and natural gas are enabling its aggressive and often anti-Western foreign policy. Russia's falling economic performance has toned down Russia's rhetoric, but has not drastically changed Russia's foreign policy narrative, which remains decidedly anti-status quo and implicitly anti-American. The U.S. needs to devise incentives for steps that facilitate Russia's integration into global markets, but deny benefits if Russia continues to pursue anti-American policies or refuses to enact the needed changes.*

As the Obama Administration embarks on a major readjustment of U.S. policy toward Russia,¹ U.S. policymakers need to understand how the economic crisis is influencing Russia's foreign and domestic policies, and thereby affects U.S. interests. Much of Russia's assertiveness and adventurism in recent years floated on a bubble of expensive oil and natural gas exports. Today, however, the Russian elite appears to be divided between those who hope that natural resources will continue to finance Russia's assertive foreign policy, and those, like President Dmitry Medvedev, who are calling for a major reform to clean up corruption, strengthen the court system, and move away from the current resource-export model toward a knowledge-based economy that is integrated into the global economy.²

The Obama Administration's strategy of unilateral U.S. concessions may fail. Instead, the U.S. should pursue a strategy based on a realistic assessment of

Talking Points

- Much of Russia's assertiveness and adventurism in recent years floated on the bubble of oil and gas income from skyrocketing energy prices.
- Since summer 2008, the Russian economy has undergone a major economic meltdown, largely due to the effects of the global financial crisis and sharply declining hydrocarbon revenues.
- Despite its weakened position, the Russian government has not significantly changed its foreign policy, showing little cooperation on Iran, continuing to pressure Ukraine and Georgia, and demanding revisions of key economic and security architectures throughout the world.
- Since the economic crisis unfolded, President Medvedev has criticized Russia's commodity-dependent export economy and advocated knowledge-based growth, but for now, the energy and state security lobbies are stronger than the economic reformers.
- The United States should encourage Russia to deepen its economic reforms and to diversify its economy, while linking foreign investment to Russia's cooperation on key U.S. security interests, such as Iran.

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Russian economic power. The White House should deny Russia economic benefits if it pursues anti-American policies. Meanwhile, the U.S. should work with its European allies to diversify their natural gas supplies, to defeat Russian hopes of blackmailing Europe into further strategic concessions, to block Russian weapons and sales to Iran and Venezuela, and to oppose Russia's attempt to re-establish its hegemony in the "near abroad." Finally, the Administration should focus U.S.–Russian strategic and economic cooperation on matters in which pursuit of mutual interests is possible.

The Russian Economic Crisis and Its Aftermath

Since the summer of 2008, the Russian economy has undergone a major economic meltdown, largely due to the global financial crisis. The crisis caused a significant decline in oil and gas revenues, the principal source of income for the Russian economy and the government.

Beginning in the fall of 2008, the financial resources for Russia's assertive foreign and defense policy dwindled, with Russia's massive hard currency reserves declining from about \$600 billion to about \$400 billion. However, economic growth resumed in the second quarter of 2009 before the reserves were exhausted.

Russia has been an important U.S. foreign policy priority since World War II. For decades, the U.S. has strived to bring Russia into the international system as a predictable and constructive partner. While progress in international security has been slow and difficult, as shown by the August 2008 war in Georgia and Russian intransigence on Iran, the prospects of progress in business and economics appears more promising.

Despite the downturn, Russia has pocketed the Obama Administration's concessions on missile

defense deployment in Poland and the Czech Republic, ignored the White House pleas for cooperation on Iran sanctions, and continued to pressure Georgia and Ukraine. Russia is also continuing its military modernization and establishing military bases from the Fergana Valley in Central Asia to the Black Sea.

At the same time, Moscow is a U.S. partner in arms control and resupplying U.S. and NATO forces in Afghanistan. A senior Obama Administration official has characterized Russia as "neither friend nor foe" of the West,³ while the United States and NATO are defined as principal adversaries in the Kremlin's national security documents.

Clearly, the type of economy and form of government that Russia assumes are strategic issues for the U.S. The Russian leadership is divided on these issues. The foreign and security policies arising from the current commodity-dependent export model, which is promulgated by Prime Minister Vladimir Putin and First Deputy Premier Igor Sechin drastically differ from policies based on a knowledge-based, high-technology economy supported by President Dmitry Medvedev and economic reformers.

Russia's falling economic performance has dampened some aspects of the revisionist rhetoric, but has not drastically changed Russia's foreign policy narrative, which remains decidedly anti-status quo and implicitly anti-American.

An economic model based on natural resources would tend to perpetuate authoritarianism, nationalism, and corruption, and it would require Russia to follow a neo-imperial policy throughout the Commonwealth of Independent States (CIS) to support Russian domination of the pipeline system. In a

1. Ariel Cohen, "Russia and Eurasia: A Realistic Agenda for the Obama Presidency," Heritage Foundation *Special Report* No. 49, March 2009, at <http://www.heritage.org/Research/RussiaandEurasia/sr0049.cfm>.
2. Andrew Osborn, "Dmitry Medvedev Surprises Russia with Attack on 'Humiliating' Economy," *The Telegraph*, September 15, 2009, at <http://www.telegraph.co.uk/news/worldnews/europe/russia/6169625/Dmitry-Medvedev-surprises-Russia-with-attack-on-humiliating-economy.html> (September 22, 2009).
3. Michael McFaul, "Russia Under Putin: Neither Friend nor Foe," *The Ripon Forum*, Vol. 40. No. 3 (June/July 2006), at <http://www.riponsociety.org/forum306h.htm> (October 26, 2009).

way, the petrostate model and the associated militarized foreign policy require Russia to label the U.S. as an enemy. A more open and diversified economy would be more compatible with democratization and the rule of law.

Russia's falling economic performance has dampened some aspects of the revisionist rhetoric, but has not drastically changed Russia's foreign policy narrative, which remains decidedly anti-status quo and implicitly anti-American. Recent increases in oil prices ensure the continuation of this policy. Even during the current crisis, Russia has continued to voice strong grievances against the West and made revisionist demands to change key international economic and European security institutions for its benefit.

Unless the Kremlin significantly reorients its foreign and security policy priorities, the Obama Administration's attempt to "reset" U.S.–Russian relations may fail. Only a coherent policy by the Obama Administration and Congress can force the Russian leadership to realize that they would be better served by cooperating with the U.S. and the West than by subverting it.

The Russian Petrostate Rollercoaster

In the 1990s, the Russian economy struggled with a difficult transition from central planning to a market economy under Boris Yeltsin. In the current decade, wealth from raw materials has fueled an increasingly revisionist foreign policy. Yet while the Russian elite views Russia as a great energy and military power, its economic productivity is only one-third of U.S. productivity,⁴ and its gross domestic product (GDP) is between \$1.1 trillion and \$1.8 trillion, depending on oil prices, and is smaller than the GDPs of France, Italy, and the U.K.

From 2000 to 2008, the Kremlin benefited from rising oil prices. Prime Minister Vladimir Putin's popularity soared as Russia entered a period of intense economic growth.

By 2008, Russia had become one of the 10 largest economies in the world. In only 10 years, its GDP had increased by more than eightfold (measured in U.S. dollars), having grown at an average annual rate of around 7 percent in constant rubles.⁵ Real wages increased significantly, from \$62 in 1999 to \$529 in 2007.⁶ Russia had the best

Economic Performance Under Putin

Economic Indicator	1998	2000	2001	2002	2003	2004	2005	2006	2007	2008 (Jan.–June)	2008
GDP Index (1998=100)	100.0	117.0	123.0	128.8	138.2	148.1	157.6	169.3	183.0	190.3	193.2
GDP (% change)	-5.3	10.0	5.1	4.7	7.3	7.2	6.4	7.4	8.1	8.0	5.6
Industry (% change)	-5.2	11.9	4.9	3.7	7.0	7.3	4.0	3.9	6.3	5.4	2.1
Investment (% change)	-12.0	17.4	10.0	2.6	12.5	19.9	10.7	13.5	21.1	13.1	9.1
Unemployment (%)	11.8	10.2	9.0	7.1	8.9	7.6	7.7	6.9	6.1	5.3	7.7
Consumption (% change)	-7.3	5.9	8.6	7.9	8.9	9.2	11.0	11.0	13.0	n/a	n/a
Current Account (billions of dollars)	0.2	46.8	33.9	29.1	35.8	58.2	62.9	96.1	78.3	91.2	102.3
FDI (billions of dollars)	1.2	4.43	3.98	4.0	6.78	9.4	9.0	29.9	52.0	n/a	27.0
Budget Balance (% GDP)	-5.9	1.2	3.0	1.4	1.7	4.4	7.5	7.4	5.4	7.0	4.1
Inflation (%)	84.4	20.2	18.6	15.1	12.0	11.7	10.9	9.0	11.9	14.7	13.3

Source: Federal State Statistics Service, statistics, as reported in Bank of Finland, Institute for Economies in Transition, Russian Report, various issues, 2004–2008.

Table I • B 2333  heritage.org

4. McKinsey Global Institute, *Lean Russia: Sustaining Economic Growth Through Improved Productivity*, April 2009, at http://www.mckinsey.com/mgi/reports/pdfs/lean_russia/Lean_Russia_full_report.pdf (October 21, 2009).
5. Olga Oliker, Keith Crane, Lowell H. Schwartz, and Catherine Yusupov, *Russian Foreign Policy: Sources and Implications*, RAND Corporation, 2009, pp. 45–82, at http://www.rand.org/pubs/monographs/2009/RAND_MG768.pdf (October 21, 2009).
6. *Ibid.*

Composition of Russian Exports

Percentage of All Exports

	1995	2000	2002	2003	2004	2005	2006	2007
Food and agricultural (excludes textiles)	1.8	1.6	2.6	2.5	1.8	1.9	1.8	2.6
Mineral resources (including oil, gas, and coal)	42.5	53.8	55.2	57.3	57.8	64.8	65.9	64.7
Chemical industry	10.0	7.2	6.9	6.9	6.6	6.0	5.6	5.9
Leather goods and furs	0.4	0.3	0.3	0.2	0.2	0.1	0.1	0.1
Wood, lumber, and timber	5.6	4.3	4.6	4.2	3.9	3.4	3.2	3.5
Textiles and footwear	1.5	0.8	0.8	0.7	0.6	0.4	0.3	0.3
Metals, precious stones, and jewelry	26.7	21.7	18.7	17.8	20.2	16.8	16.3	16.1
Machines, equipment, and transportation vehicles	10.2	8.8	9.5	9.0	7.8	5.6	5.8	5.6
Other	1.3	1.5	1.4	1.4	1.1	1.0	1.0	1.2

Sources: Federal State Statistics Service, *Rossiya i tsifrah—2008* (Russia in figures—2008), Table 26.8, at http://www.gks.ru/bgd/regl/b08_11/IssWWW.exe/Stg/d03/26-08.htm (August 27, 2009).

Table 2 • B 2333  heritage.org

stock market performance of any emerging markets during this time.⁷

This economic growth occurred despite the Kremlin's efforts, beginning in 2003, to renationalize much of Russia's natural resources and other strategic sectors of the economy. In 2003, the Kremlin took control of YUKOS, the largest publicly traded Russian oil company, and jailed its owner Mikhail Khodorkovsky. During Putin's second presidential term, the Kremlin's international rhetoric and actions became increasingly assertive, even aggressive.

The euphoria surrounding Russia as the "hottest new emerging market" and the considerable increase in living standards have obscured the fact that the economy lacks a diversified base and heavily depends on energy exports. (See Table 2.) Russia suffers from desperately weak rule of law, including property rights and corporate and state governance.⁸ Its economy is not technologically competitive, labor costs are high, productivity is

low, and foreign direct investment is stunted by state corruption and the lack of the rule of law.

According to the World Bank, energy exports accounted for 66 percent of the Russian economy as of December 2008.⁹ Exports of oil and gas, in particular, provide substantial economic rents to the Russian state and have been a driving force behind both Soviet and Russian economic growth.¹⁰ Clearly, energy and mineral revenues are financing internal social and infrastructure investment as well as the military and security buildups. (See Chart 1.) This long-standing relationship between high oil prices and Russia's assertiveness held as energy export revenues expanded through the first half of 2008. (See Table 3.)

Russia's largest revenues come from its oil sales rather than sales of natural gas. Natural gas exports earned about \$65 billion in 2008, crude oil earned \$151.7 billion,¹¹ and coal and refined products accounted for the remainder.

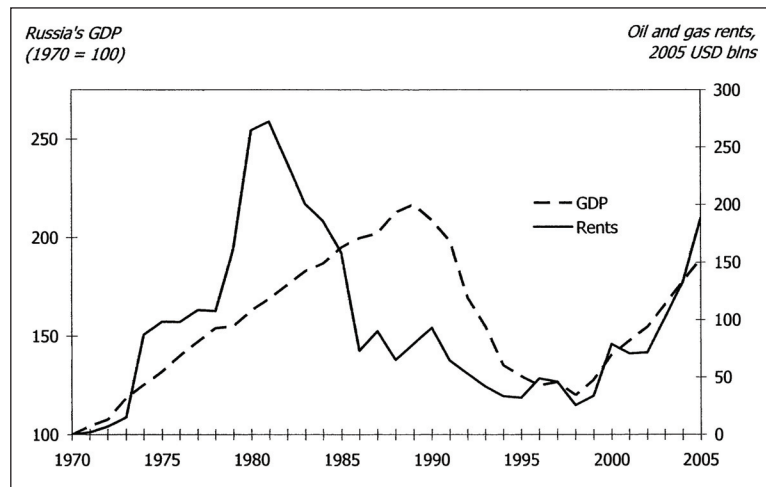
7. Samuel Charap and Andrew C. Kuchins, "Economic Whiplash in Russia: An Opportunity to Bolster U.S.–Russia Commercial Ties?" Center for Strategic and International Studies, February 2009, at http://csis.org/files/media/csis/pubs/090218_charap_econwhiplashrussia_web.pdf (August 27, 2009).
8. Working Group on Rule of Law in Russia, "Rule of Law in Russia: The Heritage Foundation Working Group Recommendations," The Heritage Foundation, June 2009, unpublished document.
9. World Bank, "The World Bank in Russia," *Russian Economic Report* No. 18, March 2009, at <http://siteresources.worldbank.org/INTRUSSIANFEDERATION/Resources/rer18eng.pdf> (June 4, 2009).
10. Clifford Gaddy and Barry W. Ickes, "Resource Rents and the Russian Economy," *Eurasian Geography and Economics*, Vol. 46, No. 8 (December 2005), p. 568.

However, natural gas sales have also created a structural dependence that the Kremlin is using for economic and political leverage in Central and Eastern Europe. Over the past decade, Russia has repeatedly cut off gas deliveries to exert political and economic pressure and/or to make political statements, while maintaining adequate revenues through oil sales. While the former Soviet satellites and republics in Eastern and Central Europe have been most affected, Western Europe was directly harmed in January 2006 and January 2009. The disruptions demonstrated Europe's dependence on Russian gas and encouraged Western Europeans to take Russian energy and foreign policy demands seriously.

The Party's Over? Even before the current economic crisis in May 2008, Russia's economic fortunes began to reverse with a series of heavy-handed government forays into economic management. Problems began with disruptions

Russia GDP and Oil and Gas Rents

Original chart below by Clifford G. Gaddy and Barry W. Ickes.



Source: Clifford Gaddy and Barry W. Ickes, "Resource Rents and the Russian Economy," *Eurasian Geography and Economics*, Vol. 46, No. 8 (December 2005), p. 568.

Chart 1 • B 2333 heritage.org

Russian Earnings from Energy Exports

Year	Total Revenue, in Billions	Average Sale Price of Urals Crude (Dollars per Barrel)
2000	\$52	\$26
2001	\$52	\$23
2002	\$56	\$24
2003	\$74	\$27
2004	\$100	\$35
2005	\$148	\$51
2006	\$191	\$61
2007	\$220	\$69
2008	Up to \$300	Up to \$100

Source: GlobalSecurity.org, "Russian Energy Policy," at <http://www.globalsecurity.org/military/world/russia/energy.htm> (August 27, 2009).

Table 3 • B 2333 heritage.org

from accelerating inflation, accentuated by Putin's public and harsh criticism of the Mechel Corporation. They have included threats of price-fixing prosecutions, the fallout from the public fight between British Petroleum and Russian oligarch-owned Tyumen Oil Company (TNK) for control of the TNK-BP oil joint venture, and the August war with Georgia. These events, coupled with the unfolding global financial crisis, caused international investors to reel, the Russian stock market to plunge, and capital to flee, sending shock waves through the Russian economy and leadership.

The Kremlin has responded with harsh criticism, blaming Washington policies for the downturn and calling for replacement of the dollar in international transactions and limiting U.S. influence in international financial institutions.¹² However, the depth of the crisis and Russia's greater economic decline relative to other members of

11. Gazprom, "Gas Exports and Enhancing Reliability of Gas Supply to Europe," press conference, June 24, 2009, at http://www.gazprom.com/posts/53/199379/2009.06.24_background_eng.pdf (October 22, 2009), and Aleksei Tarasov, "Trading Russian Petroleum Products," *Russian-American Business*, April 15, 2009, at http://russianamericanbusiness.org/web_CURRENT/articles/432/1/OIL-Traders-International (October 22, 2009).

BRIC (Brazil, Russia, India, and China)¹³ indicate that the roots of the crisis are internal.

Rising Unemployment and Growing Social Unrest. The crisis has also exacerbated social tensions in Russia. So far, no serious threat to the regime has materialized, despite a wave of spontaneous strikes and the use of SWAT teams to put down a demonstration in Vladivostok. Notably, the Russian leadership showed the limits to its tolerance of public displays of dissatisfaction and its willingness to use force when it flew in riot police to put down the protest in Vladivostok.¹⁴ Since this widely reported event, there have been additional protests and spontaneous strikes.

According to the World Bank, the number of people in Russia below the poverty line increased by 1.1 million in 2008 and will increase by 4.7 million in 2009.¹⁵ Thus, according to official measurements, 15.5 percent of the population will be poor by the end of 2009.¹⁶

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Putin and other politicians understand that the crisis could threaten regime stability, thus providing a social safety net has become the top Kremlin pri-

Russia's Economic Performance in 2008 and 2009

Percentage Changes Year over Year, by Year and Quarter

	Q1 2008	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Q2 2009
GDP	8.5	8.0	7.3	5.6	-9.8	-10.9
Industrial Output	7.0	5.4	5.4	2.1	-14.3	-14.2
Fixed Investment	16.9	13.1	13.1	9.1	-15.0	-18.2
Unemployment	6.4	6.2	5.3	7.7	10.0	8.3
Inflation	15.1	14.7	14.2	13.3	14.0	11.9

Sources: Federal State Statistics Service, statistics, as reported in *Vedomosti*, various issues, 2008–2009, and Bank of Finland, Institute for Economies in Transition, "BOFIT Russia Statistics," at http://www.bofit.fi/bofit_en/seuranta/venajatilastot/index.htm (August 20, 2009).

Table 4 • B 2333  heritage.org

ority. Nevertheless, the regime is simultaneously increasing defense spending and procurement.¹⁷

The leadership's insecurity was evident in President Medvedev's orders to the law enforcement authorities to "crush" any unrest stemming from the financial crisis. The perceived threat to the Putin–Medvedev Administration may have triggered the rewriting of the Russian Constitution to extend the president's term from four years to six years and the drafting of the country's new treason law, which would put at risk anyone working with foreigners, such as Western nongovernmental organizations.¹⁸ For now, the treason bill has been delayed by Medvedev.

Muzzling the Media. Since the beginning of the global financial crisis, the Russian leadership has tried to remain firm in the face of adversity. The

12. "WEF 2009: Russia and China Blame West for Economic Crisis," *The Telegraph*, January 29, 2009, at <http://www.telegraph.co.uk/finance/financetopics/davos/4381464/WEF-2009-Russia-and-China-blame-West-for-economic-crisis-Davos.html> (August 20, 2009).

13. In the second quarter of 2009, GDP growth was -1.6 percent in Brazil, -4.1 percent in India, and 7.1 percent in China.

14. Alex Rodriguez, "On the Streets with Russia's Protesters," *Chicago Tribune*, February 8, 2009, at http://archives.chicagotribune.com/2009/feb/08/nation/chi-russia-protests-web_rodfeb07 (August 25, 2009).

15. The poverty line is defined by the Russian government. In the third quarter of 2008, it averaged \$185 per person.

16. World Bank, "The World Bank in Russia," p. 13.

17. Xinhua News Agency, "Russia's State Defense Order Up by 8% in 2010: Deputy PM," September 22, 2009, at http://news.xinhuanet.com/english/2009-09/22/content_12098172.htm (October 21, 2009).

18. Some early government actions are outlined in Yuri Zarakhovich, "The Kremlin Reacts to Systemic Crisis with Plans to Beat Up the People and Arrest Dissidents," *Eurasian Daily Monitor*, January 9, 2009, at [http://www.jamestown.org/programs/edm/single/?tx_ttnews\[tt_news\]=34323](http://www.jamestown.org/programs/edm/single/?tx_ttnews[tt_news]=34323) (October 22, 2009).

media was initially required to censor itself when reporting on the crisis. In Russia's increasingly authoritarian system, the government controls most of the media, which discourages the free flow of information. It limits reporting on high-level cor-

In Russia's increasingly authoritarian system, the government controls most of the media, which discourages the free flow of information.

ruption and ill-conceived policies. Yet if such coverage were allowed, it could contribute to Russia weathering this economic storm.

From the reporting on the financial crisis in the Russian media, it is extremely difficult to judge what is acceptable to publish. A prominent Russian journalist has noted, "It is hard to know what will enrage the Kremlin."¹⁹ Closing down the political and media space for a public debate about economic policy is dangerous for Russia and makes it more opaque to the outside world.

Continuing Economic Deterioration. In 2007, the Russian economy grew by 8.1 percent, but by the fourth quarter of 2008, GDP growth had fallen to 1.1 percent. The Russian Ministry of Economic Development is now projecting a 8.5 percent decline for 2009, an improvement over the annualized 10 percent decline for the first half of 2009. This shows that the ministry is expecting the beginning of a recovery. Industrial production grew by 6.3 percent in 2007 and grew at a 7 percent annual rate through May 2008. It then fell by more than 6.4 percent in the fourth quarter of 2008 and almost 15 percent in the first half of 2009. Fixed investment has reversed even more dramatically, rising by more than 20 percent in 2007 through May 2008, turning negative in the fourth quarter of 2008, and then falling by more than 18 percent in the first half of 2009.

According to the World Bank, Russian reserves

(including gold) plummeted from \$597 billion in July 2008 to \$384 billion in February 2009.²⁰ They recovered in May 2009 to \$404 billion. Capital flows reversed dramatically, with an outflow of \$130.5 billion in the fourth quarter of 2008 after an inflow of \$17.4 billion in the third quarter. Capital flight has continued into 2009, largely using "bail-out money," albeit at a diminished rate due to the rise in oil prices and the ruble exchange rate. The Russian stock market suffered the worst collapse of any major emerging market, before rebounding some 90 percent since March 2009.

Finally, the energy sector, the primary engine of the phenomenal growth of the past decade, has been suffering. Despite the growing need for new sources of oil and gas, all producers have been forced to cut back investment plans as they scramble to repay debt assumed in better times. While Gazprom is still profitable, its capitalization has collapsed, forcing cutbacks in the development of new offshore fields, such as Shtockman in the Barents Sea and Kovytko in Eastern Siberia. This explains Putin's invitation to the major international oil companies to visit the Yamal Peninsula, which has mas-

Russian reserves (including gold) plummeted from \$597 billion in July 2008 to \$384 billion in February 2009. They recovered in May 2009 to \$404 billion.

sive gas reserves, and Natural Resources Minister Yuri Trutnev's promises to liberalize the strategic investment law.

Strong Fiscal Response.²¹ Although delayed, the Russian economic policy response to the crisis was strong. The Russian Central Bank launched an effective policy of managed devaluation, exploiting its massive \$600 billion reserves, while the Russian government launched a broad rescue effort,

19. Radio Free Europe/Radio Liberty, "Debating Russian Coverage of the Financial Crisis," audio file, May 1, 2009, at <http://www.rferl.org/audio/article/164211.html> (August 27, 2009), and related written report, at http://www.rferl.org/content/Debating_Russian_Coverage_of_the_Financial_Crisis/1620039.html (August 27, 2009).

20. World Bank, "The World Bank in Russia," p. 1.

21. For a full discussion of this policy response, see Richard E. Ericson, "The Russian Economy in 2008: Testing the 'Market Economy,'" *Post-Soviet Affairs*, Vol. 25, No. 3 (July–September 2009), pp. 185–207.

announcing almost 6 trillion rubles (\$195 billion and 13.6 percent of GDP) in financial support packages for Russian banks and businesses.²²

The five main state banks orchestrated the rescue operations with the aim of expanding state control over key sectors of the economy and preventing foreign banks from taking over Russian corporations that could not repay their debts. The immediate problem was dealing with Russian banks' and businesses' \$400 billion in foreign debt, of which 10 percent required refinancing, and the threatened foreign seizure of Russian assets that they had pledged as collateral. This strong *dirigiste* response stabilized the decline by mid 2009, allowing the "development debate" to resume.

The Development Debate. Since the crisis began to unfold, the Institute for Contemporary Development, a think tank in Moscow that is close to Medvedev, and some pro-reform economists have repeatedly pointed out that excessive dependence on commodity exports hurts the country, amplifies the consequences of the crisis, and over-centralizes economic control.²³ Knowledge-based growth has become the rallying cry of economic reformers who identify with Medvedev as well as a political banner for power struggle.

For now, the energy and state security lobbies are stronger than the reformers. First Deputy Prime Minister Igor Sechin and other *siloviki* (law enforcement and security senior officials) recognize that diffusion of economic power may mean the decentralization of political power. Thus, even before the crisis, the *siloviki* launched a series of attacks on Finance Minister Alexei Kudrin and jailed one of his deputies. Despite state control of the national television channels, some fissures in the governing elites are becoming obvious in print media and policy conferences, especially after President Medvedev

published his reform manifesto.²⁴ The U.S. government needs to take these fissures into account when calibrating its communication strategy with Moscow.

Russian Foreign and Economic Policy Since the Crisis

Since President Obama's July 7 visit to Moscow, Russia has become at times more receptive to U.S. overtures, in that it allows overflight and transshipment of U.S. and NATO cargoes to Afghanistan, backed off threats to target Poland with nuclear weapons, and has engaged in arms control negotiations.

However, the Kremlin has shown no significant cooperation on Iran. It has unquestioningly recognized the results of the contested Iranian presidential election and provided a stage for President Mahmoud Ahmadinejad at the Shanghai Cooperation Organization summit in Yekaterinburg in June.²⁵ Russia is also taking a harder line with Georgia and Ukraine, hurling baseless accusations that

Russia currently supplies two-thirds of Europe's natural gas imports and 42 percent of total European gas consumption.

the Obama Administration is encouraging Georgia to rearm and threatening further military action in the Trans-Caucasus.

The Russian-Ukrainian gas conflict of January 2009 demonstrated how Moscow's business interests have made Europe dangerously dependent on Russian oil and gas. Russia currently supplies two-thirds of Europe's natural gas imports and 42 percent of total European gas consumption. Some Central European countries depend on Russia for more than 90 percent of their natural gas. By 2030, Europe will

22. A substantial portion had not been disbursed as of mid 2009.

23. Russia Today, "Think Tank Slams Bailouts as Big Business Asks for More," February 9, 2009, at http://russiatoday.com/Business/2009-02-09/Think_tank_slams_bailouts_as_big_business_asks_for_more.html (August 20, 2009), and Yevgeny Gontmakher, "Modernizatsiya: Alternativa vertikalii" (Modernization: The alternative of the vertical), *Vedomosti*, August 8, 2009, at <http://www.vedomosti.ru/newspaper/article.shtml?2009/08/11/209124> (August 20, 2009).

24. Radio Free Europe/Radio Liberty, "Debating Russian Coverage of the Financial Crisis."

25. Xinhua News Agency, "SCO Leaders Kick Off Summit in Yekaterinburg," June 15, 2009, at http://news.xinhuanet.com/english/2009-06/16/content_11547927.htm (August 27, 2009).

import 84 percent of its gas.²⁶ Europe has not developed alternative sources of gas, and some countries have rejected nuclear power and coal.

Thus, Europe has made itself dependent on a monopolistic, state-controlled commodity supplier.²⁷ The European Union and individual countries recognize that their energy dependence will have severe national security repercussions, but they are undertaking few measures to reduce their dependence on Russia. One effort is the construction of the Nabucco gas pipeline, which would bypass Russia.

More ominously, some Russian leaders and parts of the media are now repeating Putin's contention that Ukraine is not a "real" state.²⁸ Russia has launched a similar propaganda campaign denying Georgia the right of statehood.

Some Russian leaders and parts of the media are now repeating Putin's contention that Ukraine is not a "real" state.

Russia's relations with Georgia are even worse than with Ukraine. Since the August 2008 war, Russia has been pressuring Georgia militarily. Russian challenges to Georgian independence—in violation of the Medvedev–Sarkozy 2008 ceasefire agreement—include establishing military bases in Abkhazia and South Ossetia, recognizing their independence from Georgia, and signing a status-of-forces agreement with the two secessionist territo-

ries. Putin has declared that Russia will spend \$500 million for military bases in Abkhazia.

Furthermore, on October 23, the Duma approved President Medvedev's request to amend Russia's defense laws to permit deployment of Russian troops abroad without parliamentary approval. The Russian president can now send troops for such reasons as defense of Russian citizens abroad, repelling an attack on Russian military units deployed outside the country, repelling or preventing an armed attack on another state asking Russia for military assistance, combating piracy, and safeguarding commercial shipping. This is a clear threat to every former Soviet state from the Baltic to Central Asia. It also implicitly acknowledges that the troop deployment in the 2008 war against Georgia may have been illegal under Russian law.²⁹

While Russia has acquiesced to a NATO presence in the Manas airport in Bishkek, Kyrgyzstan, it has moved to establish a new military base in Kyrgyzstan in the volatile Fergana Valley.³⁰ The Kremlin apparently believes that it has enough resources to conduct influence operations, pursue ambitious military reforms, develop new pipeline projects that compete with projects promoted by the EU and U.S., and selectively support its allies in the geographically undefined "spheres of exclusive interests" as proclaimed by President Medvedev in his televised address on August 31, 2008.³¹

In the long term, Moscow will use its resources to create a multipolar world in which U.S. interests are circumscribed. The economic crisis did not gener-

26. Ian Traynor, "EU Unveils Energy Plan to Reduce Dependence on Russia," *The Guardian*, November 13, 2008, at <http://www.guardian.co.uk/world/2008/nov/13/eu-russia-energy> (December 30, 2008).

27. Ariel Cohen and Lajos F. Szaszdi, "Russia's Drive for Global Economic Power: A Challenge for the Obama Administration," Heritage Foundation *Backgrounder* No. 2235, January 30, 2009, at <http://www.heritage.org/Research/RussiaandEurasia/bg2235.cfm>.

28. Stephen Blank, "Russia Pressures CIS Members to Approve Its Policies," *Central Asia-Caucasus Institute Analyst*, October 1, 2008, at <http://www.cacianalyst.org/?q=node/4949> (August 26, 2009).

29. RIA Novosti, "Russian Parliament Passes Bill on Using Troops Abroad," at http://en.rian.ru/military_news/20091023/156570108.html (October 26, 2009). See also President of Russia, "Dmitry Medvedev Submitted to the State Duma a Draft Law Establishing a Legal Mechanism Allowing the President to Use Russian Armed Forces in Operations Beyond the Country's Borders," at <http://eng.kremlin.ru/text/news/2009/08/220713.shtml> (October 21, 2009).

30. Roger McDermott, "CSTO in Crisis as Moscow Secures Second Military Base in Kyrgyzstan," *Eurasia Daily Monitor*, August 4, 2009, at [http://www.jamestown.org/programs/edm/single?tx_ttnews\[tt_news\]=35357&tx_ttnews\[backPid\]=407&no_cache=1](http://www.jamestown.org/programs/edm/single?tx_ttnews[tt_news]=35357&tx_ttnews[backPid]=407&no_cache=1) (October 21, 2009).

ate sufficient internal unrest or instability to change the prevailing foreign policy paradigms. Moreover, some factions in the Russian leadership find it opportune to blame the United States for Russia's troubles, from the economic decline to the violence in Northern Caucasus.³²

Economic Policy During the Crisis: Integration or Confrontation?

Despite an ostensibly weakened position, the Russian government continues to make strong demands to revise key economic and security architectures throughout the world. At the G-20 meeting in London in April 2009, President Medvedev attacked the dollar as the world's reserve currency, proposed creating a new supranational world currency, and promoted the ruble as a regional reserve currency. At the St. Petersburg Economic Summit in June 2009, First Deputy Prime Minister Igor Sechin called for revising the current system of energy payments, dropping the dollar as the currency for oil trade, and creating new Russian oil brands.

According to Professor Stephen Blank:

Moscow wants to stimulate demand for the ruble and convert the CIS into a closed trade and currency bloc through such maneuvers. Indeed, these maneuvers emulate Nazi economic policy in Central and Eastern Europe in the 1930s which had the same aim of subordinating these states to the metropolitan center, in those days Germany, today Russia.³³

Russian reformers want Russia to join two key international organizations. In early June, Deputy Prime Minister and Finance Minister Kudrin announced a renewed effort to complete accessions

to the World Trade Organization (WTO) and Organisation for Economic Co-operation and Development (OECD) in 2009.³⁴

Medvedev and Kudrin also want Russia to join the OECD, a club of rich democracies. While Russia does not currently qualify for OECD membership, it has recently begun formal membership talks.³⁵ In the accession process, Russia would be required to improve its rule of law and corporate governance practices, which would benefit both Russian and foreign business.

The Russian government also wants the U.S. to fulfill its promises to repeal the Jackson–Vanick Amendment, which precludes Russia from receiving permanent normal trade relations (PNTR) status. President Bill Clinton and President George W. Bush repeatedly promised to end this restriction, but never delivered.

Russia has also deployed its economic power in the “near abroad.” Russia and Kazakhstan have provided a joint loan program of \$10 billion for the countries in EurASEC, the Moscow-dominated economic bloc in Eurasia. Yet China's economic power towers over Russia. Beijing has provided \$10 billion in loans to Kazakhstan, \$25 billion to Russia, and \$500 million to Moldova.

Despite the crisis, Russia is moving forward with Nord Stream and South Stream, two gas pipelines that would link Western Europe to Central Asian gas fields, bypassing Ukraine, Belarus, the Baltic States, and Poland. Together they could cost more than \$25 billion to construct and could prove uneconomical. Moscow is engaged in an all-out diplomatic offensive to promote Nord Stream. Russia also wants the EU to list South Stream as an EU priority project, despite the EU's preference for

31. Dmitry Medvedev, interview by A. Vernitsky, Channel One, and K. Pozdnyakov, NTV, August 31, 2008, at <http://www.un.int/russia/new/MainRoot/docs/warfare/statement310808en.htm> (August 27, 2009).

32. BFM.ru, “Terakt v Nazrani: Evkurov obvinil SShA i Izrail” (Terrorist act in Nazrani: Yevkurov blamed U.S. and Israel), August 17, 2009, at <http://bfm.ru/articles/2009/08/17/ingushetiju-podderzhat-samolet-i-general.html> (August 27, 2009).

33. Blank, “Russia Pressures CIS Members to Approve Its Policies.”

34. Marc Champion and Gregory L. White, “Russia Accelerates Push to Join OECD and WTO,” *The Wall Street Journal*, June 5, 2009, at <http://online.wsj.com/article/SB124415259078886735.html> (October 20, 2009).

35. Toni Vorobyova, “Russia Should Cut Rates, Move to Inflation Targeting—OECD,” July 15, 2009, Forbes.com, at <http://www.forbes.com/feeds/afx/2009/07/15/afx6655627.html> (August 26, 2009).

building the Nabucco gas pipeline project through Turkey to Europe.

Gazprom, Russia's giant state-controlled natural gas company, wants to expand its market share in Europe by reducing dependence on the East European transit states and by undercutting European efforts to develop alternative energy sources and transportation routes, such as Central Asian natural gas supplied directly through the Nabucco, White Stream (Georgia–Ukraine–Romania), and Turkey–Greece–Italy (TGI) pipelines.

Closer energy cooperation with China and other East Asian states could shift Russia's geo-economic priorities further east, away from Europe and the U.S.

China has benefited from the economic crisis in the post-Soviet space. It loaned \$25 billion over 10 years to Rosneft, the Russian state oil company, and Transneft, the Russian state pipeline monopoly, for pipeline construction and oil field developments in East Siberia. The East Siberian Oil Pipeline will reach the Pacific around 2013, allowing Russia to become an important oil exporter to the Pacific Rim. Putin recently signed agreements in Beijing to develop a pipeline from Siberia to China and announced plans to link the West Siberian and East Siberian gas pipeline systems, which could allow Russia to shift most of its gas deliveries from the European markets to Asia. Closer energy cooperation with China and other East Asian states could shift Russia's geo-economic priorities further east, away from Europe and the U.S.

Implications for U.S. Interests

For more than 70 years, the United States has used economic levers to deal with Russia with mixed results until Ronald Reagan won a decisive geo-economic victory over the decrepit and cash-starved Soviet system. During the Great Depression, the Soviet Union was a major market for U.S. automobile and heavy equipment manufacturers. Beginning in the 1970s, the U.S. provided billions of dollars in subsidized credits to keep the USSR afloat with huge grain sales. Under Ronald Reagan, the

U.S. enticed the Saudis to flood the market with cheap oil, causing the USSR to go bankrupt and facilitating the Soviet defeat in Afghanistan. Soviet bankruptcy led to *perestroika* and the collapse of the Soviet empire, first in Eastern Europe and then in the Soviet Union. It also contributed to arms control treaties with Gorbachev and Yeltsin, Soviet withdrawal from the Third World, and ending of the Cold War.

After the Soviet collapse, the West provided Russia with substantial economic aid and technical assistance to facilitate its transition to a market economy. Yet privatization was often opaque, and many of today's tycoons acquired their assets in sweetheart deals, generating substantial resentment toward the Yeltsin administration and the West.

Today, U.S. interests in Russia include:

- Stopping or slowing Russia's slide toward a state capitalist model, which would make externally aggressive authoritarianism more viable;
- Helping Russia to develop more transparent business practices, which would attract American business;
- Developing small and medium enterprises in Russia, and
- Increasing Russia's stake in the global economy, which is based on economically liberal, law-based models.

The U.S. is also interested in sending a clear signal to the Russian leaders that their policies are leading toward imperial overstretch. Russia is aiding and abetting Iran, Syria, and Venezuela; building military bases in Central Asia, the Caucasus, and the Middle East; and pursuing ambitious pipeline projects. In the long term, these may become unsustainable liabilities that could set back or even bankrupt the Russian economy.

What the U.S. Should Do

It is in long-term U.S. and Russian interests for Russia to abandon its revisionist rhetoric and policies and to join the community of market economies. Russia will be a more viable U.S. partner if it demilitarizes its foreign policy and refocuses on economic modernization and international integration, as proposed by President Medvedev in September

2009. However, such a shift will require profound changes within Russia, which U.S. bilateral and multilateral policies could facilitate or hinder. The U.S. needs to devise incentives for steps that facilitate Russia's integration into global markets, but deny benefits if Russia continues to pursue anti-American policies or refuses to enact the needed changes. Specifically, the U.S. should:

- **Work with key European governments to address energy vulnerabilities that result from their overreliance on Russian natural gas.** Working together, the nations of Europe could formulate and implement effective and realistic free-market energy policies. The U.S. should encourage European governments to remove regulatory barriers that impede access to other energy sources. The U.S. should also work with them to apply anti-monopoly legislation to Russian government-owned companies if Moscow continues to deny upstream access to Western companies.
 - **Support diversification of energy transportation routes in Eurasia.** This specifically includes constructing oil and gas pipelines linking Kazakhstan and/or Turkmenistan to Europe across the Caspian Sea. These pipelines would connect to the Baku–Tbilisi–Ceyhan oil pipeline and the Baku–Erzerum gas pipeline, linking Azerbaijani and Central Asian producers to European markets via the proposed Nabucco pipeline. The U.S. should work with European countries and Turkey to prevent increased European dependence on Russian and Iranian gas through the Russia-led South Stream gas pipeline project.
 - **Cooperate with Western banking regulators, intelligence services, and law enforcement agencies to track Russian state and oligarch money laundering activities, corruption, and unfair competition practices.** The Obama Administration should prioritize gathering and acting on intelligence on questionable Russian activities. The U.S. should lead an international effort among law enforcement agencies to prevent and stop complex transnational crimes.
- **Place conditions on Russian borrowing from international financial institutions.** According to the World Bank, Russia has appealed to borrow billions of dollars for social programs in 2010–2012. The U.S. should condition such borrowing on Russia taking steps to ensure transparency and the rule of law as well as cooperating with vital U.S. foreign policy and security priorities, such as Iran.
 - **Encourage Russia to deepen its economic reforms and to diversify its economy.** The U.S. has a strong interest in Russia evolving beyond an authoritarian petrostate and further integrating into the rule-based global economy. However, state monopolization and control over key sectors of the economy threaten that development.
 - **Make the rule of law and good governance litmus tests in developing U.S.–Russian economic relations.** The Obama Administration should elevate the rule of law to the same status as arms control and Iran. U.S. should uphold foreign shareholders' rights when violated by corrupt Russian officials and expand its law enforcement programs to combat Russian money laundering. Without a fundamental change ensuring the rule of law, both Russians and foreigners will continue to suffer from the arbitrariness and corruption which characterize contemporary Russia in all spheres—economic, civil, and political.
 - **Support Russian membership in the WTO and OECD if Russia opens its market and implements the transparency, rule-of-law, and anti-corruption measures expected of a developed country.** Membership in these organizations should increase Russia's stake in the international rules-based system, benefiting its own economy. WTO membership also includes remedial treatment of Western companies that

When Russian entities violate laws on corruption and money laundering, the U.S. and its allies should not hesitate to vigorously prosecute the offenders and deny visas to government and business figures involved in the illicit activities.³⁶

36. Cohen and Szaszdi, "Russia's Drive for Global Economic Power."

are attacked by corrupt government officials. The U.S. should promote privatization through bilateral discussions, and firm commitments to improve the competitive environment should be integral to any final WTO accession package. To join the WTO, Moscow also needs to resolve its trade disputes with Ukraine and Georgia.

- **Repeal the Jackson–Vanick Amendment.** The amendment is a relic of the Cold War, designed to support the free emigration of Soviet Jews. However, Russia has consistently permitted such emigration. U.S. Presidents have waived Jackson–Vanick year after year, but only Congress can repeal it. The Obama Administration should push Congress to eliminate this counterproductive irritant in the bilateral relations.

Conclusion

When dealing with Russia, the U.S. should staunchly protect its national security and foreign policy interests, including continuing its opposition to the Iranian nuclear weapons, deploying missile defenses, and negotiating the best deal possible on strategic arms. This is not the time for counterproductive unilateral concessions, which could encourage further Russian recalcitrance. Instead, increasing Russia's stake in the global economic pie could move its rulers over time to emphasize the economic agenda over the 19th century-style expansionism. Congress and the Obama Administration should pursue this option, while still driving a hard bargain on vital national security priorities.

Economic and foreign policy are closely intertwined everywhere, and Russia is no exception. The

current economic crisis has selectively toned down the rhetoric, but it has not sufficiently changed the basic foreign policy priorities of the top Russian national leadership. Russian elites are still deciding whether to modernize as a part of the West or to become a major international force apart from the West. In at least some circles, there is the growing realization that Russia needs to diversify away from being a petrostate and a commodity exporter and finally join the OECD and WTO.³⁷ However, this should not happen unless Russia changes its foreign policy behavior significantly, especially in regard to Iran and Venezuela.

The Obama Administration should safeguard American interests while maintaining dialogue on policies toward Russia with European allies, Russia's post-Soviet neighbors, and Russian society. As self-proclaimed realists, the Obama Administration needs to employ the entire foreign policy toolbox, including foreign economic policy, in pursuit of U.S. strategic goals vis-à-vis Moscow.

—Ariel Cohen, Ph.D., is Senior Research Fellow in Russian and Eurasian Studies and International Energy Security in the Douglas and Sarah Allison Center for Foreign Policy Studies, a division of the Kathryn and Shelby Cullom Davis Institute for International Studies, at The Heritage Foundation. Richard E. Ericson, Ph.D., is Chair of the Department of Economics at the East Carolina University and former Director of the Harriman Institute at Columbia University. The authors thank Daniella Markheim and Ted R. Bromund, colleagues at The Heritage Foundation, for their review of and contributions to this paper.

37. This is reflected in the rather unrealistic 20-year development plan that the government approved in mid January 2009. Bank of Finland, Institute for Economics in Transition, *BOFIT Weekly*, January 23, 2009, at <http://www.bof.fi/NR/rdonlyres/882556F8-2026-4425-A1E8-D70E405B6FCB/0/w200904.pdf> (October 21, 2009).