

A POLITICAL ECONOMY OF RUSSIAN FOREIGN POLICY:  
THE EFFECTS OF NATURAL RESOURCE-FINANCIAL SECTORS ON  
THE FORMATION OF RUSSIAN FOREIGN POLICY IN THE CONTEXT OF  
THE INTERNATIONAL MARKET

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## ABSTRACT

### A POLITICAL ECONOMY OF RUSSIAN FOREIGN POLICY: THE EFFECTS OF THE NATURAL RESOURCE-FINANCIAL SECTORS ON THE FORMATION OF RUSSIAN FOREIGN POLICY IN THE CONTEXT OF THE INTERNATIONAL MARKET

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This research aims to analyze Russian natural resource-finance sectors' effects on Russian foreign policy from the collapse of the Soviet Union on. The main question it tries to answer is why they are successful to determine the main contours of a relatively peaceful foreign policy in a crises-laden Russia which have had so many reasons to switch to an aggressive behavior. In this regard, the military-industrial complex is the other crucial economic sector to be referred to frequently. Given the overwhelming nature of the international structure that Russia finds itself in, and given the general change in the worldview of the Russians, it becomes clear that the resource-finance sector on the one hand and the military-industrial complex on the other are much more than mere economic sectors, being organic material cores of alternative national and international identities. Such a holistic approach in turn makes it possible to draw on the explanatory power of the legitimacy factor and to go beyond different group preferences in accounting for Russian foreign policy. Analyzing different sectors' and their commodities' structural characteristics in the context of the international market helps to discard the "politics of international trade" as a too narrow conceptual framework to study Russian foreign policy and to understand different economic sectors' true explanatory utility.

Keywords: natural resource sector, finance sector, military-industrial complex, international market, foreign policy, political economy, identity, legitimacy

## ÖZ

### RUS DIŞ POLİTİKASININ SİYASİ İKTİSADI:

#### ULUSLARARASI PİYASA KONTEKSTİNDE DOĞAL KAYNAK-FİNANS SEKTÖRLERİNİN RUS DIŞ POLİTİKASININ OLUŞUMUNA ETKİLERİ

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Bu çalışma Sovyetler Birliği'nin dağılmasından sonraki dönemde Rus doğal kaynak-finans sektörlerinin ülkenin dış politikasına etkilerini araştırmayı amaçlamaktadır. Cevaplanmaya çalışılan temel soru, bu sektörlerin saldırgan dış politikaya yönelmesi için bir çok nedeni olan Rusya'nın barışçıl tutum sergilemesinde genel çerçeveyi belirleme konusunda başarılarının nedenleridir. Bu bağlamda askeri-sanayi kompleksi diğer önemli bir ekonomik sektör olarak ele alınmaktadır. Uluslararası siyasal piyasanın ezici ortamında ve Rusların dünya bakışındaki genel değişim ışığında doğal kaynak-finans ve savunma sektörlerinin ekonomik aktör olmanın ötesinde iki alternatif kimliğin maddi temelini oluşturdıkları tespit edilmektedir. Bu tür bir bütüncül yaklaşım Rus dış politikasını açıklamak için meşruiyet faktörünün analize dahil edilmesine ve çeşitli ekonomik grupların seçim ve tercihlerinin ötesine çıkma fırsatı sağlamaktadır. Bunun yanında, bu sektörlerin ve ürünlerinin yapısal özelliklerinin uluslararası piyasa kontekstinde değerlendirilmesi, Rus dış politikasını açıklamada farklı ekonomik aktörlerin “analitik araç” olarak kapasitelerini belirleme bakımından “uluslararası ticaret politikası” kavramsal çerçevesinin yetersizliğinin ortaya çıkarılmasına yardım etmektedir.

Anahtar Kelimeler: doğal kaynak sektörü, finans sektörü, askeri-sanayi kompleksi, uluslararası piyasa, dış politika, siyasi iktisat, kimlik, meşruiyet

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## INTRODUCTION

This research aims to analyze Russian natural resource-finance sectors' effects on Russian foreign policy from the collapse of the Soviet Union on. The main question it tries to answer is why they are successful in determining the main contours of the relatively peaceful foreign policy in a crises-laden country, which have had so many reasons to switch to an aggressive behavior. This thesis doesn't come up with specific hypotheses to be tested in the strict "scientific" sense. In that regard, it fits the category of an "exploratory research," where the purpose is "to provide greater familiarity with the phenomena" so that "more precise research questions" and perhaps empirically testable "hypotheses" can be formulated.<sup>1</sup> This said, the main organizing arguments developed are being related to rich empirical data to be sure. Looking at the nature of the resource-finance sector, it is claimed that its inherent or structural characteristics create a kind of irresistible drive to be integrated with the international market. This in turn works to separate economic sphere from the political one in Russia, where absolute dominance of politics has been so crucial a factor accounting for aggressive foreign policy historically. Moreover, this pull to play by the rules of the international market gradually weakens the military-industrial complex as the basis of the traditionalistic inclinations. The introduction of the international political and especially economic structure helps to go beyond economic determinism regarding Russian foreign policy. Given the overwhelming nature of the international structure that Russia finds itself in, and given the general change in the worldview of the Russians, it becomes clear that the resource-finance sector on the one hand and the military-industrial complex on the other are much

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<sup>1</sup> Jarol B. Manheim and Richard C. Rich, *Empirical Political Analysis: Research Methods in Political Science* (USA: Longman Publishers, 1995), 85.



more than mere economic sectors, being organic material cores of alternative national and international identities. And more than their or their representative identities' interaction, it is the overlaps of this duality with the international market structure that eventually shape Russia's international behavior. Such a holistic approach in turn makes it possible to draw on the explanatory power of the legitimacy factor and to go beyond different group preferences in accounting for Russian foreign policy. Analyzing different sectors' and their commodities' structural characteristics in the context of the international market helps to discard the "politics of international trade" as a too narrow conceptual framework to study Russian foreign policy and to understand different economic sectors' true explanatory utility.

Historically speaking, in Russia, the immanence of external threat or the perception thereof combined with the critical scarcity of economic assets gave rise to an authoritarian polity to mobilize all available resources for security aims.<sup>2</sup> The state substituted human factor for too scarce resources to deal with too powerful "enemies." Thus formed dominance of economic sphere by the political one in the service of militaristic foreign policy aims increased the ease with which the political center could mobilize national wealth at wish disregarding the demands of oppressed society. Culture/value systems or ideological inclinations went hand in hand with this structure. That aggressive-expansionist foreign policy was working and even generating some economic benefits increased the attractiveness of the system.<sup>3</sup> Yet

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<sup>2</sup> See Igor Chubais, *From the Russian Idea to the Idea of a New Russia: How we must Overcome the Crisis of Ideas*, trans. and ed. J. Alexandr Ogden (John Kennedy School of Government, 1998).

<sup>3</sup> The expansionist policies had a very important economic reason as well. Wasteful rural economy required new fresh lands, which were controlled by the warrior Turkish tribes to the east and south. This naturally required a strong military organization to make possible Russian colonization "so essential to its economic survival." "One of the basic reasons for the tenacity with which Russians have managed to hold on to conquered territories lies in the fact that their political absorption was and to this day continues to be accompanied by colonization." Without increasing productivity and significant trade, the Russians offset their demographic expansion by expansion towards unexploited lands in central and southern Russia. That by 1880s there remained no reserve to exploit, was one of the most important factors that brought about "agrarian crisis" during the late imperial period and the collapse of the state. Richard Pipes, *Russia under the Old Regime* (New York: Charles Scribner's Sons, 1974), 14, 15, 20. Interestingly, towards 1980s a very similar fate befell Russia. As the capital-extensive nature of the economy (i.e., where priority was given not to productivity per input but overall output) reached its geographical and labor force limits, this, combined with the failure to

the immense social and economic cost committed to sustain it was too high compared to the outcomes. In time this mechanism acquired an autonomous dynamic,<sup>4</sup> whereby Russia expanded “enslaving both Russians and the neighboring nations.”<sup>5</sup> That is to say, aggressive foreign policy and oppressive internal political economy were closely interrelated. Eventually, to the end of the 20<sup>th</sup> century, the combination of the impossibility of continuing the competition with the given political economy against the most developed nations of the world, a general change in the value systems of the Russians about the right manner of organizing political and economic life and the decrease in the international threat brought about the collapse of this structure.

Till 20<sup>th</sup> century the main source of wealth was unproductive land; no significant trade and industry was the case.<sup>6</sup> Afterwards though Stalin could build his industrial empire in mere decades, it was still a security-oriented-economically-wasteful system in the service of militarist foreign policy that emerged and survived by absorbing immense quantities of coerced human labor and Soviet Union’s vast natural resource potential.<sup>7</sup> However, in late 20<sup>th</sup> century, the “disappearance” of the

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expand (the concrete case was Afghanistan) and political pressures of intensified phase of the Cold War (“Star War”) was the crucial factor ending the Soviet state.

<sup>4</sup> As technological improvements and proto-administrative structure developed under the Turko-Mongol rule enabled the emergence of a politico-economic system capable of supporting an army to withstand enemy incursions, the lack of barriers and the river networks that were key reasons for vulnerability turned out to be useful means for outward expansion. The lack of natural shield resulted in the perception of security as territorial depth: the more far away the “hostile” neighbors from the core of the nation were the more secure it was felt. Nicolai N. Petro and Alvin Z. Rubinstein, *Russian Foreign Policy: from Empire to Nation State* (New York: Longman, 1997), 6.

<sup>5</sup> P. Ia. Chaadaev, “Neopublikovannaia Stat’ia,” *Zven’ia* 3/4 (1934): 380.

<sup>6</sup> Edward Acton, *The Present and the Past Russia: the Tsarist and Soviet Legacy* (London: Longman, 1995), 1; John M. Thompson, *Russia and the Soviet Union: An Historical Introduction from the Kievan State to the Present* (Colorado: Westview Press, 1998), 3, 27.

<sup>7</sup> “The real problem Russia has to face is: what do you do with all the mistakes that were made in the seventy years of the past system—the factories that were built to produce the wrong things, the factories that were built in the wrong places, entire cities built in the wrong places—and when I say wrong, I mean: they would not have been there if Russia were a capitalist country—cities like Perm, Yekaterinburg, Omsk, Novosibirsk—there was quite serious misallocation that came about because of a system that didn’t recognize real costs and real prices.” Throughout the world, throughout the entire northern hemisphere, at least through the twentieth century, all the nations moved to warmer places. The only exception has been Russia. This stopped in the early 90s, “but the bad news is, it doesn’t get warmer.” Clifford G. Gaddy, “Russia’s Economic Future,” *Washington Profile* 30 October 2002: 1, 3.

external threat is likely to solve the problem of scarcity too. Natural resource potential that was “scarce” while Russia was in war with the entire world seems to be more than “abundant” for a Russia that chooses to cooperate.<sup>8</sup>

In late 1980s, with the decrease in the international threat perception, the state’s absolute control of the economic sphere started to loosen. This not only meant the privatization of the economic life but also and more importantly, the release of market mechanism<sup>9</sup> in Russia within the context of the working international market. This has been one of the most fundamental yet overlooked aspects of the process that stands behind the collapse of Russia’s Soviet empire and that continues to this day. The process was initiated by the Soviet political elite, mainly due to changes in the value systems and the perceptions of the external threat. But it lost much of its popularity as the failure of the grand reform was becoming clear in the early 1990s. Actually, the initial aim and belief was that Soviet Union’s vast industrial capability centered on the-state-of-the-art military sector will adapt into (by conversion) and prosper in the international market with the help of Western financial support and friendly opening of world markets. Russians simply counted on this to be able to reach the life standards of the West with ignorable effort. Not long before, however, they realized that neither Western help nor the level of competitiveness of the Russian industry was good enough to achieve this end. The colossal misery and

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Database                      on-line.                      Available                      from                      Brookings                      Institution  
<<http://www.brook.edu/views/interviews/gaddy/20021030.htm>>. [30 December 2003].

<sup>8</sup> “...Modern Russia and the Soviet Union possessed rich natural resources, but much of this wealth, such as oil, natural gas, and other abundant minerals, was exploited only recently. For most of its history, Russia was a very poor country, its people struggling to survive and improve their way of life while supporting, with limited resources, a government-organized defense against recurrent enemies. Unfortunately, carrying the burden of the state and the army often meant that the people lived in harsh poverty. Since World War II, progress in raising the quality of life has been made, and the resources exist for citizens of the region to live more comfortably in the future.” (Thompson, 5).

<sup>9</sup> Privatized economy and even the whole system of capitalism is not the same thing as market. Much more inclusive and able to generate much greater dynamism than the former two, actually, it was the release of market that changed the face of the world about a couple of centuries ago. In its ideal form, in the world of market there emerges the principle of “survival of the most efficient.” Though this stems from the competition with similar economic actors for selling the most valuable with the least price, eventually it boils down to the most efficient use of the assets and thus more wealth and more military/political power in the international level. In this sense, the collapse of the USSR was a kind of collapse under the pressure of the market too. For the specificities of free market see: Robert Gilpin, *The Political Economy of International Relations* (Princeton: Princeton University Press, 1987).

accompanying discontent as the result of the collapse of the old system and the failure to replace it with even a slightly comparable new one created an environment where numerous attempts have been made to turn Russia back. In its ultimate form this meant old politico-economic system, where isolated economy was to be dominated by the political forces to commit national resources, and totally, and if required forcefully mobilized human potential to defense centered industry, again, to be justified against the hostile outside world that perceivably deceived Russia. What makes such attempts probable is the peaceful collapse of a military superpower where the bulk of its expertise and economic infrastructural basis remains intact even to this day. However, besides the limits of exaggerating external threats to Russia today, the very sector that has developed and prospered under internal and international market rules *by default* has been powerful enough to block such attempts. The immense natural resource sector of the Russian Federation led by the energy sub-branch and organically tied to the financial sector popped up in the market environment unintentionally and created enough satisfaction or at least force to challenge the attempts to re-politicize Russian economy and to re-securitize its foreign policy. By default since, the initial plan was to bend this sector to the conversion of the defense industry centered economy, yet in time it declared its independence and started to dominate the latter with all its authoritarian and imperialistic inclinations. First it was ideational factors with the help of which new political groups of the new regime were fighting, yet later on reform initiative created economic actors, which had material benefits in the continuation of the process.<sup>10</sup> At the beginning Russian political elites had their own plans, after a couple of years the initiative was taken over by the international market.

Related to these, though military industry and its lobby attained the prominent place during the first years of the reform process, their failure to adapt to the new environment resulted in their fall. “The stage was now set for the ascent of the oil and gas industries.” Though at times, especially in the wings of internal and external crises the military industry would re-bid for dominance, trying to challenge the

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<sup>10</sup> Michael McFaul, “A Peace: Domestic Politics in the Making of Russian Foreign Policy,” *International Security*, no. 3 (winter 1997/98): 11.

overwhelming international structure rather than to reform itself would bring about the gradual decline of its power vis-à-vis the financial industrial groups.<sup>11</sup>

The importance of energy-led resource sector comes to the fore given the Russians are no longer prepared to trade almost all the butter for a single gun to be used against non-existent threat from the Western world which by all measures surpassed Russia anyway. The existence of resource sector made this possible after the decision had been made. That is to say, unlike the medieval Europe where new economic forces within the old political system built up forcing the change in the latter, in Russia this started by the international politico-economic pressure, Soviet population which was after a decent life and Gorbachev's interpretation and a new vision to respond to it. Still, the argument is that *in the absence of the resource-finance sector it would have been impossible to fight the forces of regression*. Almost all authors studying this issue speak of the resource-finance groups' moderating effect and liberal vision, but none go this far. Perhaps this stems from not seeing it in the context of international politics and especially international and internal market. Placing it there reveals that it is more than a mere sector. It is the tangible basis of the alternative way of existence and what makes the way of life Russia finds itself in possible and bearable.

The new economic structure was successful not only and even not primarily by struggling with the forces of the past. It convinced that it stands to be a good or even a better substitute. If traditional methods, first and foremost coercion doesn't work in foreign policy and is too costly with almost no return, then another rational option is to compete. And Russian natural resource firms seem very well suited to compensate for the absence of Russian traditional coercive foreign policy assets by offering their competitiveness based on the principle of consent; both materially and psychologically. Where generals are not welcome or aren't able to penetrate with their arms, cash and technology of the banker-energymen are. When the Russians are

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<sup>11</sup> For the rise and fall of the military industrial complex's lobby and occasional references to the rise of that of the finance-resource sector see Tor Bukkovol, "Arming the Ayatollahs: Economic Lobbies in Russia's Iran Policy," *Problems of Post-Communism*, no. 6 (November/December 2002). The first important indication of the rise of the natural resource lobby was Chernomyrdin's rise to prime ministership in December 1992.

suffering from the contraction syndrome after relentless expansion from almost the very beginning and are back to 17<sup>th</sup> century in terms of the size of their territory, energy-led resource sector expands exactly into the lost territories. During harsh times, when Russia perceives itself in the hostile, unfamiliar and difficult-to-live world, energy sector comfortably blazes through. It knows how to play with the rules of the new game, in a cooperative manner. The tension that could have increased to the point of explosion by crippled Russia in a new environment has been given a venue to be gradually discharged.

In the outside world resource sector makes Russia important yet, unlike its nukes, “worth to be befriended” too. For years Russia was important because it was dangerous, resource sector however, makes Russia important because it is useful. Militarized and dangerous Russia was a poor one, friendly and useful Russia has a potential to get rich.<sup>12</sup> If the traditional way of life meant the devotion of the entire material and human resources to the service of international security which eventually failed anyway, and if peaceful life can only bring more prosperity, the new way’s legitimacy increases. Resource-finance sector’s interests become national interests and it becomes the very symbol of success in the world of the Western nations that defeated Russia.

The mere independence of resource-finance sector in the sense of being privatized, or even its connection to the international market would have not been enough to withstand attempts gravitating backwards, aggressive foreign policy included. Besides these factors, the decisive one has been the very nature of resource sector that was big enough and competitive enough in international market to generate enough wealth and power to withstand the shocks, and to create assurances that provided there is more integration can much more be gained compared to the other alternative. True, such an inclination required peaceful competition abroad dictated by the nature of international market and cooperative relations with first and

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<sup>12</sup> In 2000, an institute for the fuel and energy complex was established at Moscow’s prestigious foreign policy body, MGIMO, “highlighting the increased importance that the energy factor was now playing in Russian foreign policy thinking.” Mark A. Smith, *Russia’s Energy Diplomacy* (March 2002), 1. Database on-line. Available from Conflict Studies Research Centre <[http://da.mod.uk/CSRC/Home/Russian\\_Foreign\\_Policy/F75](http://da.mod.uk/CSRC/Home/Russian_Foreign_Policy/F75)>. [15 May 2003].

foremost the dominant nations of the world, which at the same time happened to dominate the international market. But Russia's overall and relatively peaceful foreign policy after the collapse was beyond some people's preferences. The structural characteristics of the natural resource sector create a great incentive for it to integrate with the international market. Restructuring itself under international market rules it pressurizes Russian economy to obey by these rules and entrenches the private sphere. The introduction of market principles and rule of law to institutionalize it in turn means the difficulty with which the political center can mobilize national resources at wish for its grand foreign policy aims or to feed gargantuan armed forces.

There are resistances to new developments. In the economic sphere it is the developed (during Soviet times) military-industrial sector that constitutes "the other" of the resource-finance sector. Peaceful relations with the outside world means that sprawling Russian military industry doesn't receive orders, and the marketization of the Russian economy means that they are gradually being deprived of the-still-generous subsidies mainly provided by the resource sector. However, stemming more from the inertia of history than the fertile ground it finds today, such resistance gradually loses dynamism. The resonance generated by the overlap of omnipresent and omnipotent international pressure and the new structure of the Russian economy seem not favorable at all to the traditional forces. The constant pressure of the international market rewards energy led natural resource sector and punishes military industry, and the related identities. It needs to be clearly restated that "Russia turns back" option is beyond the power and interests of the military and the military industrial complex. The point is about huge forces of discontent with a great potential. It is the accumulated intellectual, cultural, discursive and material infrastructure combined with the terrible economic, social and psychological situation the Russians find themselves in that make it so formidable force of backward gravitation. Like the resource sector in tune with something beyond itself-the prevailing forces of international political economy and some changes in the value systems of the people, military industry is beyond the tangible factors too; it runs deeper to historically accumulated pool of material and cultural assets.

At the beginning Russians ascribed too much importance to international politics disregarding the autonomous dynamic of international market. Having good relations with the Western nations was not enough for them to enter the international market, which meant economic collapse. The conceptual distinction between international politics and international market is not drawn as clearly as it needs to be in analyses of Russia's foreign policy formation too. This thesis will be careful in this regard. As will be shown, the fact that Europe is the predominant market for Russian resource goods in itself creates some pressures for the resource sector and eventually Russia to seek good relations with European nations. Or there is a great deal of politics of international market too, whereby natural resource sector's goods are acceptable and foreign-investment-attractive, whereas that of the military sector, despite being internationally competitive in the pure economic sense, are in the opposite category. Yet still, international market is something beyond international politics to some degree. And the dominant nations of the world are aware of the costs and limits of interfering with its rules. It was in this context that perfect political relations with the developed nations while lacking international competitiveness has not been enough for the Russians to benefit from the international market. Yet without perfect relations with the Western nations while having a competitive sector they realize they have more chance. Russia, whose international political stance has drastically decreased, reenters it through the international market.

As will be referred to repeatedly, there has been a good deal of scholarly work that directly or indirectly handled the issue of struggle between reformist vs. traditional forces in Russia with cooperative vs. aggressive foreign policy preferences and even outcomes, where the reformists are related to the new financial-resource sector and traditionalists are one way or another related to "the other," mainly the defense industries or defense sector centered industry. However, such works mainly do not go beyond associating different foreign policy attitudes with different economic sectors and pointing how at given situations the interrelationship between the two created some outcomes.



One of such studies, by Michael McFaul, comes very close to the phenomena analyzed in this thesis. In Russia there is a transition from an almost absolute autocracy to democracy. According to Edward Mansfield and Jack Snyder, for Russia in such a stage, the likelihood of going to war is twice as much as are the states that remain autocracies. Though there have been military clashes between Soviet and Russian governments in August 1991 and between legislative and executive branches in October 1993 and in Chechnya, there has been a relative peace “compared to regime changes in other great powers over the last two hundred years” which has not degenerated into a major international conflict.<sup>13</sup> “Why?” asks McFaul. “The answer has to do with the ideas and interests of the winners in Russia’s regime transition.” So far in Russia political power remained in the hands of “liberals” who due to their both normative and material interests pursued peaceful and integrationist foreign policy. Unlike “radical communists, extreme nationalists, segments of the armed forces, or parts of the military industrial complex,” those in power stand to get least form a belligerent foreign policy. Moreover there are no international allies for the losers in Russia.<sup>14</sup> But Michael McFaul doesn’t tell *why* power remained in the hands of the liberals. Neither does he tell what apart from *preferences* of some people with material interests and even liberal ideas affected Russia’s relatively peaceful foreign policy. This study tries to explain exactly this “why.” Again, what helps us in this regard is the introduction of international market and potential power and rewards that the natural resource sector promises in interacting with it; promises that go beyond the interests of specifically defined groups.

The sector that is behind the cooperative foreign policy is the natural resource sector, from energy to wood to diamonds. Though the leading subsector is the energy, the entire natural resource sector carries similar characteristics: they are big internationally and internally, competitive in the international market, most privatized and related to their cash generating capabilities, directly connected to the

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<sup>13</sup> Edward D. Mansfield and Jack Snyder, “Democratization and the Danger of War,” in *Debating the Democratic Peace*, eds. Michael Brown, Sean Lynn-Jones, and Steven Miller, (Cambridge, Mass.: MIT Press, 1996), 302.

<sup>14</sup> McFaul, 5-6, 21, 34.

Russian financial sector. The energy branch however, has more: it is strategically much more attractive in the international market, has more potential areas to expand in its neighborhood, and simply much more available literature and data. Thus it will be referred to more frequently. However, unless specifically stated, implied or clear from the context, energy sector will generally refer to Russian natural resource sector as a whole, the wealthiest country in terms of the combined reserves and export volume of natural resource products.<sup>15</sup> What makes this “putting together” more meaningful is that it is almost the same persons and conglomerates that gathered the bulk of the resource sector in their hands, be it energy or not. Financial sector is the reason and the consequence of this accumulation as will be made clear. That is why recently they started to be referred to as the Financial Industrial Groups (FIGs).

The first chapter is mainly of a descriptive character. It concerns itself with the drastic decline of the Russian military-industrial complex comparing its current situation to its heydays during the Soviet years. The most important point is military industry’s being much more than a mere economic sector, which appears to constitute the core of the alternative traditionalistic identity waiting to be called up. Generally speaking, following five chapters (2-6) analyze the structural characteristics of the natural resource sector and on the basis of their size and international political and economic competitiveness conclude that the most profitable option for them must be integration with the international market. Supporting this conclusion by empirical data they show that this tendency not only acts against the military-industrial complex but also helps to separate political and economic spheres within Russia, whereby the state must find it increasingly difficult to mobilize national resources for cost-blind foreign policy ventures. The 7<sup>th</sup> chapter evaluates how resource-finance groups affect the general contours of Russian foreign policy and makes inferences about the foreign policy towards the Western states within this context. Placing the resource-finance sector within “the other” liberal national and international identity model, this chapter analyzes the advantages of introducing international politico-economic context to have more proper results

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<sup>15</sup> Interestingly, in terms of its size, geographical location and richness in natural resources Russia resembles Canada. Canada’s the main trade partner is the US. For Russia it is the EU. Despite much more differences between the two nations Russians seem to be aware of such facts.

about the real effects of the two main economic sectors. It appears that in such a context the explanatory power of the sectors as organic parts of different identities increases tremendously. Chapter 8<sup>th</sup> concentrates on former socialist bloc and former Soviet states and draws attention to the moderating effects of the resource sector. The 9<sup>th</sup> chapter is a continuation of the previous one where the limits of the state influence on especially the energy sector, given that it is already embedded in the international market, are analyzed in a more detailed way. The last chapter deals with an unexpectedly more authoritarian rhetoric (than what would have been expected looking at the economic aspects of the issue) on the part of the resource-finance groups and still more authoritarianism towards the states of the former Soviet Union in general. It appears that the FSU states may be the gift given to Russia for its hegemonic games in return for a more peaceful Russia on a global scale.

## CHAPTER 1

### **MILITARY-INDUSTRIAL COMPLEX: FAILURE, DISCONTENT, HUGE POTENTIAL AND THE MATERIAL CORE OF THE “TRADITIONAL” IDENTITY**

What was the place of the military industry in the old Soviet economy and what is it in the Russian one today? What does it mean beyond economy, regarding “the way of life”? What are the problems that may provide a fertile ground for those who may want to revitalize the traditional political economy and foreign policy?

“Perhaps as large as one third” of the Soviet economy was devoted to military purposes.<sup>16</sup> Towards the last decades of the Cold War, defense industries were absorbing one-third of the industrial force, 60 percent of the machine-building industry, 80 percent of all research and development personnel, and 20 percent of energy output of the Soviet Union.<sup>17</sup> The defense industry companies produced not only military goods but also civilian ones. They provided 83 percent of the medical equipment, 92 percent of equipment for light industry, 76 percent of the agricultural machinery, an important part of the production of electrical appliances, as well as

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<sup>16</sup> Michael Mandelbaum, “Introduction,” in *The New Russian Foreign Policy*, ed. Michael Mandelbaum (USA: Council on Foreign Relations, 1998), 2.

<sup>17</sup> Keith Bush, “Conversion and Unemployment in Russia,” *RFE/RL Research Report*, no. 2 (1993): 29-32.

more sophisticated investment goods.<sup>18</sup> Russia inherited about 70 percent of the Soviet military-industrial complex (MIC),<sup>19</sup> which consists of 2000 enterprises and 960 research centers/design bureaus.<sup>20</sup> However, with the collapse of the Soviet Union and actually, with the change commenced by Gorbachev in the domestic political economy and foreign policy of the Soviet Union, the MIC started to receive less orders and subsidies. It was hit by cuts in spending, market reform, friendly relations globally, and severed relations with the former republics of the Soviet Union and the states of the socialist alliance.

Russian military production fell by more than 80 percent compared to 1991. 2 million jobs have been eliminated, with the pay in the MIC 40 percent lower than in Russian industry as a whole. Facilities, with almost half the equipment obsolete, today operate only at 10-15 percent of capacity.<sup>21</sup> Actually, in 2000 only 3 percent of central (generally in Moscow and St. Petersburg), and only 1 percent of regional enterprise managers indicated that they used world standard technology.<sup>22</sup> Between the peak of Soviet military build-up in the 1980s and the lowest point in 1997, the share of defense spending in Russian GDP dropped from 15-17 percent to 3-4. In 1997 not a single military aircraft was produced, whereas in Soviet times the number was as high as 545.<sup>23</sup>

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<sup>18</sup> Television sets, sewing machines, vacuum cleaners, photographic equipment; diesel engines, equipment for oil extraction, etc. Antonio Sanchez-Anders, "The transformation of the Russian defense industry," *Europe-Asia Studies*, no. 8 (December 1995): 17.

<sup>19</sup> Igor Khripunov, "Russia's Weapons Trade: Domestic Competition and Foreign Markets," *Problems of Post-Communism*, no. 2 (March/April 1999): 40.

<sup>20</sup> Stanislav Simanovsky, "Problems and Prospects for Russian Industry," *INTERAVIA* (July/August 1998): 18.

<sup>21</sup> Khripunov, "Russia's Weapons Trade," 41.

<sup>22</sup> Alexei Izyumov, Leonid Kosalsi, Rosalina Ryvkina, and Yurii Semagin, "Market Reforms and Regional Differentiation of Russian Defence Industry Enterprises," *Europe-Asia Studies* 54 (September 2002): 966. Among other things, this indicates lack of foreign investment too.

<sup>23</sup> Simanovsky, 19; Another source says that this happened in 1996. Igor Khripunov, "Have Guns, Will Travel," *Bulletin of the Atomic Scientists*, 3 (May/June 1997). Database on-line. Available from EBSCOhost < <http://www.epnet.com/ehost/login.html> >. [20 May 2003].

The proportion of the total output represented by the military production decreased progressively. According to the League for the Support of Defense Industries, only one-tenth of the industry's productive capacity is now producing defense-related goods.<sup>24</sup> This doesn't mean that production of civilian goods is a success with a potential to offset problems generated by a sharp decline in the military output. A problem of crucial significance is that civilian goods produced by the defense plants cannot compete with imported products because of their poor quality and high prices. As a result, the volume of consumer goods manufactured at these plants decreased substantially as well.<sup>25</sup> Below is yet another data about the bad state of the MIC, which include both civilian and military orders.

Table 1 Russian Defense Industry Output Growth and Capacity Utilization of Defense Enterprises, 1995-2000 (%)

Years	1995	1996	1997	1998	1999	2000
Output change compared with previous year	-20	-20	-27	5	37	25
All orders as percentage of production capacity	49	43	44	43	49	52
Federal orders only	No data	No data	29	17	22	19

Source: Ksenia Gonchar, *Russia's Defense Industry at the Turn of the Century*. November 2000: 1-60. Available from Bonn International Center for Conversion  
<http://www.bicc.de/industry/brief17/brief17.pdf> [17 December 2002].

Today, unable to compete with the cheaper and much better goods of the developed countries, civilian sections of the MIC tend to support protectionist economy and protected outside markets (say, CIS economic area). This failure of the reform (conversion) of the military industry means the existence of a potential base ready to react to the calls whoever wants to revitalize it.

<sup>24</sup> *Krasnaya zvezda*, 28 January 1995.

<sup>25</sup> Khripunov, "Have Guns, Will Travel."

The failure of the privatization of the MIC<sup>26</sup> deteriorates the picture. In mid-1996 the privatization process of the defense sector has practically finished,<sup>27</sup> and the Russian government adopted a list of 480 enterprises and organizations that could not be privatized.<sup>28</sup> The military enterprises in the center (especially Moscow and St. Petersburg areas) and those that happen to be of crucial importance remained in state hands, whereas those in periphery were mainly privatized. Interestingly it was those in periphery that produced the bulk of the civilian goods.<sup>29</sup> In short, strategic defense industries not producing much civilian products and that are closest to the political center, Moscow, are in state hands. This might increase their exposure to political manipulation.

The MIC was huge, and its decline has been dramatic. Such a swift decline of such a giant in a couple of years cannot help but create an internal discontent to be reflected in the foreign policy of the Russian Federation. As stated above “Russian defense industry was hit by cuts in spending, market reform, friendly relations globally, and the disintegration of the former republics of the Soviet Union and the states of the socialist alliance.” If simple logic has any value then simply by reversing this sentence it can be understood what this once-huge complex would want: discarding market reforms, conflict-prone relations globally and forceful reintegration with the former imperial lands. However, the problem is beyond the needs of a given economic sector. This is a very crucial point that constitutes one of the backbones of the arguments developed in this thesis. The foreign policy attitude of the defense sector “are closely related to specific economic interests but follow the same pattern as *Soviet* foreign policy, including close relationship with “client” states, hegemony in the former Soviet space, and interest-based or even antagonistic relations with the

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<sup>26</sup> For patterns of privatization and great problems of conversion see Antonio, “Russian defense industry,” 23.

<sup>27</sup> Sanchez-Anders Antonio, “Privatization, Decentralization and Production Adjustment in the Russian Defense Industry,” *Europe-Asia Studies*, no. 2 (March 1998): 4.

<sup>28</sup> Simanovsky, 19.

<sup>29</sup> Alexei Izyumov et al., 970.

West.”<sup>30</sup> Military-industrial complex is much more than a sector. Even saying that it was *the* economy of the USSR would not suffice. It was the very core of the previous identity. And in the face of the material-psychological problems generated by the disastrous reform process there is a tendency to revitalize the previous identity and the MIC as the core of the old way of life. The MIC’s fall has accompanied and hence been associated with the radical decline of Russian political and economic stance internationally and internally. That is why whenever there is a reaction to the liberal reforms, whenever traditional agenda comes to the fore military industrial complex is “around.”<sup>31</sup>

Armed forces of Russia are not analyzed thoroughly in this thesis, despite occasional references. Sure, we are more interested in economic infrastructure and moreover, as the MIC was first and foremost the material basis of the Soviet military, the fate of the two cannot be different. Once glorious, huge and wealthy, the situation of armed forces today is very bad. And just like the MIC, the failure of reform is the main problem in the military forces. Despite drastic decreases in funding, traditional military-political ideology and vested interests have not allowed for the accompanying decrease in the size. This means less funding per capita, remaining potential discontent and a great base for resurrection. This said, despite an unusual increase in the political activities of the military, there is an “absence of autonomous and overt political interference.”<sup>32</sup> Russian military historically has been under almost absolute control of the political forces. And despite senior officers’ threats

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<sup>30</sup> The defense industry may be happy to see its relations with “rogue states” create problems in relations with the West. Robert Stowe, “Foreign Policy Preferences of the New Russian Business Elite,” *Problems of Post-Communism*, no. 3 (May/June 2001): 54.

<sup>31</sup> Yurii Feodorov, “Kaspiiskaia Politika Rossii: k Konsensusu Elit,” (“Russia’s Caspian Policy: towards the Consensus of the Elites”) *Pro et Contra* (Summer 1997): 3; Aleksei Zudin, “Bizness i Politika v Prezidentskoi Kampanii 1996 Goda,” (“Business and Politics in Presidential Campaign of 1996”) *Pro et Contra* (Winter 1996): 2.

<sup>32</sup> Barany, “Politics and the Russian Armed Forces,” in *Russian Politics: Challenges of Democratization*, eds. Zoltan Barany and Robert G. Moser (Cambridge: Cambridge University Press, 2001), 175.



they are hardly fundamentalist nationalists.<sup>33</sup> It would be difficult to say that the MIC and the military coordinate their political activities thoroughly either. But as stated, the main point is not a given economic sector neither the military institution. The point is the great forces of discontent created by the fall, crises-laden conditions and the existence of potential institutionalized bases to be rallied. Similarities make their eventual actions converge and they can be and has been organized by the political elites. Roy Allison's brilliant argument about the Russian military can be applied to other "institutions of discontent" as well. "Most likely, the military aspect of Russian foreign policy will remain highly significant, but... it will only partly be shaped by the military elite itself."<sup>34</sup>

There are two venues that can fuel the defense industries: state procurement and military exports. Today Russia's defense budget is too small to support the military industrial base. In 1996, procurement funds were \$3-4 billion, whereas the minimum needed to keep the defense industry afloat was estimated to be about \$10.5 billion.<sup>35</sup> Although devaluation and increasing energy prices in 1998-1999 came as a rescue, and there have been some federal procurements after defense contracts with the state fell by nearly 95 percent between 1990-1997,<sup>36</sup> the expenditure still falls short of such plans. State orders busy only one-fourth of the defense industry's capacity.<sup>37</sup> Though Russian defense budget increased to about \$10 billion in recent years, the ratio of military procurement has not changed much, as the overblown military forces struggle to feed themselves with the remaining financial resources that survive immanent corruption.<sup>38</sup>

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<sup>33</sup> Roy Allison, "Military Factors in Foreign Policy," in *Internal Factors in Russian Foreign Policy*, eds. Neil Malcolm, Alex Pravda, Roy Allison, and Margot Light (Oxford: Oxford University Press, 1996), 249.

<sup>34</sup> Ibid., 278

<sup>35</sup> Khripunov, "Have Guns, Will Travel."

<sup>36</sup> Barany, 194.

<sup>37</sup> Vladimir Mukhin, "Russia's Weapon's Makers Gunning for New Business," *Russia Journal*, 12 March 2003.

<sup>38</sup> This situation has had negative repercussions on the quality of the supplies for the Russian army. At present, the modern armaments of the Russian army represent 30 percent of the total, compared with

One of the most important strengths of the MIC and one of the main problems it creates within Russia and with regard to its foreign policy, especially between Russia and the West, is weapons exports. Despite arguments that Russia continues to arm global discontent, in advance let's note that there has been a fundamental change in terms of its weapons exports: shift from the ideologically motivated one to a commercialized one. Yet apart from some circles happy with the created problems, weapons exports help to preserve the dangerous infrastructure, while revenue disappears in the hands of few corrupt men.

Total exports of the Soviet Union, averaging \$14 billion a year, peaked at more than \$20 billion in 1987.<sup>39</sup> During the Cold War, however, Soviet arms exports were based on normative imperatives; it was part of the "ideologically motivated security assistance."<sup>40</sup> 90 percent of Soviet exports were supplied through military assistance grants, primarily to Eastern Europe. Thus, annual exports of \$14 billion resulted in only US\$1.6 billion return, less than half of the return in 1996.<sup>41</sup> In that sense, although the London-based International Institute for Strategic Studies (IISS) calculates Russia's share as dropped to 7.5 percent of the global weapons market in 1992, or to \$2.6 bn, compared to 35.6 percent, or \$27.4 bn in 1988,<sup>42</sup> Russia increased its revenues considerably. And now it can again be regarded as number two or at least three after moving back to the 5<sup>th</sup> place in the early 1990s.<sup>43</sup> Russia's military-industrial complex enjoyed its third consecutive year of growth in 2002. It delivered a total of \$4.8 billion worth of arms last year and received revenues of \$4.5

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60-80 percent for Western countries. The stock is predicted to deteriorate in an accelerated manner, the expected percentage for the year 2000 being 10 percent, and 5-7 percent by 2005. Antonio, "Russian defense industry," 69.

<sup>39</sup> Christopher R. Hall, "A Farewell to Arms," *Harvard International Review*, no. 2 (Spring 1997). Database on-line. Available from <<http://www.hir.harvard.edu/articles/index.html?id=232>>.

<sup>40</sup> Simanovsky, 39.

<sup>41</sup> Hall.

<sup>42</sup> *The Military Balance*, IISS (New York: Oxford University Press, 1997), 265.

<sup>43</sup> Bukkovol, "Arming the Ayatollahs," 35.

billion, a third consecutive post-Soviet record. Arms exporters also said they expect to export some \$4.5 billion in arms in 2003.<sup>44</sup>

The crucial principle in Russia's sale of high technology weapons systems is that of the highest bidder. The clients are at present required to be solvent, that is to say, political criteria in arms sales have been abandoned and nowadays priority is given to strictly economic aspects.<sup>45</sup> Russian leaders are quite interested in “commercializing armed sales”<sup>46</sup> and “profit making.”<sup>47</sup> Moreover, being deprived of its former markets in Eastern and Central Europe due to the “Westernization,”<sup>48</sup> and of such lucrative ones as Iraq and Libya due to the embargos imposed by the United Nations, and unwilling to sell to the remaining old customers who are not solvent, who remains for Russia to sell to, is, by design, the countries that are not already traditionally controlled by the Western countries, or the weapons that Western countries decide to be too high-tech to be sold. Despite fears Russia is not after arming the world of discontent against the US or the Western states. Actually, however irreconcilable, similar reasons that force Russia to be integrated with the West and international organizations explain this state’s controversial arms sales:<sup>49</sup> to generate assets for economic revival.

Unfortunately not all of the reasons are this “innocent” and even those that are may have pernicious consequences. There are important factors that may turn the export issue into a serious problem in terms of political economy and foreign policy of Russia. One of the reasons that pushes Russia to export as much weapons as it can is

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<sup>44</sup> Lyuba Pronina, “Arms Export Boom Is Losing Steam,” *The Moscow Times*, 9 June 2003.

<sup>45</sup> Antonio, “Russian defense industry,” 23.

<sup>46</sup> Simanovsky, 39.

<sup>47</sup> Khripunov, “Russia’s Weapons Trade,” 45.

<sup>48</sup> One of the main reasons making Russia mad about the integration of former Warsaw Pact countries to NATO and EU is that among other things this means that the weapons markets of these states will be or actually are already closed to Moscow.

<sup>49</sup> Celeste A. Wallender, “Russia’s Interest in Trading with the ‘Axis of Evil,’” *Ponars Policy Memo*, no. 248 (October 2002): 1.

the failure of the defense conversion.<sup>50</sup> This means that Russia still has more military plants than it needs, which preserves the potential for a future would-be military build-up. This makes certain circles more willing about their agenda than what would have been the case in this production potential's absence. Moreover, many of such plants do not operate under market principles. "The majority of Russian defense enterprises would be considered bankrupt in Western terms," noted a recent study by the US National Intelligence Council.<sup>51</sup> A great deal of state subsidies, at least in the form of very cheap energy prices compared to world standards remain to be the case. This means that the MIC continues to thwart the emergence of market in Russia.<sup>52</sup> Moreover, relative independence of some actors from the federal center, who sell arms without its consent, may potentially facilitate the plans of those with traditionalistic agenda. For example in the case of the nuclear technology transfer to Iran,<sup>53</sup> it is argued that "the best explanation" is the "capture" and "privatization" of Russian foreign policy by a narrow-interested and very powerful Minatom, almost without state control.<sup>54</sup>

One of the reasons of the developed world's silence regarding Russia's sensitive weapons trade is the fear that the failure to find a modus vivendi with Russian arms exporters may cause either unrestricted arms trade outside the confines of international regimes or increased "internal consumption," i.e., massive rearmament. In such a scenario, arms producers will enjoy strong support from trade unions and proponents of protectionism.<sup>55</sup>

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<sup>50</sup> Celeste A. Wallender, "The Economization, Rationalization, and Normalization of Russian Foreign Policy," *Ponars Policy Memo*, no. 1 (August 1997): 5.

<sup>51</sup> Robert Wall, David A. Fulghum, and Alexei Komarov, "Russian Defense Industry Struggles with Reform," *Aviation Week & Space Technology*, 20 August 2001, 2.

<sup>52</sup> Segei Vasiliev, *Ekonomicheskie Predposylky Oligarkhii i Avtoritarizma v Sovremennoi Rossii*, Brifing 6, Moscow Carnegie Center, 1.

<sup>53</sup> For a nuclear plant in Bushehr Russia is to receive \$800 million, and there is a possibility for 10-year agreement for 5 more plants for \$6 billion.

<sup>54</sup> Minatom is too big to be ignored. But at the same time Wallender maintains that it acts within NPT. Wallender, *Russia's Interest*, 5-6.

<sup>55</sup> Nikolai Sokov, "Domestic Structure, Economic Growth, and Russian Foreign Policy," *Ponars Policy Memo*, no. 23 (October 1997).

Now Russia spends about 4.6-5 percent of GDP for military.<sup>56</sup> Despite reductions Russia's enormous arms complex included about 2,000 enterprises directly engaged in military production, a host of subcontractors, 920 research organizations, and a work force of roughly 5 million in 1997.<sup>57</sup> In 2000 there were still 1600 firms with a combined employment of over 2 million.<sup>58</sup> Thus despite reductions and reforms the economy continues to be over-militarized. This condition creates fertile ground for alternatives.

According to Gaddy, the present political economy of Russia is prone to a militarized economy, like in old times. His argument is that in Russia there is a kind of "libertarian virtual economy." Here government intervention is minimal and value is being kept either in regions or in corporate hands. There is a great deal of looting as well. The result would be inequality, even more fragile public sector and looting, leading to either disintegration or a backlash for re-centralization. A strong leader may come and engage in partial redistribution. In such a case this system will go on for quite a long time.<sup>59</sup> Yet a more likely scenario, according to Gaddy, is "a revival of support for strong central authority based on real or perceived threat to national survival." This will be a "militarized virtual economy." It would be an economy in which the decision of who is the recipient of value through the virtual economy's structure would be made from the top, on the basis of national priorities, rather than through raw struggles on the principle of survival of the fittest. There would be priority and nonpriority sectors of the economy, as in the Soviet system," and it can develop into a full command economy.<sup>60</sup> This is an interesting point supporting one

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<sup>56</sup> Aleksei Arbatov, "Kakaya Armia Nam Nuzhna?," ("What kind of Army do we Need?") *Rossiia v Globalnoy Politike*, no. 1 (January/March 2003): 1; Zbigniew Brzezinski, "Living With Russia," *The National Interest* (Fall 2000): 10.

<sup>57</sup> Khripunov, "Have Guns, Will Travel."

<sup>58</sup> Alexei Izyumov et al., 960.

<sup>59</sup> Perhaps this is what is happening with Putin!

<sup>60</sup> Clifford Gaddy, *The Russian Economy: What Is It and Where Is It Headed?*, 15-21 August 1999: 6. Aspen Institute Congressional Program. Database on-line. Available from Brookings Institution <<http://www.brook.edu/dy/dybdocroot/views/papers/gaddy/19990815.htm>>.

of the main arguments in this thesis about how the remaining traditional structure can guide behavior by the necessary insertion of the “foreign enemy” factor, given crises-prone life in Russia.

Talks of the MIC, as a locomotive of the Russian economy has been the case from the early 1990 on, when the MIC was the most powerful lobbying power within the ruling elite.<sup>61</sup> Recovery in industrial production after 1998 crisis owed much to the revitalization of defense production; this is said to assure Putin of this sector’s locomotive capabilities.<sup>62</sup> 1998 devaluation was good for the MIC; both for its military and civilian goods. Apart from devaluation, NATO bombardment of Serbia and military campaign in Chechnya were other factors that resulted in increasing spending.<sup>63</sup> Actually the tendencies in Russian economic growth since the crisis reflect, at least partly, the failure to reform the military sector. Though in case Russia decides to resort to the “locomotive” method it would “stuck on a widening plateau without depth, i.e., that remains technologically backward,” the thing is that there is much “unused but quite usable production and even surge capability” in the defense infrastructure.<sup>64</sup>

Moreover, “Russia’s top brass” continues to cling to a military strategy that only works when the entire economy is geared to support the army and the entire male population can be called up at any time. They learned to command “an army whose greatest strength was its sheer size.”<sup>65</sup> The same logic applies to the military hardware too. The issue of supply during the Soviet times was solved from the start

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<sup>61</sup> Irina Kobrinskaia, *Vnutrennie Faktory Vneshney Politiki v Postkommunisticheskoi Rossii*, (*Internal Factors of Foreign Policy of Post-Communist Russia*): 281. Database on-line. Available from Carnegie Moscow Center <<http://www.carnegie.ru/ru/pubs/books/volume/27649806ls-05ik.pdf>>.

<sup>62</sup> Igor Khripunov, "Russia and Global Security: Approaches to Nuclear Arms Control and Nonproliferation," *NBR Analysis*, no. 4 (August 2001): 8.

<sup>63</sup> Alexei Izyumov et al., 959-960.

<sup>64</sup> Stephen Blank, “Arms Sales, Soviet Style,” *Perspective*, no. 2 (November-December 2002): 2. Database on-line. Available from Institute for the Study Conflict, Ideology and Policy <<http://www.bu.edu/iscip/vol13/Blank.html>>.

<sup>65</sup> Alexander Golts, “Military Reform Going Nowhere Again,” *Moscow Times*, 07 May 2002.

by committing all the productive potential of the country to the production of military equipment. Innumerable soldiers were planned to be armed with innumerable amount of weaponry forcefully extracted from the command economy.

Besides the discontent, what drives the MIC as regards Russian political economy and foreign policy is the still immense tools it enjoys. Investments made yesterday create advantages today. Economically, culturally and politically speaking the Russians may find it easier and “cheaper” to resort to old means to secure their perceived interests, which are in decline. Since there are already practiced patterns, human skills and material infrastructure, which can be relatively easily, geared to revive the old lifestyle. But the MIC does have a very powerful competitor. Russian natural resource and finance sectors challenge the military industry not only in terms of size but also regarding the making of internal and international identities.

## CHAPTER 2

### THE CHARACTERISTICS OF THE NATURAL RESOURCE SECTOR IN THE CONTEXT OF INTERNATIONAL MARKET

Being privatized (the most privatized sector of the Russian economy) generally, residing on the largest (combined) mineral reserves of the world and gathered in few big conglomerates of global size increase the stakes of handling its business for the natural resource sector. Its stand vis-à-vis market can be understood in this context. The fundamental reason for the drive to be integrated by the rules of market externally and internally is that this is the most *profitable* option facing it. With 32 percent of proven total world reserves, Russia is the biggest in terms of natural gas<sup>66</sup> and 7<sup>th</sup> (5 percent)<sup>67</sup> in terms of oil.<sup>68</sup> Russia is the largest energy exporter if oil and gas are taken together.<sup>69</sup> It is the world's largest nickel, second largest aluminum,

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<sup>66</sup> Russia has much more chance of becoming global natural gas producer rather than oil. It "is to gas what Saudi Arabia is to oil." Fiona Hill and Florence Fee, "Fueling the Future: The Prospects for Russian Oil and Gas," *Demokratizatsiya*, (Fall 2002): 1-3.

<sup>67</sup> Some speak of Russian reserves as much as 140-150 billion barrels. Anton Sakovich, "Ambichiozniy Proyekt Lukoila," ("Lukoil's Ambitious Project") *Russkaya Gazeta*, 8 October 2002.

<sup>68</sup> Iran 15 percent, Qatar 7 percent, Saudi Arabia and the UAE 4 percent and the US and Algeria 3 percent in natural gas. *BP Statistical Review of World Energy*, 2001.

<sup>69</sup> Although Russia has second largest coal reserves in the world, coal sector, losing its competitiveness is after protectionist economy, and is not favorable towards market reforms.



and third largest diamond producer,<sup>70</sup> and is home to about 10 percent of the world's copper and 6 percent of gold reserves, to state a few.<sup>71</sup>

According to its deputy director, Valerii Remizov, Gazprom is worth between \$250 and \$900 billion.<sup>72</sup> Western experts estimate its annual revenues at \$20 to \$25 billion and its profits at \$6 billion. If it were ranked in the Global Fortune 500, it would be the world's second-largest profit-maker after Royal Dutch Shell. According to its head, Alexei Miller, Gazprom produces 20 percent of the world's gas output and generates annual sales of \$17 billion, accounting for 8 percent of Russia's GDP.<sup>73</sup> Though the largest shareholder, Moscow's share is no more than 38 in this company. And despite a general view of Gazprom as the "tool of the state," its stance vis-à-vis market, domestic political economy and foreign policy has been no less liberal compared to other actors of the resource-finance group. In terms of annual production levels, Lukoil and Yukos can be considered equal to Exxon and Shell. Actually Lukoil is world's largest in terms of proven oil reserves. Russian Aluminum (RusAl), accounts for more than 70 percent of Russia's total aluminum output, which means 1/8 of total world output.<sup>74</sup> To give another example, Russian Norilsk Nickel is the largest nickel exporter in the world.

Total size in terms of global resources and size of the main companies in global context matter, since if they were relatively small, though again there would be a reason to integrate with the international market, no endeavor to institutionalize it with long term domestic and foreign policy implications might be the case. Being big makes it possible for such companies to compete in the global market successfully, drawing on such advantages of size as economies of scale and reliable long-term relations. As to private character, being state firms they would be open to political

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<sup>70</sup> It is in the face of the inability to reach reliable data on the reserves of many of the natural resource goods in Russia that the size of their exports are resorted to. Of course, the size of the produce doesn't necessarily indicate the size of the resources. However, fortunately this is so in the case of Russia.

<sup>71</sup> Martha Brill Olcott, "Reforming Russia's Tycoons," *Foreign Policy*, (May/June 2002): 73-74.

<sup>72</sup> *Reuters*, 7 August 1995.

<sup>73</sup> Jan S. Adams, "Russia's Gas Diplomacy," *Problems of Post-Communism* (May/June 2002): 14.

<sup>74</sup> Olcott, 73.

manipulation internally and externally, it can be expected, especially in a state like Russia. Private ownership makes them more profit-oriented. However, specifically looking to “state-dominated” Gazprom’s behavior, it is possible to argue that simply huge size and structural competitiveness in the international market in itself offers too many rewards even for the state to interfere considerably. In that sense, at some point it will be claimed that even re-nationalization of resource companies may not change much in terms of their effects on the structure of Russian economy and in their international behavior. Public ownership doesn’t necessarily mean command economy and there are many such companies competing at home and international markets successfully; some big French companies are good examples in this regard. However, the fact is that Russian resource majors are privately owned generally speaking, and it must be at least a debatable argument that Russia with the history of political absolutism (only in late 19<sup>th</sup> century and for a very brief period did there emerge something resembling semi-autonomous economic sphere) would behave like France.

The nature of the commodity of the sector in question is the indispensable factor making integration with the international market easy, or at least doable and attractive. By virtue of the very characteristics of its commodity the natural resource sector doesn’t require constant and very costly innovations to be internationally competitive. (Russian financial sector is not competitive internationally. However, it is a very significant factor in Russian domestic economy and politics, and eventually in its foreign policy. And the main source of its cash comes from the resource sector, to which it is directly connected). Quite a lot of them being of strategic nature it is not only easy to find customers but also eager foreign investors: this can be called the international political competitiveness. If to compare this sector with the other biggest one in Russia, it is clear that markets of the developed world is closed to Russian uncompetitive industrial goods and to competitive to a certain degree yet strategically unacceptable products of the military industry. Developed world has its own companies regarding industrial products struggling to survive in the international market, and what is more for military products, as stated, security implications make it impossible for them to be willing buyers. Besides not being able

to penetrate the biggest markets of the world, the heavy and light industry face the threat of dealing with the foreign competitive goods and being driven out even at home. Again, this is not the case for the resource sector. More important still, it is very difficult if not impossible for Russia to get foreign investment from these countries to its uncompetitive industrial sector and sensitive military one. No one would be interested in increasing war-making capability of another nation; especially if it is Russia. Just the opposite, the markets of the developed world not only welcome the raw materials of the natural resource sector, but they are more than willing to invest there; since it doesn't make the owner strategically more powerful (say, increasing its military capability), it is the source of easy profits, and this way the supply of such strategic goods can be secured. Or even if they are not able to invest, they would certainly prefer a stable and transparent partner when the fluctuations in supply of such goods as oil may create serious problems. Available data support this argument. The bulk of the FDI in Russia has come to raw materials (energy foremost), the financial and other service sectors.<sup>75</sup> Despite such advantages resource-finance sector faces problems to realize its potential in the international market due to the domestic politico-economic structure. And they respond by bringing in market to be able to go to the international arena. This in turn creates pressure for domestic politico-economic reform with foreign policy implications.

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<sup>75</sup> Neil Robinson, "The Economy and the Prospects for Anti-Democratic Development in Russia," *Europe-Asia Studies*, no. 8 (2000): 103.

## CHAPTER 3

### NATURAL RESOURCE SECTOR'S SUBSIDIZING OF THE RUSSIAN ECONOMY AND THE CONSEQUENT DRIVE TO LIBERALIZE

Oil/gas sector is the greatest net creditor of the Russian economy.<sup>76</sup> In a sense it provides credits to different enterprises instead of the Central Bank, or the banking system in general, which is anyway incapable of performing its task. There have been many cases where Gazprom saved national industry.<sup>77</sup> This was especially clear during 1998, the year of crisis.<sup>78</sup> Natural gas export prices, which are around \$90 per cubic meter, are six times higher than subsidized domestic prices. Russian economist Yuri Kononov at the Energy Systems Institute of the Russian Academy of Sciences claims that consumer energy prices in Russia are still only one-half to one-third the prices in Western markets.<sup>79</sup> During Soviet times the state intentionally kept its abundant energy and raw materials cheap for the military-industrial complex's and the overall economic growth. Russia inherited and continues to cling to the same

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<sup>76</sup> Yakov Pappé, "Ortaslovie Lobbi v Pravitelstve Rossii (1992-1996)," ("Resource Lobbies in Russian Government (1992-1996)") *Pro et Contra* (Winter 1996): 4

<sup>77</sup> Yakov Pappé, "Neftyanaya i Gazovaya Diplomatiya Rossii," ("Russia's Oil and Gas Diplomacy") *Pro et Contra*, (Summer 1997): 1-2.

<sup>78</sup> Petra Optiz, Hella Engerer, and Christian von Hirschhausen, "The Globalisation of Russian Energy Companies-A Way Out of the Financial Crisis?," *International Journal of Global Energy Issues* (2002): 12.

<sup>79</sup> David G. Victor and Nadejda M. Victor, "Axis of Oil?," *Foreign Affairs*, no. 2 (Mar/Apr 2003): 57-58.

wasteful system.<sup>80</sup> Today US produces \$1,500 worth of economic output per barrel of oil consumed. Whereas, price controls, a glutted local market, and neglect of conservation results in Russian economy's production of only \$300 worth of economic value per barrel burned.<sup>81</sup> This is one of the main reasons why Russia is the second largest energy consumer in the world.<sup>82</sup> Despite this low prices, Russian industry is still unable to attain competitiveness and thus to pay its energy bills. There are accumulated non-payments to the energy sector calculated in billions of dollars.<sup>83</sup> Politically supported, huge, energy intensive and wasteful economy incapable paying already very low prices is not the best option for the energy sector.

The thing is that the wasted energy products that produce almost no value at all in international standards, or whose value is being "destroyed" by the Russian uncompetitive industry and agriculture, could have earned much more by just being exported. Though oil sector's being privatized can be thought of as the main reason for it to resent this situation, Gazprom too, despite state domination treats this issue similarly, as a rational economic actor. Thus, the main point is not their being privatized or not, but rather, and more importantly, their size and competitiveness in international market and the domestic politico economic system that strips them of a huge and handy potential profit. Especially, the failure of conversion in the military sector combined with its refusal to leave the scene already creates potential base waiting to be utilized by traditionally inclined political and military elites, and the greatest help in keeping it more or less intact comes from the energy sector; the one that is to suffer first in case there is a reversal. The implications and eventual outcomes stemming from this structure may not be difficult to predict.

Actually, energy sector can hardly reject to subsidize industry and agriculture under given conditions in Russia. There is a great deal of political will to keep these two

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<sup>80</sup> Marshall I. Goldman, "Russian Energy: A Blessing and a Curse," *Journal of International Affairs*, no. 1 (Fall 1999): 74.

<sup>81</sup> The same level as in Iran and worse than in Saudi Arabia. Victor and Victor, 57-58.

<sup>82</sup> Russia consumes almost one-third of oil it produces domestically.

<sup>83</sup> At the beginning of 1995, agro-industry owed the oil and gas complex over \$10 billion.

labor-intensive and traditionally entrenched sectors satisfied, and resistance of few extremely wealthy resource companies may be politically costly. The emergence of Russian resource companies is a dark history and Russians still question the manner with which few people grabbed almost the entire wealth of the nation. Actually, there is a general tendency to blame them for the disastrous economic and social consequences of economic reform. Among other things, this makes such companies a kind of hostage if not a corroborator of the state and shadowy relations. This in turn means there might emerge or already emerged a kind of Latino-American alliance between the state and the powerful sectors of the economy.<sup>84</sup>

Indeed, it can be argued that there is a certain implicit deals whereby resource companies get very attractive privileges by subsidizing the entire Russian economy. They may lose billions but their gains too are huge, both economically and politically. For instance, special rules, or absence of such rules make it possible for them to get their products to world markets without much tax, which immensely increases their profit margin. The way the state overlooks their manipulation of their true accounting is another example.<sup>85</sup> Hence, frequently, what they get for their non-market support to the economy are similarly anti-market privileges. It would be logical to infer that having a stake in an anti-market system, energy sector would not be willing to challenge the status quo. As mentioned, the perception that by subsidizing the economy they pay a kind of bribe for the illicit property they have got yet had no reason to get, increases risks. This in turn may work or some would say, already works against market. All sectors and state cooperate to kill the market and energy sector obeys with political and economic gains.

However, as Fiona Hill argues, energy sector has been “the main source of value to subsidize and sustain the vast portion of Russia’s economy that has been *unable* to

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<sup>84</sup> Hillel Ticktin, “Permanent chaos without the market: the Latinoamericanization of the USSR,” *Studies in Comparative Communism*, no. 3 (September 1992): 242-256.

<sup>85</sup> Vasiliev, 2.

transform into market economy.”<sup>86</sup> That is to say, tough unable and unwilling to change conditions under the given situation in Russia, resource companies may well want to change the very rules of the game by bringing in market. There are examples. Big oil companies like Lukoil and Sidanko (close to Oneximbank) afraid of angering such depressed sectors of the economy regarding subsidies, busy themselves in reaching a compromise. Yet as such negotiations are not very fruitful, they are increasingly interested in “market reform and more easily implemented bankruptcy procedures” to solve the problem. Interestingly sometimes they are able to seem cooperative with their powerful competitors-for-favor and try to change them at the same time. Not very much offended by posing themselves as the “saviors” of the defense industry by placing orders on them for some of their energy equipment, they actually finance the MIC’s conversion projects! The number of such defense companies producing for the oil and gas complex is rising steadily.<sup>87</sup>

The point is that, ending the state-manipulated rent economy and replacing it with a truly market one would benefit the resource sector most among other actors. First they will have more to export. And of course, marketization would drive out the sprawling awkward military industry, thus removing Damocles’ sword hanging over their head. Moreover, the huge gains of the full integration with the international market force them to restructure themselves as respectable corporate citizens. And reformed companies would hardly want to act as islands in the middle of a rent economy. Or perhaps they cannot; foreign shareholders, creditors, and even buyers would like to see transparency and corporate cleanness, which may not be possible within current economic system. Furthermore, coming of the rule of law into the domestic economy would legitimately institutionalize almost the entire valuable wealth of the nation that could be profitably privatized and have already been privatized by these few companies. This way, they would become much less vulnerable to political abuse and blackmail. As to concrete foreign policy

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<sup>86</sup> Hill and Fee, 3.

<sup>87</sup> Igor Khripunov and Mary M Matthews, “Russia’s Oil and Gas Interest Group and Its Foreign Policy Agenda,” *Problems of Post-Communism*, no. 3 (May/Jun 1996): 27.

implications, weakening of the defense-centered industry and strengthening the autonomy of the market economy would hinder state's arbitrary mobilization of national resources at wish for militaristic foreign policy purposes, as it traditionally did.

For bringing market in and for survival in the international market Russian resource companies need foreign investment. However the issue of investment shows that it is not only energy companies that believe that playing by the rules of market is the best option for Russia. International market discourse is becoming a point of common reference with the eventual positive results for Russian political economy and foreign policy.



## CHAPTER 4

### FOREIGN INVESTMENT INTO THE RESOURCE SECTOR: PROBLEMS, PUZZLES AND THE EMERGING “MARKET DISCOURSE” AS THE POINT OF COMMON REFERENCE

Russia once became the world’s largest exporter of oil in 1973. Its state-owned enterprises produced more than 12.5 mbd in mid 1980s, the largest amount of oil ever produced by a single country, representing one-fifth of global production.<sup>88</sup> Between 1988 and 1998, however, Russian oil production fell 50 percent from 11 mbd to 6. For many years in 1990s oil production was not very profitable due to limited export capacity, low and underpriced domestic demand and lack of foreign investment.<sup>89</sup> 1998 financial crisis, ruble devaluation (lowering ruble denominated input costs) and 300 percent increase in the price of oil during 1998-2001 was a boon for the Russian oilmen. Russian oil exports began to rise in 2000 for the first time since the Soviet days. Reforms started a year earlier and long-term relationships with foreign firms<sup>90</sup> and capital too played their crucial role.<sup>91</sup> Putting aside such exogenous developments as ruble devaluation and increase in oil prices, the main reasons that can be counted on for a stable business have been (and, it can be

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<sup>88</sup> That sum is one-third more than Saudi Arabia’s peak (about 8mbd) share at the end of 2000. Edward L. Morse and James Richard, “The Battle for Energy Dominance,” *Foreign Affairs*, (March/April 2002): 17.

<sup>89</sup> Hill and Fee, 5-6.

<sup>90</sup> Especially, Conoco, BP Amoco, Exxon Mobil, Royal Dutch Shell, Halliburton and Schlumberger.

<sup>91</sup> Morse and Richard, 24.

claimed, will be) internal reforms of and foreign investment put into the energy sector. Although less important, the issue of foreign investment is a more complicated one for the purposes of this thesis and needs a thorough and prior analysis.

Required investment for the Russian oil industry was estimated in the range of \$35 to \$100 billion in 1992-2000.<sup>92</sup> Yet, Russian energy sector as a whole received only \$20 billion over the last 10 years. The amount of the accumulated foreign direct investment in the sector until 2000 was only \$6 bn.<sup>93</sup> Unlike oil Russia retains its status as the largest exporter of natural gas from 1993 on, but this is not because gas sector received the investment it needed. Simply, its stage of development spurred during Soviet times reached its peak; having the largest reserves of natural gas globally matters as well. This said, unless gas sector receives substantial investments its future is at best problematic too. Fuel and energy complex's need stand at \$460-600 billion over the next 20 years.<sup>94</sup> Annual critical investment to stabilize production just at the current level is estimated to be \$5-7 bn for the oil industry and \$5 bn for the gas industry.<sup>95</sup> The only source for all these in the short run is beyond Russian borders.

This doesn't mean that energy firms have been outright supporters of every sort of foreign investment however. Many of the oil oligarchs not only avoid serious investment themselves but also have been against some forms of foreign involvement.<sup>96</sup> This is a puzzle, at first glance, running counter to the main assumption in the thesis that oil firms, different from other sectors and even the state

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<sup>92</sup> See James Watson, "Foreign Investment in Russia: The Case of the Oil Industry," *Europe-Asia Studies*, no. 3 (May 96).

<sup>93</sup> Klaus E. Meyer and Christina Pind, "The Slow Growth of Foreign Direct Investment in the Soviet Union Successor States," *Economics of Transition*, no. 1 (1999): 201-214.

<sup>94</sup> Adams, 20; Smith, 3.

<sup>95</sup> Juhani Laurila, "FDI and the Russian Energy Sector. An Ill-Managed Partnership?," *The Month in Review*, no. 3 (2001): 4.

<sup>96</sup> Goldman, 79.

must be willing to abide by the rules of international market and thus to accept foreign direct investment. This makes us to have a closer look at the configuration of internal political economy in Russia.

But first it needs to be noted that mainly they have been against those kinds of investments that were about giving over important shares to the foreigners. Any rational company would like to control as much of its shares as it can whether the new comer is a foreigner or a domestic company. As every economic game, this one too is about “a struggle for actives,”<sup>97</sup> and there is nothing unusual.

Moreover, energy majors’ inclination towards marketization is not the result of instinctual affection: they are after increasing their profits and if they decided to do this by market rules it is mainly because they are potentially capable to do it and stand to gain from this transformation most among all possible options and actors *in the long run* and *in principle*. That is to say, this resistance is more about form than substance.

All the FIGs acquired their wealth by anything but legal means. And within Russia the relationship between state apparatus and economic sphere is anything but guided by the rule of law. There is a very complex and corruption-ridden fine balance between the two, where the vulnerability of each is tied to some strengths got in return. And any change from outside not controlled by one of these actors is not welcome. One of the most controversial issues regarding a special form of foreign investment, production-sharing agreements (PSAs) too can be explained in this context.

It would not be wrong to say that the crucial factor in terms of PSA development has been oil companies. When in 1998, financial crisis and low oil prices brought two of the Russian oil companies to the verge of bankruptcy and challenged others, there emerged calls from among the eight leading Russian oil company heads for a

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<sup>97</sup> Sergei Kolchin, “Neft i Globalizatsia: Rossiiskaya Spetsifika,” (“Oil and Globalization: Russian Specificity”) *MEP*, no. 2 (2003): 3.

dialogue on PSA. Combined with the government of Primakov, much more influential in the parliament than the previous ones, this paved the way for an amended and more practical version of the PSA Law in December 1998 (in force since February 1999), after years of struggle.<sup>98</sup> Yet when oil prices moved from below \$10 in early 1999 to more than \$35 per barrel, problems emerged. “The key sector of the Russian economy, oil,” doesn’t want foreigners while it is better off.<sup>99</sup> Now Putin favors foreign investment, yet oil/gas firms have to a certain degree lost their interest due to their good financial situation.<sup>100</sup> Again, this may sound confusing regarding one of the implicit conceptual dichotomies developed in this paper. Oil firms against foreign investment and state, in the face of the most conservative politicians, Primakov and Putin, desperately struggling for PSA, the most crucial form of foreign investment?<sup>101</sup> However, if such primary executive figures including Putin have been so eager about PSAs this has been more because of the aim to decrease the frightening influence of very powerful oil magnates that sometimes appear to control the entire economy with serious political consequences than for the formers’ attachment to market principles.

Whatever its intentions, the state’s worries about exerting some control are not ungrounded. The colossal wealth of these groups sometimes appears to be transferred to whatever can be counted as power in the widest possible sense. Just in 2000 it was very difficult to speak of a free press due to the oligarchs.<sup>102</sup> Though Putin’s efforts

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<sup>98</sup> Mikhail Subbotin, “SRP: novyi etap staroi borby,” (“PSA: new stage of the old battle”) *MEP*, no. 2 (2003): 5; Goldman, 80; Andreas Heinrich, Julia Kuszniir, and Heiko Pleines, “Foreign Investment and National Interests in the Russian Oil and Gas Industry,” *Post-Communist Economies*, no. 4 (2002): 500.

<sup>99</sup> Goldman, 81-82.

<sup>100</sup> Heinrich, Kuszniir and Pleines, 506.

<sup>101</sup> There are estimations that it may result in \$65-100 billion inflow in over the next 8-10 years. Subbotin, 1.

<sup>102</sup> Berezovsky held shares or controlled ORT, TV-6, Nezavisimaya Gazeta, Novaya Izvestiya, Kommersant and Ogonyok magazine; Potanin: Komsomolets, Russki Telegraf and Ekspert Magazines, Komsomolskaya Pravda and shared ownership of Izvestiya with Lukoil; Gazprom controlled the newspapers Trud and Rabochaya Gazeta; Gusinsky and his bank owned a series of newspapers including the influential Segodnya as well as independent television and radio station. Stephen White, *Russia’s New Politics: The Management of Post-Communist Society* (Cambridge: Cambridge University Press, 2000), 150.

and “success” since then doesn’t mean any freedom either, it would not be a gross mistake to say that the state just turned the balance in its favor, and nothing more. Another example would be social support programs. Though at the beginning privatization had made the companies free from burdensome social responsibilities, by virtue of re-defined tax code they were re-inherited.<sup>103</sup> This means that social welfare programs that were assigned to the state before are now in the hands of the oligarchs, who may and do try to turn this advantage into political capital.

And in today’s politico-economic configuration the interference of an outside foreign investor is likely to benefit the state and not the oil companies; or more properly perhaps, Putin rather than the resource magnates. For instance, when energy sector continues to subsidize other sectors heavily, and as PSAs guarantee to foreigners secure venues for increasing amounts of export, will this not mean that Russian businessmen will be confined to the already glutted and underpriced domestic energy market? The corollary is that they will be stripped of an important part of their cash, and desperate to sell in the domestic market would depress already low prices. This in turn would help wasteful industrial and agricultural practices to linger on; which is anything but a reformist attitude.

Today even such “open-minded” companies as Yukos are against PSAs,<sup>104</sup> despite standing out in terms of having huge and technologically challenging reserves. Not surprisingly, this ambitious company, which surpassed Lukoil towards the end of 2003 as the biggest in Russia with its ambitious head Khodorkovsky, has had greatest problems with Putin recently. After its successful climb and speculations about Khodorkovsky’s such high political plans as becoming the president of Russia, he has been arrested. This resembles what happened to Gusinsky and Berezovsky before. Those oligarchs who start to challenge Putin’s new regime are being eliminated. The PSA seems to be just another tool whose effect is of a more gradual nature.

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<sup>103</sup> Olcott, 69.

<sup>104</sup> Goldman, 79.

The internal political economic configuration in Russia today helps us understand yet another paradox. Considering immense amounts of revenue earned by resource sector companies one at first is confused about why this money is not becoming *the* source of investment. Apart from the inadequacy of this money for the decaying gargantuan Russian infrastructure, Russians themselves avoid investment at home. Capital flight from the oil industry during 1992-1995 was about \$7 bn.<sup>105</sup> In 2000, almost \$20 billion left Russia –about the same amount that Russia's oil exporters earned.<sup>106</sup> The main reason is the same as those that make foreign capital *in general* (not PSAs) stay away from Russia: political and economic insecurity. Besides the risks, as the rate of return in Russia is much less than in many other countries, money flies to the latter.<sup>107</sup> In that sense, not feeling secure to make investments themselves, such resource companies are being politically compelled to bring foreigners in, which in turn may mean leaving much more to the latter than what would be the under normal conditions. Perhaps, another reason for the state's push for PSAs is to frighten the Russian majors to cut off the capital flight and to invest home. However, unlike PSAs that treats foreign companies preferentially creating a safe heaven in insecure Russian political and economic environment, nobody guarantees what would happen to the cash Russian companies are making if they stay home.

The fear to surrender the control of strategic sectors to foreigners has been an important factor in some Russian official circles too. Even pragmatism may sometimes appear against special forms of foreign investment. Coming of the foreign investment “whatever the terms” may not be in the interest of the country. After all, “the size of the prize makes it difficult for the most Western firms to turn their back

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<sup>105</sup> Vladimir Tikhomirov, “Capital Flight from Post-Soviet Russia,” *Europe-Asia Studies*, no. 4 (1997): 591-615.

<sup>106</sup> Victor and Victor, 53-54.

<sup>107</sup> According to Gaddy, while it is energy companies that subsidize the rest of Russia, such flight is good since if all the money coming from export of raw materials were to remain in Russia its value would be destructed and this would be a much worse thing for Russia. Capital flight makes both the resource sector and the rest of the economy to go on, though this move leads nowhere. Yet had this money remained in Russia that would have resulted in the collapse of the Russian economy. See Glifford Gaddy, *Has Russia Entered a Period of Sustainable Growth?*, Presentation at the Carnegie Endowment for International Peace, Washington, DC., 17 October 2001.

on Russian oil.”<sup>108</sup> When influential and “market-friendly” figures<sup>109</sup> oppose some kinds of foreign investment, claiming that they are not necessary for the future development of Russia’s oil and gas industry, they are more against the terms rather than the substance of foreign investment, as anyone with patriotic feelings would do. Chubais, for example, does believe that Russian energy sector is in a desperate need of investment.<sup>110</sup> However, as said, another, if not a more important factor in this regard is the alliances of vested interest groups crosscutting economic and political realms. More often than not it is to which group one belongs to that determines his stand. Oil firms were successful against some forms of foreign investment in collaboration with “friends” in the federal and regional governments,<sup>111</sup> which is not always about patriotism.

Yet it is amazing that not only oil firms,<sup>112</sup> but the very top of the state (including Yeltsin before)<sup>113</sup> have sought foreign companies’ and their states’ help to balance against the other. Or actually, they mainly refer to the international market, a more legitimate and “transcendental” language beyond subjective political preferences; and it is not always about finding a pretext. In that sense even conservative Primakov’s and Putin’s moves cannot be confined to the desire to change the nature of Russian political economy along traditional lines or to create an absolute dominance of political sphere for personal aims. While preparing his doctoral dissertation at a mining institute in mid 1990s, before his meteoric rise to power, Putin extensively researched the development of Russia’s natural resources. He

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<sup>108</sup> Olcott, 72.

<sup>109</sup> Few examples would be Anatoly Chubais, former Vice Prime Minister and current head of Russia’s electricity monopoly, UES, German Gref, Russia’s Minister for Economic Development and Trade, and Aleksei Kudrin, Russian Deputy Premier and Finance Minister.

<sup>110</sup> Stanley Reed and Paaul Starobin, “BP’s Russian Spoils,” *Business Week*, 24 February 2003, 56.

<sup>111</sup> Herrera, “Russian Economic Reform, 1991-1999,” in *Russian Politics: Challenges of Democratization*, eds. Zoltan Barany and Robert G. Moser (Cambridge: Cambridge University Press, 2001), 156.

<sup>112</sup> Olcott, 74.

<sup>113</sup> Aleksei Zudin, “Oligarchy as a Political Problem of Russian Postcommunism,” *Russian Social Science Review*, no. 6 (November-December 2000): 4-33.

wrote about turning to the market forces to vitalize Russia's enormous extractive industries, the need for state support for them to compete with the Western transnationals, and advocated private capital, including foreign involvement since state alone was not enough for the required level of investment. Putin was doing this when communists and nationalists were fighting to keep Russian resources in Russian hands. Though coming to power might cause some changes and despite contrary evidences, Putin has done a good deal to subject the extractive industries to the market rules and foreign involvement.<sup>114</sup> The point is that international market and its principles is acquiring the mantle of a paradigmatic discourse; the legitimate language that is becoming dominant and that is determining the vocabulary of accusations and defenses alike. To repeat, the point is that Russians see the benefits of this vision to the entire country (not to a single institution), having the great resource sector that creates assurances that a new way of life can be a success. What is more, this analysis makes it possible to conclude that there is no resource company-state dichotomy in Russia in the strict sense of the world. More than being represented in the state apparatus, the belief that Russia may end up better off in the new environment is acquiring a common backing, considering the existence of the huge and internationally competitive resource sector. This is the main reason behind my claim that even if private nature of the resource companies are disregarded great changes in the nature of Russian political economy and its foreign policy may not be the case. To cut short, combined with some structural features of the Russian natural resource business this market-oriented worldview paves the way for the increasing involvement of foreigners that Russia does need, despite debates about its form and pace.

There is a logical argument that though it is better for Russia to have foreign investment than no investment at all, it doesn't need and shouldn't sell its rich oil and gas resources to the foreigners. It may be more reasonable to wait for 10-20 years until Russian firms and financial institutions accumulate enough money to make the required investments themselves and have all the money stay in Russia. Yet being late to invest makes the unit cost of future production much higher as infrastructure

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<sup>114</sup> Olcott, 68.



might get almost entirely obsolete until that time. Moreover, there would certainly be considerable decrease in oil/gas production, where not only the sector but the Russian economy in general will suffer. It is not only money but also Western know-how and technology that are needed, and some of them can only come with the investments.<sup>115</sup> Geographically speaking, Russians may not need foreign investment in some parts of their country, but in other parts it may be indispensable. In the face of exhaustion of the old fields they have to move deeper or northwards and eastwards for new oil/gas resources, which means prohibitive costs and unavailability of appropriate technology. Due to the failure to replace depleting fields with these new ones, there has been “negative ratio of production to exploration” until 1998.<sup>116</sup> Though the ratio improved somehow, there is still an imbalance, and if it continues, Russia’s current resources may dry up by 2040. Even “extremely rich Gazprom” needs Western investment for its expensive fields to compete in the increasingly competitive European market.<sup>117</sup> There is one more thing that makes even controversial PSAs attractive for energy firms sometimes. Political environment in the new fields generally is as unpredictable for the Russian companies as they are for foreigners. Governmental agreements are useful to both sides of business in such places.<sup>118</sup> Furthermore, old fields are already embedded in corruption and it is only in the new ones that the establishment may give corruption up in the face of gains, almost impossible without foreign involvement.<sup>119</sup> Expectedly, there have been successes in such fields located in the challenging geographical and political landscape. All of three PSAs with foreign majors are in this category: Exxon in Sakhalin I, Shell in Sakhalin II, and Total-Fina-Elf in Kharyaga. Sakhalin I and

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<sup>115</sup> It will take a great deal of time for the Russian firms to accumulate required finance, yet to get the required technology may take forever.

<sup>116</sup> Optiz, Engerer, and von Hirschhausen, 11.

<sup>117</sup> Joe Barnes, *Terror, Oil and Geopolitics: The Evolving U.S.-Russian-Iranian Triangle*, (James A. Baker III Institute for Public Policy: Rice University), 19; For instance, the exploitation and transport of Shtokmanovskoe field is estimated to cost as much as \$25-30 billion, while Yamal-Europe project is more expensive. Vitaliy Tretyakov, “Treugolnik SSHA-Islamskiy Mir-Rossia,” (“Triangle USA-Islamic World-Russia”) *MEP*, no. 9 (2002): 2.

<sup>118</sup> Victor and Victor, 56.

<sup>119</sup> Tretyakov, 2.

Sakhalin II projects, speeded up starting from 1996 on, include Japanese and Indian companies as well. By 2003 just these two projects may account for 1/4 of all direct investments to the Russian fuel-energy sector. Direct revenues from these projects so far reached \$1/4 billion. In total the revenue is estimated at \$1.5-2 billion.<sup>120</sup>

Interestingly, economies of scale matters much more for Russia in the energy sector than many other countries. That Russian oil resources are located in difficult-to-extract and difficult-to-transport areas far from the open sea means that long and expensive pipelines and supporting equipment should be built. And such expensive infrastructure creates a strong incentive for the Russians to export at full capacity, unlike the OPEC countries.<sup>121</sup> As more and as quick as they can may be the best option.

Moreover, Western companies, by making investments in infrastructure such as new pipelines and export terminals, obtaining important geological data, and training the local labor force, might have a positive impact on the cost structures that Russian firms will encounter when they do eventually launch their own independent projects. It is estimated that large investment in the industry is capable of creating a swift return that Russia needs so much. Moreover, though about half of the profits is to remain in foreign hands, there is much more to remain in Russia.<sup>122</sup> In the Law on PSA of 1999, for example, there is an article stipulating a 70 percent quote to rely on the Russian equipment. The point is that there are reasons for having or at least opportunity costs of not having even those foreign investments, which stipulate the transfer of shares and/or PSAs. To repeat, such relatively objective conclusions of the market vision does result in increasing foreign involvement in Russian resource sector, despite political maneuvers of each group and individuals to get the most they can.

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<sup>120</sup> Unfortunately, geographical difficulties combined with uncertainty over the future of PSAs delays the development of these fields. Subbotin, 2.

<sup>121</sup> See, Victor and Victor, 57.

<sup>122</sup> See Watson.

Of course, not every form of direct foreign involvement is as strict as PSAs. Despite trying to keep the “crown jewels” to themselves, intent on expanding abroad, and being eager participants of the international market Russian firms are becoming more open to joint ventures with international firms.<sup>123</sup> And more consolidated the firms more secure they are in their dealings with the foreigners. Prior to corporatization and partial privatization oil oligarchs’ position as heads of their respective companies were not secure at all where a partnership with a foreign company, bringing with it greater publicity and increased fiscal demands from central and local government, was more of an obstacle than a help. Yet, as their status has solidified in time the resource majors have started to deal with Western companies with more confidence.<sup>124</sup> Although quite important, as a source of energy and raw materials Russia is not so important as to dictate the rules of the game to the West.<sup>125</sup> They have to make quite a lot to attract foreign investment they need. As the significant loosening of legal restrictions to foreign ownership indicates,<sup>126</sup> Russians seem to understand that foreign investment has too many alternative places to go.<sup>127</sup> It was due to such developments that by late 1990s more than 60 foreign companies were involved in joint ventures in oil sector.<sup>128</sup>

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<sup>123</sup> Morse and Richard, 26, 30.

<sup>124</sup> Daniel Yergin and Thane Gustafson, *Russia 2010 and What It Means for the World* (Random House, 1993), 248-249.

<sup>125</sup> One of the main reasons of repetitious reference to “the West” is that having territorial problems with Japan, Russia has not been able to attract significant amount of capital from its rich neighbor which is in need of raw materials.

<sup>126</sup> From 1992 to 1997 a presidential decree allowed foreigners to own no more than 15 percent of the total assets of Lukoil, Yukos and Surgutneftgaz. Foreign ownership in Gazprom had been restricted to 9 percent in 1992. As a result the foreigners were confined to minority stakes. Heinrich, Kusznr and Pleines, 503.

<sup>127</sup> Foreign investors responded to these restrictions by leaving for other places including the littorals of the Caspian. This resulted in decreases in oil production in offshore areas and other difficult terrains including Arctic region, in turn forcing Yeltsin to revoke his previous decree in November 1997 allowing foreigners full amount of stock. In 1999 the share of foreign investors in Gazprom was elevated to 20 percent. Goldman, 79.

<sup>128</sup> The resulting foreign capital investment equaled \$1.5 bn. Heinrich, Kusznr and Pleines, 496.

Table 2. The development of oil producing joint ventures in Russia, 1992-2000

Years	1992	1994	1996	1998	2000
Number of oil producing joint ventures	30	38	31	42	30
Oil production by joint ventures (mt)	10	17	22	20	30
Share in total Russian production (percent)	3	5	8	6	9
Oil export by joint ventures (mt)	4	9	13	10	N/A
Share in total Russian oil export	3	7	10	7	N/A

Source: Andreas Heinrich, Julia Kusznr, and Heiko Pleines, "Foreign Investment and National Interests in the Russian Oil and Gas Industry," *Post-Communist Economies*, no. 4 (2002): 497.

Moreover, despite all the problems, the trend in Russian energy companies has been the increasing involvement of foreign (Western) companies and institutions as shareholders.

Table 3 Shares of Foreign Investors in Russia's Major Oil and Gas Companies, 1996 and 2001

Company	1996	2001
Gazprom	2% ADRs	1% freely traded ADRs 5% Ruhrgas (Germany) (10% grey schemes)
Lukoil	12% ADRs 8% Arco	35% ADRs 8% BP-Amoco
Rosneft	None	None
Sibneft	N/a	N/A (management claims to control 88% of the company)
Sidanko	None	10% BP-Amoco
Surgutneftgas	None	11% ADR; some more ADR issues were bought by affiliates of the company)
Tatneft	12% ADRs, 10% different foreign financial institutions	28% ADRs, 3% different foreign financial institutions
TNK	None	97% TNK International ((i.e., Access/Renova (USA) in cooperation with Alfa Group (Russia))
Yukos	None	32% Standard Bank (London)

Source: Andreas Heinrich, Julia Kusznr, and Heiko Pleines, "Foreign Investment and National Interests in the Russian Oil and Gas Industry," *Post-Communist Economies*, no. 4 (2002): 504.<sup>129</sup>

<sup>129</sup> "Note 1: ADRs (American Depositary Receipts) are depository receipts issued by an American bank to promote trading in a foreign stock or share (the bank holds the underlying securities and the ADRs are issued against them). Note 2: Under the relevant rules, the share register of a Russian

To reiterate, this shows how structural characteristics that energy sector carries and what it promises combined with (if not causing the emergence of) the common “market ideology” bring foreign investment into Russia.

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company may contain information about nominee rather than beneficial shareholders. This list tries to give only foreign beneficial shareholders.”

## **CHAPTER 5**

### **STAKES OF EXTERNAL MARKETIZATION AND INTERNAL REFORM IN RESOURCE SECTOR: INCREASING DISTANCE BETWEEN ECONOMIC AND POLITICAL SPHERES**

Actually at the beginning the point of concentration was Russian resource companies' drive to adapt to the rules of market internally and internationally. Lengthy digression to handle the issue of ceding the controlling shares to foreigners and/or PSAs was due to the importance they attain in political and academic debates and the problems they create in terms of conceptual tools employed in this thesis. And dealing with this problem shed light on significant phenomena such as the place of "market thinking" among Russian elite. However, it is conceptually too narrow (even within general foreign involvement category) to be an important indicator of ambitious Russian resource companies' endeavor to become global competitors. As said, disregarding the exogenous factors it has been internal reform that accounted for Russian energy major's unprecedented rise since 1999, besides foreign involvement. And it seems that internal reform is the best measure of the true intentions of the Russian firms. The latter provides a more convenient and qualitatively more inclusive conceptual framework to understand the real stand of these companies in terms of political economy and foreign policy of Russia too.

They "might not be able to take on OPEC in 2002, but Russian energy companies will likely to be able to give Exxon and Shell a run for their money in 2020."<sup>130</sup>

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<sup>130</sup> Hill and Fee, 25.

Though this may “require inclusion of some Western firms in Russian firms as stock holders,”<sup>131</sup> Russian majors are aware that being a respectable citizen of international market would decrease the need to turn the control of shares in foreign hands in order to have an access to financial resources and other rewards of the international market such as technology and know-how.

To fund expansion both at home and abroad through planned stock offerings in Western markets, reform is important for the Russian companies. Russia’s leading businessmen see even Western investment as raising “investor confidence and increasing the share value of the assets they already control.”<sup>132</sup> The drive to become a global competitor being held constant, Russian firms reluctance to hand over controlling shares is positively related with the pace and scope of internal market reform. If they want less and less controlling shares in foreign hands or uncontrolled increase in PSAs, they have to make more and more reforms internally.

Russians are proud that Gazprom endeavored and has been successful in becoming the first Russian company that established equal relations with important Western firms and banks and secured credits from the latter on its own guarantees.<sup>133</sup> Yet, today for Gazprom it is more expensive to borrow from a Western creditor than for a Western corporation.<sup>134</sup> According to a study by PricewaterhouseCoopers, Western oil assets changed hands in the late 1990s for about \$5 per barrel; Russian assets, on the other hand, traded at less than 20 cents per barrel.<sup>135</sup>

The problem is that if Russian businessmen want to engage in initiatives requiring even millions of dollars then they have to go to the foreigners. Their long term credits with relatively low rate of return cannot be compared to the short-term and

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<sup>131</sup> Tretyakov, 4.

<sup>132</sup> Olcott, 67, 69.

<sup>133</sup> Pappe, “Neftyanaya i Gazovaya,” 2.

<sup>134</sup> Tretyakov, 4.

<sup>135</sup> Victor and Victor, 55.

expensive credits available within Russia, where profit can be made almost only with 2-3 years of low-rate loans. And when going to international financial institutions, they face such demands as transparency and international standards in their accounting.<sup>136</sup> The crucial point is that, resource sector by its very nature have much greater chance of getting such credits compared to other sectors of the Russian economy. Requirements of the international market to enjoy its benefits are doable.

Russian energy sector has much higher aims than simply to survive. They are capable and willing to be powerful international players with great investments away from the borders of Russia.<sup>137</sup> Whatever the scope, to become global competitors they will certainly need to play by the rules of international market; they cannot impose their own. And Russian oil firms do restructure themselves in terms of being respectable corporate citizens. To compete with international majors and face up to the demands of minority shareholders (including foreign investment funds), Russian companies have begun to improve their often awful corporate governance records. The migration towards internationally accepted financial reporting standards has compelled them to adopt better managerial and production practices. Efficiency tools such as better software now made it possible for many Russian managers to rationalize production, thereby increasing profitability and effectiveness of long-term corporate investment.<sup>138</sup>

There are two types of companies in Russia: those globalizing and those locally oriented. Integration among the oil companies (estimates predict that there will remain 6-7 oil companies of global scale instead of 12-15 that was the case at the beginning) and increasing adherence to international standards show that oil companies in Russia entered the process of globalization before the remaining part of

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<sup>136</sup> Optiz, Engerer, and von Hirschhausen, 30.

<sup>137</sup> Actually, some would claim that they want to “take over Western business in the next 10-15 years-not letting Western firms break further into Russian oil.” Hill and Fee, 23.

<sup>138</sup> Morse and Richard, 24.



the economy.<sup>139</sup> And globalizing companies fare incomparably well.<sup>140</sup> There is an argument that if production and transportation costs were tuned to international levels, some of the oil and gas exports wouldn't be profitable.<sup>141</sup> Russian firms expectedly respond by playing by the rules of the new game. "The socialist logic of maximizing technically possible output was replaced by increasingly serious economic constraints regarding profits and costs."<sup>142</sup>

Interestingly, this endeavor is reflected in more domestic investments. It becomes clear that over last years capital outflow from Russia have consistently moderated. According to Goskomstat (State Statistical Committee) in the first half of 2002 companies with foreign participation accounted for 27 percent of GDP, employing about 1.87 million people. There are indications that much of this capital may be indeed Russian.<sup>143</sup> Especially oil majors started to "reinvest capital at a rapid rate." This issue has much to do with the increasing confidence of the resource-finance groups. Although there is much more to do, Russia's oil companies have largely transcended their robber-baron days. Backed by improved rule of law, they try to secure their new wealth and meet the performance criteria dictated by the financial markets, especially because their shares are now publicly offered.<sup>144</sup> Shadowy and actually bloody privatizations of the Soviet and Russian economy created small groups who got huge gains and from 1993 on there has been "an ever increasing quest for stability in Russia" to prevent redistribution.<sup>145</sup> Yukos' Khodorkovsky is

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<sup>139</sup> Kolchin, 1; Catherine Locatelly, "The Russian Oil Industry Restructuration: Towards the Emergence of Western Type Enterprises?," *Institut d'Economie et de Politique de l'Energie* (January 1999): 20.

<sup>140</sup> Optiz, Engerer, and von Hirschhausen, 4.

<sup>141</sup> Eugene Khartukov, "Low Oil Prices, Economic Woes Threaten Russian Oil Exports," *Oil and Gas Journal* (8 June 1998): 25-30.

<sup>142</sup> Optiz, Engerer, and von Hirschhausen, 9.

<sup>143</sup> Schroder Salomon and Smith Barney, "Russia: Foreign Deirect Investment and the BP-TNK Deal-The Broader Picture," *CITIBANK: Economic and Market Analysis*, (14 February 2003): 4.

<sup>144</sup> Morse and Richard, 17.

<sup>145</sup> Sergei Medvedev, "Power, Space, and Russian Foreign Policy," in *Understandings of Russian Foreign Policy*, ed. Ted Hopf (Pennsylvania: The Pennsylvania State University Press, 1999), 39.

honest about it: “You can say that it all started with us. Well, it started someday and now it must be ended. The situation has come to a head.”<sup>146</sup> At the beginning weak legal system and non-existent property rights were crucial factors paving the way for a small number of men acquire a tremendous amount of wealth. Now reaching the limits where further expansion would only bring too costly battles and where they may even lose than gain, they concentrate on maintenance rather than further acquisition. For instance, there is a recent wave of pro-business legislation on bankruptcy and commercial court procedures. The lobbying group representing Russia’s largest business, the Russian Union of Entrepreneurs and Industrialists (PSPP by Russian acronym) worked hard for these.<sup>147</sup> Furthermore, recently implemented judicial reforms and tax harmonization, partly as a result of the pressure exerted by these firms, should translate into a better environment for all of them.<sup>148</sup> This situation reminds late 19<sup>th</sup>-early 20<sup>th</sup> century property ownership stabilization process in the United States after raw struggle for distribution was nearing its end.

Resource groups adapt to market and the rule of law because they calculate that it is a more profitable and a more secure option. But this at the same time increases the wealth of the entire nation, adding to their legitimacy and making them more confident in the face of political manipulation. As came to the fore during problems with OPEC in 2002, oil firms were not eager to cooperate with the state when that militated against their interests. For them that was “a violation of an explicit agreement between the government and the private sector,” where the “companies would become more transparent and pay taxes but remain free to grow with less government interference.”<sup>149</sup> Interests, it becomes clear, are being defined according to the market principles. This reference to the market discourse to legitimize action seems to be tremendously important. The increasing performance and increasing

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<sup>146</sup> “Putin Gathers Business Leaders,” *Associated Press*, 20 February 2003.

<sup>147</sup> But the author believes that this new trend towards stabilization is less than a public good; it favors big business rather than minority shareholders. David M. Woodruff, “The End of ‘Primitive Capitalist Accumulation?’ The New Bankruptcy Law and the Political Assertiveness of Russian Big Business,” *Ponars Policy Memo*, no. 274 (October 2002).

<sup>148</sup> Morse and Richard, 24.

<sup>149</sup> *Ibid.*, 29.

success are achieved by adapting to the rules of market. The gravitation can be said to emanate from the international market, it is the starting point. Its economic and political rewards are very high and it is doable for the resource sector. Adapting to it at the same time means the need to reform their internal structures. The implication of the latter, explicitly expressed by those companies is that they can remain successful only if not being interfered by political manipulation. Ultimately this may mean a pressure on the entire Russian economy to marketize itself. Because, the huge size of the resource sector makes bright enough promises for the whole economy to follow suit and to reap benefits. It is not only these firms that benefit from their success. Their success means more money, more employment and perhaps eventual revitalization of the Russian economy. Moreover, as will be claimed, it even means more political importance ascribed to Moscow in international relations. Common and legitimate market discourse doesn't stem from its belonging to the very powerful politico-economic actors; it stems from the belief that everybody stands to benefit.

As predicted by the theoretical framework of the thesis, in time energy majors not only play by the rules of the market internationally but also restructure themselves along the same lines, bring it into the Russian economy in general and try to institutionalize it by the rule of law. If "80 percent of the country's business is now in private hands"<sup>150</sup> and if this gets institutionalized then that would be unprecedented event in Russian history with foreign policy implications. Raw materials sector, the most profitable of all sectors is the most privatized as well. In 2003, of the 82 companies planned to be privatized a considerable portion were still composed of the same kind of enterprises. And not surprisingly, it is the most privatized and most successful resource sector that is more willing and that is more capable to initiate the institutionalization of the current de facto autonomous position of the economic sphere. As Pipes puts,

Under primitive conditions, authority over people and over objects is combined, and it required an extraordinarily complex evolution of law and institutions, which began in ancient Rome for it to be split authority exercised as sovereignty

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<sup>150</sup> Ajay Goyal, "Corruption is in the eye of the beholder," *The Russia Journal*, 04 March 2002.

and authority exercised as ownership... In Russia this separation occurred very late and very imperfectly. Russia belongs *par excellence* to that category of states, which in the political and sociological literature it has become customary to refer to as 'patrimonial.' In such states political authority is conceived as exercised as an extension of the rights of ownership, the ruler (rulers) being both sovereigns of their realm and its proprietors.<sup>151</sup>

Bodin said that in Europe there were only two such states: Turkey and Muscovy, where there was no distinction between "authority and ownership" or "dominium and imperium."<sup>152</sup> In this patrimonial state there is "no formal limitations on political authority, no rule of law, no individual liberties. There can be, however, a highly efficient system of political, economic and military organization derived from the fact that the same man or men-kings or bureaucrats- (those who treated "political authority as commodity") dispose of the country's entire human and material resources. It was the combination of absolute political power with nearly complete control of the country's productive resources that made Russia so formidable an institution.<sup>153</sup> And it was this structure that empowered the rulers of Russia to manipulate and mobilize the entire assets of the nation for aggressive foreign policy purposes at wish, at the expense of both the Russians and the neighboring nations. However late, this condition may hold no more. And with the mentioned would-be institutionalization it may become a history.

There are many who do not believe that financial industrial groups will bring in market and consequent state-economy independence.<sup>154</sup> As the Soviet system was regarded a transition to Communism which never came, today's system too may go

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<sup>151</sup> Pipes, xxii.

<sup>152</sup> Jean Bodin, *The Six Books of a Commonwealth* (1606) (Cambridge, Mass. 1962), Book II, Ch. 2, 197-204, quoted in *ibid.*, 65.

<sup>153</sup> *Ibid.*, 23, 41, 94.

<sup>154</sup> Timothy Frye, "Capture or Exchange? Business Lobbying in Russia," *Europe-Asia Studies*, no. 7 (2002): 19, 20, 34; Neil Malcolm and Alex Pravda, "Introduction," in *Internal Factors in Russian Foreign Policy*, eds. Neil Malcolm, Alex Pravda, Roy Allison, and Margot Light, (Oxford: Oxford University Press, 1996), 19-20.

on forever.<sup>155</sup> According to Chubais, Russia is between “oligarchic capitalism” of Latin American states where decisions are made by the state controlled by financial and industrial groups and people’s capitalism offering equal condition for all, and where state is independent of business.<sup>156</sup> There are more radical views. In Russia there is “a state form that parallels regimes in Latin America, with their social divisions, politicized armies, weak legal systems, and corrupt governments, even if they co-exist with private property, a relatively open press, and competitive elections.”<sup>157</sup>

Still, looking at the stakes of integration with the international market given the size and ease of competition for the Russian resource sector, I would insist in expecting more positive results. Apart from making whimsical/messianic and/or cost-benefit-blind mobilizations difficult, such developments’ effects on the wasteful and potentially dangerous sectors of the economy, the MIC first and foremost, were dealt with in a preceding chapter. The separation of the economy and the state will also be the guiding principle in analyzing whether Russia uses its energy firms as tools of its foreign policy or not; one of the most debated topics in similar studies. Before that however, one point needs to be clarified: how big the resource-finance groups are to have such huge influences?

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<sup>155</sup> Anthony Phillips, “Notes Towards a Russian Political-Economy,” *Russian and Euro-Asian Bulletin*, (January, 1997). Internet on-line. Available from <<http://www.cerc.unimelb.edu.au/bulletin/buljan97.htm>>

<sup>156</sup> Paul Klebnikov, *Godfather of the Kremlin: Boris Berezovsky and the Looting of Russia* (New York: Harcourt, Inc., 2000), 269-270.

<sup>157</sup> Ticktin, 242-256.

## CHAPTER 6

### **THE POWER OF THE RESOURCE-FINANCE GROUPS WITHIN RUSSIA REVISITED: ECONOMIC SIZE AND POLITICAL INFLUENCE**

Russian resource-finance sector's stand in terms of internal political economy and foreign policy matters because besides being big enough to be considered a player of global importance it literally dwarfs other sectors of the domestic economy. The USA too has considerable natural resources and related private companies of global importance, for example, but their stance vis-à-vis domestic economy is not of dominant nature. This is crucial since being globally important and domestically dominant, though interrelated somehow do not have to overlap as much as they do in the case of Russia. Moreover, the two have different qualitative implications.

Even one branch of the group in question, the energy, is the greatest, most dynamic, most profitable and politically the most powerful sector of the Russian economy. Oil and gas sector account for 40-50 percent of Russia's total exports.<sup>158</sup> Its share in Russian GDP range from 13 to 25 percent.<sup>159</sup> Fuel is the source of 30 to more than 50

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<sup>158</sup> *US Department of Energy*, Internet on-line. Available from <<http://www.eia.doe.gov/emeu/cabs/russia.html>>; Victoria Lavrentieva, "Gref Says It's Time to Squeeze Big Oil," *The Moscow Times*, 20 February 2003.

<sup>159</sup> *US Department of Energy*; Glifford Gaddy and Fiona Hill, "Putin's agenda, America's Choice," *Brookings Institution Policy Brief*, no. 99 (April 2002): 4.

percent of all federal tax receipts.<sup>160</sup> Moreover it constitutes 30 percent of industrial production.<sup>161</sup> Below are statistics from yet another source, which, though slightly different from some data above, once more proves the crucial standing of this sector in Russian economic life.

Table 4 The Share of the energy sector in the Russian economy (%)

1992	1993	1994	1995	1996	1997	1998
Percentage of Industrial Production						
23.0	24.0	26.4	26.8	29.0	28.5	31.4
Percentage of Industrial Investment						
53.1	55.7	54.8	57.0	60.1	64.1	59.2
Percentage of Export Revenues						
37.6	31.6	40.4	37.7	44.1	43.8	37.6
Export Revenues (bn US dollars)						
20.2	18.9	27.3	30.6	39.3	38.3	27.8

Source: Petra Optiz, Hella Engerer, and Christian von Hirschhausen, "The Globalisation of Russian Energy Companies-A Way Out of the Financial Crisis?," *International Journal of Global Energy Issues* (2002): 36.

Clifford Gaddy argues that energy exports accounted for about 90 percent of Russian GDP growth, around 30 percent increase in budget revenues in 2001, compared to 1999, and were the main reason behind Russian budget surplus for the first time since the collapse of the USSR. Different estimations have it that, Russia exports such large quantities of oil and oil products that a dollar's increase in the price of a barrel of oil translates from \$1 to \$2 billion or more export revenues annually.<sup>162</sup> Some other experts relate one dollar change in the price of oil to 0.35 percent of

<sup>160</sup> Lavrentieva; Lynne Kiesing and Joseph Becker, "Russia's Role in the Shifting World Oil Market," *Caspian Studies Program Policy Brief*, no. 8 (May 2002): 5.

<sup>161</sup> Lavrentieva.

<sup>162</sup> Fiona Hill, "Energy Integration and Cooperation in Northeast Asia," *NIRA Policy Research*, no. 2 (25 February 2002): 4; Victor and Victor, 50. This much dependence creates some understandable fears. There are increasingly widespread calls for diversification. There are official claims that the failure to change this structure may slow the growth rates down to 2-3 percent in 2005.

Russian GDP annually.<sup>163</sup> These data are confined to just oil/gas sectors, and adding other natural resource and finance branches (which are gathered in the same conglomerates) would inflate them considerably. The general argument in this chapter can be challenged that this greatness may be partially explained by the drastic shrinking of Russian GDP from late 1980's on, and when and if the latter gets normalized it will fade away. Yet considering the terribly underinvested Russian energy sector and again, exclusion of other resource and even finance sector from the above data this challenge can be easily met.

To repeat, this wealth is gathered in few very large conglomerates. Deferring qualitative aspects of their influence, it is clear that by their very size such companies cannot help but affect Russian political economy.<sup>164</sup> Again, Gazprom means 90 percent of Russia's gas production, operator of Russia's 150,000 km gas pipeline gird and 43 compressor stations, and one fifth of global natural gas reserves. It has 367,000 employees, 87,000 miles of pipeline, and more than 1 million acres of land. The largest earner of hard currency in Russia, it accounts for 25 percent of federal tax revenues and for 7-8 percent of Russian GDP.<sup>165</sup> The VIOCs (Vertically Integrated Oil Companies, in Russian VINK) or Russian oil majors, "the crown jewels of Russian economy," are the largest privatized companies in Russia.<sup>166</sup> Among them Lukoil, Yukos, Surgutneftgaz, TNK and Sidanko stand out to dominate the Russian energy market.<sup>167</sup> Russian Aluminum and Norilsk Nickel are of sheer size as well.

As mentioned before, resource and financial sectors are inextricably linked; here is their brief history. Partial liberalization of prices and trade was the first factor to cause a redistribution of wealth in Russia and formation of new interest groups.

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<sup>163</sup> Troika Dialogue, *Russia Market Daily*, 15 April 15 2002.

<sup>164</sup> Kobrinskaia, *Vnutrennie Faktory*, 284-285.

<sup>165</sup> Hill, "Energy Integration," 5.

<sup>166</sup> Lee S. Wolosky, "Putin's Plutocrat Problem," *Foreign Affairs*, no. 2 (March/April 2000): 2.

<sup>167</sup> Locatelly, 2.



Consequent devaluation and inflation provided the fertile ground for the emergence of financial groups with huge gains.<sup>168</sup> The other factor that dictated the rules of redistribution was privatization. The crucial second round<sup>169</sup> or “cash phase” of the privatization that started in July 1994 was boon for those who had already amassed fortune due to liberalization-the finance groups. This was simply “bank acquisition of resource extraction enterprises.”<sup>170</sup> Loans for shares programs in September 1995 brought about further privatizations of Russian oil companies “by favoring the emergence of financial-industrial groups.”<sup>171</sup> The major spheres of profits in post-Soviet Russia were in goods and services that the people simply had to buy whatever the cost, and in goods and services that had access to foreign currency. Banks, media and raw materials were favored targets.<sup>172</sup> That is why such conglomerates are referred to as Financial Industrial Groups (FIGs).

Not surprisingly the wealthiest men of Russia are directly linked to resource-finance sector. Of the 17 “official” Russian billionaires, only one appears to come from non-raw materials sector; yet all of them are related to some financial groups.<sup>173</sup> The

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<sup>168</sup> Russian National Credit, Menatep, Inkombank, Oneksimbank capitalized on their close political ties to finance government transfers, Most Bank of Vladimir Gusinsky was the bank of the Moscow city government, while previous state banks such as Agroprombank, Promstroibank, and Zhilsotsbank or Gosnab (Tokobank), and Alpha Bank of Ministry of Foreign Economic Relations became private ones. McFaul, 17-18.

<sup>169</sup> The first round of this process between 1992-1994 saw the insiders to take over two thirds of all privatized enterprises; it just “ratified” the interests of old groups, mainly directors. Though not a good development in terms of economic development and efficiency this move was important to co-opt the old interest groups into the new regime.

<sup>170</sup> In this loans for shares program biggest winners were Oneksimbank and its umbrella industrial entity Interros Group (Norilsk Nickel-the largest nickel exporter in the world, oil companies-Sidanko and Surgutneftgaz and Svayinvest-Russia’s largest telecommunications enterprise); Menatep with its industrial arm Rosprom (roughly 80 percent of Yukos and important position in several mineral companies); Logovaz (major stakes in Sibneft, Aeroflot and ORT-Russia’s largest television network); Alpha Bank (a strategic position in Tyumen Oil as well as control of several cement and trading companies). Ibid., 19.

<sup>171</sup> Yukos, Lukoil, Surgutneftgaz and Sidanko were among the first involved. Particularly Menatep and Oneximbank stand out in this regard. Locatelly, 2-5.

<sup>172</sup> Phillips.

<sup>173</sup> Six were affiliated with Menatep/Yukos, one with Sibneft, one with Surgutneftgaz, one with Lukoil (has close relations with Imperial Bank), one with Base Element (RusAl), two with Interros Norilsk Nickel, two with Alfa Group/TNK, one with Millhouse Capital (Sibneft/RusAl) and one with Severstal (a steel company), one with AFK Sistema (the only non raw materials sector billionaire in

same applies to the “unofficial” ones too. Unlike laymen who think of the politicians as the richest, according to informed people, “the richest were almost invariably the country’s leading bankers.” Perhaps the most famous of the financial barons, Vladimir Potanin, heads a bank (Oneximbank) that would not rank among the top 100 by size in the United States. The combined size of Oneximbank and one of its chief rivals, Menatep, is smaller than that of Centura Banks in Rocky Mount, N.C., a state bank of a medium size. It is the Russian tycoons’ relatively cash-rich status in a cashless economy that gives them so much power.<sup>174</sup> To solve its economic problems (especially in fighting inflation), the state needs to borrow heavily from such banks at very high rates, for example.<sup>175</sup> The banks’ stand in the world and especially in the region is quite bright actually. Fifteen Russian banks are among the top 1,000 in the world and 14 of them are among the top 25 in Central and Eastern Europe, according to an annual report by *The Banker*.<sup>176</sup> Sure the source of this cash is the natural resource sector; the sole most important cash generating institution. Oil companies alone account for nearly 60 percent of the market capitalization of the Russian stock market.<sup>177</sup>

There are differing views about the organized political influence of these actors in terms of domestic political economy and foreign policy. Despite the existence of numerous organizations related to them, almost none is influential in the political sphere.<sup>178</sup> However, in the face of political institutional culture in Russia and few people accumulating this much wealth, to look at organizations, as the indicator of

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this list). Natalia Yefimova, “Russia No. 4 on Forbes’ Billionaries List,” *The Moscow Times*, 3 March 2003.

<sup>174</sup> White, 150; Clifford G. Gaddy, *Beyond a Bailout: Time to Face Reality About Russia’s ‘Virtual Economy,’* Unpublished Paper, June 1998. Database on-line. Available from Brookings Institution <<http://www.brook.edu/views/articles/gaddy/199806.htm>>

<sup>175</sup> Herrera, 147.

<sup>176</sup> Igor Semenko, “15 Banks Listed Among Top 1,000 in World,” *The Moscow Times*, 07 July 2003.

<sup>177</sup> Wolosky, 1.

<sup>178</sup> Pappe, “Neftyanaya i Gazovaya,” 11.

their influence may not be helpful. Actually nobody questions their personal and informal power. Due to the difference of interests, lack of coordination and legal framework for lobby activities, much greater influence of personal relations has become the case.<sup>179</sup> The absence of strong political parties adds to the power of such interest groups in influencing the state and its foreign policy.<sup>180</sup>

To state the obvious, they are politically the most powerful among economic actors. Others are “dwarfed by the political organization of bankers, oil and gas exporters, and other extractive industries.”<sup>181</sup> Even beyond other economic actors, they are regarded “the most powerful subjects of Russian politics after the president and the Communist Party.”<sup>182</sup> But do they have a common stand despite the absence of the formally organized behavior? Though oil and gas sectors differ as regards organization and relations with the state constituting just a “number of powerful interests,”<sup>183</sup> this “does not undermine their common agenda.”<sup>184</sup> Their small number increases the potential for cooperation. Once again, the claim that there is no general policy attitude of the fuel and energy complex,<sup>185</sup> can be countered that as in the case of the armed forces and the military industry, though not coordinated, such structural factors as the nature of the product, the stance vis-à-vis market and the outside world in general, eventually make the behavior of almost all the resource-finance sector groups converge in principle or on average with regard to domestic and foreign policies.

The power of these groups cannot be attributed to the political landscape alone. Michael McFaul argues that “weak democratic institutions,” “Yeltsin’s political

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<sup>179</sup> Smith, 1.

<sup>180</sup> Khripunov and Matthews, 30.

<sup>181</sup> McFaul, 19.

<sup>182</sup> Tretyakov, 7.

<sup>183</sup> Stowe, 55.

<sup>184</sup> Khripunov and Matthews, 34.

<sup>185</sup> Pappe, “Neftyanaya i Gazovaya,” 1.

success,” “superpresidentialism,” “a fragmented party system,” “impotent countervailing forces representing pluralist interests,” and “isolated” decision-making system paved the way for “a small, well-organized coalition of economic interest groups to occupy a central role in the making of Russian foreign policy.”<sup>186</sup> If he means that these were the reasons not for the *emergence* of this coalition but for their *occupation* of a central role then one needs to be careful to agree. True that they were preferentially treated in wealth distribution by Yelstin’s team. However *after* acquiring such internally/externally strategic sectors of the crippled Russian economy somehow, groups like these cannot help but have a very serious influence whatever the political structure. Apart from constituting the great portion of the Russian economy they are the most strategic ones; say, regarding cash/foreign currency generating capabilities, to state just one. Related but much more important than that, it is the new and overwhelming international game with its political and economic rules in which Russia happened to find itself that determines the power of such groups. These FIGs have the best and most of Russia that is needed to survive (and prosper) in this new world. Evaluating their meaning within this actual structure and related conceptual framework is, perhaps the most crucial point to reach more proper conclusions about their effects on Russian political economy and foreign policy. And it is this point that many authors refuse or fail to see with consequent trivial outcomes.

In that sense, this thesis is not about economic determinism or reductionism. Rather, by introducing international political economic framework and especially international market a holistic approach is sought. It is only within such a structure that the configuration and interaction of different groups in Russia can be understood; where a more important point becomes to measure the degree to which aims and interests of different actors overlap with the dominant international structure. In that sense, again, this thesis is not about simply the influence of different economic interest groups on Russian internal political economy and its foreign policy. The reason is not that some more factors are introduced into their analysis. The reason is the placing of the military-industrial and resource-finance sectors into

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<sup>186</sup> McFaul, 27.

international structure (where they should be placed) which reveals that they are more than mere sectors with much more (explanatory) power. They are inextricable and the most important material components of different, opposite and actually alternative ways of life. Resource-finance groups and liberally inclined people on the one hand and the military, military industrial complex, and traditionalists on the other are rather the most powerful conglomerate-institutions representing different identities; one that Russia had for years but never worked satisfactorily, the other that started badly but seems to be the only method to get (not “back”) to a normal life. One that is in harmony with the prevailing rules of the international political economy (that Russia is unable to change), and is quite successful there promising more wealth and more peace, and the other, which, to change the rules of the game to fit its material-cultural assets needs to isolate Russia from this overpowering international environment into coercive, poorer and internally and externally conflict-prone empire and a way of life that may only be the beginning of more drastic failures.

## **CHAPTER 7**

### **GENERAL CONTOURS OF RUSSIAN FOREIGN POLICY AND THE WEST: ALTERNATIVE IDENTITIES AND THE ISSUE OF LEGITIMACY**

Almost all views about the stance of the resource-finance groups in terms of Russian foreign policy converge. According to Mikhail Margelov, Russian Federation Council Member and Chairman of the Committee for Foreign Affairs, “the business community, especially the energy sector, has paved the way toward stable, predictable relations between Russia and the US.”<sup>187</sup> Not surprisingly, on the side of the liberalizers financial elite too is mentioned again and again. Few extremely powerful banks and bank-led “financial industrial groups” brought about the emergence of “informal integrationist lobby” whose stand have much to do with tangible interests instead of emotions or ideology.<sup>188</sup> Boris Berezovsky’s appointment as Deputy Secretary of the National Security Council on October 29, 1996, after the presidential elections where his role was immense in the reelection of Yeltsin, is thought to be the new institutional actors’ plan to influence “international economic and security policy formulation and implementation.” It was this “enhanced leverage of internationalist magnates” to whom can be attributed a relatively calm stance in the face of NATO expansion and the signing of the Russia-

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<sup>187</sup> “Summer of a Dinner Discussion with Mikhail Margelov, Russian Federation Council Member and Chairman of the Committee for Foreign Affairs,” *CSIS*, 30 September 2002: 2.

<sup>188</sup> This is the second factor put forward by Blacker, the first being the willingness of the ruling elites for integration and the third being the West’s patience. Blacker, “Russia and the West,” 190-191.

NATO Founding Act, different from the previous two years overwhelmed by the stiff opposition of Russia to this move by the West.<sup>189</sup> The “most dynamic and largest export-earner” sectors of Russian industry with their need for Western cooperation, adaptation to global market and need for stability are to have “moderating effects” on Russian foreign policy. This may well be check on some overtly nationalistic and anti-Western policies causing in turn “more flexibility and compromise” among Russian decision-making community. Instability in Russia paves the way for forceful methods in its foreign policy, yet oil and gas industry “promotes a healthy alternative.” For a foreseeable future oil and gas complex is to affect Russian foreign policy, focusing on Russia's “economic expansion, further advancement of market reforms, and integration into the world economy.”<sup>190</sup>

Despite the general consensus on the peaceful attitude and actions of the resource-finance groups vis-à-vis Russian foreign policy and their representing an opposite position with regard to traditional forces, there is hardly an embrative structural framework and systematic analysis. Arguments in this regard are generally confined to the *preferences* of actors but not *why* they are successful (to want something is not sufficient for success), first of all. Of course, any economic actor would like to have stable relations with a partner to sell, or to get credits, technology and know-how if available. But such kind of “politics of international trade” is a too narrow theoretical framework for an in depth analysis. There is much more to resource-finance sector's desire for peaceful relations especially with the Western world, which has to do with preventing *the* alternative political economy and foreign policy, in which case they are to be the first losers. Moreover, there are other factors beyond preferences that eventually affect Russian peaceful foreign policy. This point was analyzed in preceding sections: A healthier state-economy relations in Russia as the unintentional (to a certain degree) byproduct of the drive to become a member of the international market on the part of the resource-finance groups was shown to be one of the increasingly important reasons in this regard. Though directly related empirical data

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<sup>189</sup> Leon Aron, “The Foreign Policy Doctrine of Postcommunist Russia and its Domestic Context,” in *The New Russian Foreign Policy*, ed. Michael Mandelbaum (USA: Council on Foreign Relations, 1998), 45.

<sup>190</sup> Khripunov and Matthews, 32.

have not been called up to support this argument so far, in next sections, especially analyzing “tool of the state” argument this point will get clearer. Still, why they are *able* to have such a great effect should be answered regarding all these points. At that stage, besides size and political and economic competitiveness in the international arena, the legitimacy issue too will be revisited. Sure, many authors do not concentrate much on *why* they are successful since, they take the sector in question just as one of the many factors to affect Russian foreign policy. However, as mentioned above, this thesis, guided by the theoretical imperatives of introducing international politico-economic structure in advance has a prediction that as the organic part of a greater picture, the resource-finance sector has been and is likely to be much more important in shaping the general contours of Russian foreign policy than what has been ascribed to it in related studies.

To start with, due to such reasons as geographical proximity and infrastructural convenience Russian resource sector overwhelmingly depends on European countries. It exports its natural gas to 20 states of the Central and Western Europe. The biggest importers are Germany (32.6 percent), Italy (20.2 percent) and France (11.2 percent). In 2001 75.2 billion m<sup>3</sup> natural gas was exported to EU, 3/5 of the Russia’s total export.<sup>191</sup> The fastest growing energy resource of the EU, natural gas accounts for 22 percent of its energy consumption. It purchases 62 percent of Russian total gas exports accounting for 20 percent of its overall gas consumption.<sup>192</sup> This means 1/3 of its total imports. 60 percent of revenues of Gazprom are generated by sales to Europe.<sup>193</sup>

Overwhelming dependence on Europe in terms of natural gas is not a coincidence. Unlike oil, trade in gas is generally a regional business, because it is mainly moved

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<sup>191</sup> These are 2001 figures. Tretyakov, 1-2.

<sup>192</sup> “EU/Russia Energy Dialogue: An Overview,” 1 June 2001.

<sup>193</sup> “The Geopolitics of Energy in the 21<sup>st</sup> Century,” *An Overview and Policy Considerations, A Report of the CSIS Strategic Energy Initiative* 1 (November 2000): 5.



by pipelines, and long-distance pipelines are prohibitively costly.<sup>194</sup> In the absence of any comparable customer Russia seems to depend on Europe as the crucial partner for years to come. Though the shipment of oil is much flexible than that of gas, the locations of Russia's major oil resources, availability of ports and sea routes, and extraction cost per barrel make Europe the best market for Russian oil as well. The EU currently imports 53 percent of Russia's total oil exports, accounting for some 16 percent of its oil consumption.<sup>195</sup>

Adding to this huge trade volume the fact that the EU is one of few most important sources of finance, technology and know-how for these sectors, there emerges a solid ground for them to seek peaceful relations with the European countries. True, they are after good relations not because of some ideological inclinations but because pragmatically this is the most profitable option. But when interpreted narrowly this may result in problematic conclusions. There is an argument that these economic groups concretely want access to Western capital and markets. And when there has been an issue threatening these interests, such as problems surrounding NATO expansion, they intervened "to sustain engagement." Yet when those issues do not have much to do with these interests such as arms controls (CFE and START II for example) they have shown little concern. Leaving these issues to the Ministry of Atomic Energy and defense enterprises, they disregarded Western diplomats' seeking "to link these peripheral issues with engagement."<sup>196</sup> Though right to some degree, such evaluations run the risk of being too narrow: And if the point is that Russian energy majors want peaceful international political relations with the Western states only to have an access to their economic institutions it is wrong.

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<sup>194</sup> A small but growing fraction of gas is being compressed and cooled to liquid form, sold at prices set by world markets, and shipped long distances to destinations including the United States. Only a small amount of Russia's vast gas reserves, however, presently have the characteristics needed to make this export option economically worthwhile. Victor and Victor, 58.

<sup>195</sup> "EU/Russia Energy Dialogue: An Overview," 7. Oil accounts for 44 percent of EU's energy consumption.

<sup>196</sup> McFaul, 25.

The problem is much more complex and fundamental. They don't simply seek good relations with the West but more significantly offer it as the alternative or at least as something moderating of other tendencies; since there is another option for Russia to choose. More than seeking good relations in an empty space for their narrow economic purposes they try to hinder the other alternative. They hinder because it is a possibility, an option, and actually *the* other option, and will not have positive consequences for the FIGs.

As mentioned, they are private companies or even in the case of Gazprom have considerable minority shareholders. Any confrontational stance in Russian foreign policy of a large scale would inevitably mean the disruption of the domestic political economic balance between state and economy, where the state would need to utilize more resources than it currently has. This would result in the penetration of the private companies and their eventual takeover. The securitization of foreign policy would need to be accompanied by the militarization of the economy where the importance of the energy sector would be its usage or "destruction"<sup>197</sup> to fuel the inefficient military industry. This would result in the worst consequences if the nations to be confronted will be the Western ones; very powerful states politically/militarily they would also isolate Russia from the crucial benefits of the international market. But even, say, confrontation with China would bring about similar outcomes. Securitization of foreign policy in any significant scale might get

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<sup>197</sup> Gaddy model: "The simplest way to understand today's Russian economy is to imagine that it consists of only four sectors. First, there is the household sector. It supplies labor. Second, there is a government, or budget, sector that transfers tax receipts to the households. Third, there is a value-adding production sector (we call it "Gazprom" for short). We designate these three, respectively, "H" (for households), "B" (for budgets), and "G" (for Gazprom). Finally, there is a fourth sector, a value-subtracting manufacturing sector, "M," that encompasses all the rest of the economy (speaking somewhat loosely—but not very). Think of M as a single plant that takes 100 rubles of labor from H and 100 rubles of gas from G and makes a product worth 100 rubles. It subtracts, or destroys 100 rubles worth of value. But it pretends that it is a value-adder. To do that, it overprices its output. It claims it is worth not 100, but 300. And everyone else accepts that pretense. They do so because they can use the overpriced output in barter trade with one another (where prices have no meaning) or to pay their own taxes. M pays G for the gas by giving it one-third of its final product, claiming it is worth 100 rubles. (In market terms, it is worth only 33 1/3.) That is fine with G, since it merely passes the product on to B in fulfillment of its tax obligation. (We assume a 100 percent tax rate on value-added.) M, of course, pays its own taxes—100 rubles—in kind as well. Problems begin to arise only in respect to the households. H expects to be paid 100 for its labor, but cannot accept in-kind payment. It needs (at least some) cash. But the cash value of M's remaining product is only 33 1/3. Hence, "wage arrears." Gaddy, *Beyond a Bailout*, 3.

out of control in the fertile ground left from the past. Even if this option doesn't have to settle down to its ultimate logical conclusions, something in between still would be disastrous enough. That is why it was not only the Western states but any large-scale security-oriented mobilization that such groups have been against; from Japan to Chechnya.<sup>198</sup> Therefore, to let the resource-finance sector to account just for good relations with the Western world (the EU and the US) is not the best use of this factor heuristically speaking. It helps to explain the general inclination in Russian foreign policy and sheds light to relations with the Western world within this framework.

There is a tendency to compare the resource-finance groups' stance to the traditional forces in Russia, indeed. Leon Aron speaks of "the internationalist business elites and regions, whose institutional priorities are largely inimical to those of the military industrial complex."<sup>199</sup> Khripunov too is of the opinion that oil and gas complex's emphasis on geo-economics and moderation works against the military industrial complex.<sup>200</sup> Another author agrees that resource-finance conglomerates rose to prominence with regard to the foreign policy formation towards the West and the CIS, and calls them "liberal economic forces of the peace" different from the "illiberal forces of the war."<sup>201</sup> A Western diplomat argued that developments regarding unprecedented and unexpected cooperation between Russia and NATO in 1997 was due to the influence of Chubais and the financial elites who were not interested in confronting the West, and wanted "to avoid remilitarization of the economy."<sup>202</sup> Yet, as said, even such studies, failing to introduce the international context and to place the sectors in question into two alternative identity models clearly, undervalue their importance that emerge as a result of the agent-structure interaction. This in turn rules out the usage of the very convenient concept of

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<sup>198</sup> Prime Minister Chernomyrdin's (Gazprom's former chief and known as the man of the energy sector) endeavor to end Chechen crisis is an example in this regard.

<sup>199</sup> Aron, 48.

<sup>200</sup> Khripunov and Matthews, 30.

<sup>201</sup> McFaul, 27.

<sup>202</sup> *Washington Post*, 27 May 1997.

legitimacy in accounting for Russian foreign policy, regarding the abovementioned “why” question.

Peaceful relations are not what resource-finance groups just want. They seem to be successful as well. Why? True, resource-finance sector not only constitutes a very large but also the most strategic part of the Russian economy. This in turn bestows on it tremendous political leverages. In addition to this, as analyzed before, the increasing autonomy of the economic sphere plays its role too. But still there is something more to this issue. The old politico-economic system with its foreign policy extension has serious legitimacy problems. It resulted in bloody empires outside and oppressive life inside and despite devoting all it had still lost the war, however cold it was. Its rivals appeared to have not only more developed security institutions but also incomparably higher life standards. In Russia this gave rise to a general belief that the winners’ way of life must be superior and more legitimate.<sup>203</sup> As said, this was related to the fact and perception that no nation was willing to invade Russia (nor able either, given its nuclear capability).<sup>204</sup> Therefore, from 1980s on Russia decided to join and act within this superior system of international political economy. Despite drastic failures and doubling of the disappointment with the new system, in time there did emerge an indicator of success in this “higher world,” in the world of the winners. And it is the resource-finance sector that stands as the tangible phenomenon showing that the new way of life and the new identity can work indeed. That without any resort to conflicts outside and oppression inside even a better life can be the case. That coercion is of no help but can only hinder the easier and more prosperous existence. True, given Russia let market in the related groups prospered beyond any expectations and emerged as very powerful actors economically and politically. This factor in itself would explain a great deal about why Russian official stance should reflect their position. They were great winners who had huge stakes in the continuation of the new system and who had enough to set the agenda reflecting

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<sup>203</sup> This generally summarizes what is meant by the change in the values systems of the Russians.

<sup>204</sup> At this point it should be noted that, Russia’s over-securitized identity was not only about defense. It certainly had hegemonic intentions, and the inability to win a security struggle or the belief in an almost inevitable defeat if start a new one haunts the Russians consistently.

their interests. Moreover the outside international political and economic institutions with their overwhelming power have been behind these actors. Yet still, this is about more than power of resource-finance groups internally and international structure externally. Despite all disastrous socio-political consequences that accompanied resource-finance groups' rise and prosperity, they rode on the changes in domestic politico-economic discourse and acted and became successful in a related international environment. The issue of legitimacy in this sense cannot be disregarded. Commanding the legitimate discourse with their huge potential, the resource-finance sector's success becomes Russia's success and their actions are perceived beyond narrow interests of a given economic actor. This is a working model with its internal and external characteristics directly linked to each other. There is a resonance created by their interaction, which is powerful and legitimate, has peaceful and prosperous implications and promises more. That is why traditional forces try to change the entire model of the new way of life. Changing just the internal political economy would not suffice or inserting a foreign enemy alone would hardly work. The general rhetoric of the traditional forces concerns changes both in national and international identity. The requirement to alter the entire model of life is one of the reasons of their failure too; that seems to be very difficult.<sup>205</sup> In the new world that Russia found itself and somehow decided to stay in, the resource sector makes life bearable despite all the difficulties and creates assurances that future will be better. In its absence, given the drastic failures of the reform there would be every reason for Russia to turn back, costly yet more decent life compared to the current one in general, in the face of the human and infrastructural resources that were working quite well just about a decade ago and that are more or less intact waiting to be re-organized.

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<sup>205</sup> Still, it must be the effect of history that they want first to insert an omnipresent external threat to justify the isolation of the economy and change of its structure. Moreover, interestingly, the theoretical model of this thesis would rule it out that huge Russian arms exports are part of a more embracive plan to change the prevailing system in Russia. Despite all the problems regarding the transfer of sensitive conventional and nuclear technology to such states as Iran and China, they are conducted within given international political and economic system. And if to disregard their help to perpetuate the military industrial infrastructure (the only significant potential problem in this regard), they appear to be negligible in terms of "getting Russia back." Russian arms sales do not target the model Russia chose/was compelled to try.

There is one more point regarding the politics of international trade issue that needs to be handled before completing this chapter. There is interdependence between the EU and Russia actually. Yet unlike Russia, which has no comparable alternative, Europe can switch to other sources relatively easily; an increasing level of competition for the stable and lucrative European market is the case. This increases its leverage in its endeavor to have a better Russia. There are interesting cases showing the domestic and foreign policy effects of having a partner like the European Union. In 1994, Russia signed but did not ratify EU Energy Charter (ECT). Even when Gazprom opposes the call of the charter for internal reform in line with market principles, forces within government and Duma favoring good relations and aware of the stakes with European states pressure the gas giant. The chart, moreover, foresees the lending of Russian transport grid to other gas producing states, like that of Central Asia,<sup>206</sup> where Russia has used its energy leverages mercilessly. Certainly, these calls won't disappear without consequence. This is politics of trade with such a liberal entity as the EU to which Russia should respond having no comparable alternative.

Perhaps, the effects wouldn't have been the same if the main partner had been, say, China. There might well have been "different politics" of the trade. Still the politics of international trade is a deficient conceptual framework to evaluate the true meaning of the Russian resource sector, as long as it has venues (and it does)<sup>207</sup> to go to the international market. Since, regarding its size and competitiveness and thus the stakes of becoming a respectful member of international market creates much more potential to be confined to a trade with a given region and politics thereof. Even in the absence of direct relations with Europe, the stakes of becoming an actor of global importance in the international market would guide Russian resource giants. In that

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<sup>206</sup> Adams, 20-21.

<sup>207</sup> In spite of some structural dependence on the EU, especially in the case of natural gas, this is not very different from going directly to the international market. The EU being the main market decreases the degree to which business relations can be manipulated by "international politics" and this forces Russia to concentrate on marketization; the most effective language to speak to Europeans. Actually, Europe (Europe that went beyond politics within, with foreign policy implications) amplifies international market's pure pressure to affect Russia. Hence, in this case the politics of trade becomes embedded in the international market.

case the EU would still be valuable as the dominant entity of international market. That is to say, the main source of dynamism can be claimed coming from within the resource sector, its structural characteristics. And the importance ascribed to Europe's developed nations has at least as much to do with their general position in the international market as the volume of trade with them. The fact that the partner is Europe amplifies and accelerates the already-there drive of the resource.

This said, it is interesting that the bulk of Russian energy partnership or relationship is linked to the European territories that were the bone of contention of the Cold War, and the former imperial lands (Soviet states). Materially and psychologically this is the main region that Russia has had problems, been involved for centuries and had connections. And since resource companies do so well in these exact lands where traditional methods get increasingly obsolete, their importance in terms of shaping and moderating Russian foreign policy increases.

## **CHAPTER 8**

### **FORMER SOCIALIST BLOC AND FORMER SOVIET STATES: ARE RESOURCE-FINANCE GROUPS THE TOOLS OF THE STATE?**

The energy majors are increasingly involved in former socialist bloc and former Soviet countries' energy resource projects and energy infrastructure. How are these involvements related to Russian foreign policy? How do the interests of the energy companies and Russian state intersect? Is one using the other as a tool? Or if there is a mutual interaction what are its nature and characteristics? And what is the difference from the relations with the Western states?

Now having financial resources for which Russia is not always the country with the best return, having familiar personal and infrastructural connections with those countries as heirs of the same socialist system, being big enough and the closest specialized companies for such a task, trying to secure better and stable connections to the other actual and potential partners-European market first and foremost, create incentives for Russian energy companies to get energy actives in the region in question. Some of the states welcome Russian investment as any foreign investment, some indebted due to their energy purchases need to swap their energy assets, and some, like Azerbaijan and Kazakhstan, choose energy companies to secure Russian consent to their projects of international importance. As to the Russian state, of course, the basics of Russian history and politics would help us to predict that it would like create a dependency, say, by pressurizing companies to play with the "faucet" and/or to get the control of the frequently vital energy assets of those



countries for political aims in order, say, to get them into a collective security organization. Or would it like to do more, to regain the absolute control of “lost territories”?

Now having “substantial resources” Russian firms keep expanding and are competing for assets in Poland, Latvia, the Czech Republic, Slovakia, and Croatia, despite some problems.<sup>208</sup> Lukoil expanded its operations to southern Europe a few years ago by purchasing refining assets, pipelines and ports in Bulgaria and Romania; it started to negotiate the purchase of a refinery from Hellenic Petroleum in Greece.<sup>209</sup> Having investments there it is rational for oil/gas sectors to be interested in deep and “mutually acceptable” relations with the former Soviet states, especially those involved in oil/gas issue area. And there are few of them that are not involved in this business one way or another. Overall, some authors would argue that Lukoil is interested in controlling anti-Islamic sentiment in Moscow due to its interests in the Caspian region.<sup>210</sup> Lukoil’s strategy is outward expansion, like Gazprom, even at the expense of inward contraction. It is courting former Soviet states before it is too late and already has serious presence in Lithuania, Latvia, Moldova, Belarus Azerbaijan, and Kazakhstan. It supports civilized relations not based on coercion. Gazprom is for “correct” relations with the southern neighbors, including Kazakhstan, Uzbekistan and Turkmenistan.<sup>211</sup>

The importance of such countries increases if they are part of the network that connects Russia to the main source of its energy revenues, to Europe. That is why,

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<sup>208</sup> Yukos’ failure to acquire a terminal in Lithuania in 2001 is one of the well known. Morse and Richard, 26.

<sup>209</sup> This kind of economic expansion is not confined to Eastern Europe. However, as regards the areas outside of the post-socialist world investment capability of the energy firms is rather limited. In 2000, Lukoil bought Getty’s 1,300 gas stations in the United States. Although the stations are already partially supplied from Lukoil’s refinery in Bulgaria, the company intends to acquire a large refinery in the United States to increase deliveries to Getty’s pumps. After Lukoil’s ambitious moves internationally, now Yukos, which made a \$45 billion deal with Sibneft, pushes hard for a global role. However, projects in such states as Sudan and Latin America are not profitable, those in Europe and the US mainly serve their image. Kolchin, 2.

<sup>210</sup> Khripunov and Matthews, 37.

<sup>211</sup> Pappe, “Neftyanaya i Gazovaya,” 4.

for instance, Gazprom seeks good relations with Ukraine, Belarus and Moldova.<sup>212</sup> It was influential in good relations between Russia, and Poland, other Central Eastern European states and Baltic republics, while Russia was getting more and more angry due to the expansion of EU and NATO. Because of the similar reasons it was mainly due to Gazprom that Russia signed its first border agreement with Latvia, with which its relations were one of the worst among the former Soviet states.<sup>213</sup> There have been claims that the Russo-Chechen peace deal of May 12, 1997 owed much to the lobbying of the (then) biggest Russian oil company, Lukoil, which was interested in a peaceful Chechnya as a transportation hub for its oil drilled in Azerbaijan and Kazakhstan, and destined to Black Sea terminals.<sup>214</sup>

“Russia’s liberal coalition,” besides contributing seriously to the policy of integration with the West, hindered the “ideological” or political integration with the former Soviet states, it is argued.<sup>215</sup> This can be explained by claiming that they simply do not need such a favor of their country to make profits in those countries. Being competitive in the international market, by this very characteristic they are able to compete and still be profitable, without ideological/political/military dominance by the home country. They do not need to create isolated space from other competitors to make profits.

Beyond energy actives in such countries, expectedly they are concerned about the internal political economy of Russia too. The best case has been the union issue with Belarus, the idea that majority of the Russians support. They would agree, as liberals in Russia do, to such an integration only “as long as it is done in an economically rational way.”<sup>216</sup> Or let’s take another example. To get its products to the international market, due to the limits of geography and the shape of the former

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<sup>212</sup> Ibid.

<sup>213</sup> Kobrinskaia, *Vnutrennie Faktory*, 283-284.

<sup>214</sup> Aron, 46.

<sup>215</sup> McFaul, 25-27.

<sup>216</sup> Ibid.

Soviet infrastructure, Russia heavily depends on former Soviet and socialist states. Since energy companies make the bulk of their huge profits by selling to the international market, offering some portion of that revenue to the states on the route seems much cheaper and legitimate to everybody involved than coercing them into compliance. The second option not only would disrupt relations with the main partners and the dominant nations of the international system but also would mean the reliance on Russia's traditional coercive methods that may get out of control. As stated before, in its extreme this would mean the revitalization of the military industry, disruption of the domestic political economy and confrontation with almost the whole world.

However, that they do not *need* the state doesn't rule out that they are being *used* by the state. This has been one of the most discussed issues in similar studies. Does the federal center manipulate this sector for its sinister aims to dominate these republics or would it be a "gross overestimation of its current potential"? Or, is it the oil/gas sectors that influence foreign policy of the state?<sup>217</sup>

Oil and gas sectors give Russia a voice especially in its immediate neighborhood. In Baltic pipelines and ports; in Ukraine, Belarus and Moldova, energy dependency; in the Caucasus and Central Asia, involvement and transport create incentive and tools for influence. When some authors refer to Russia's "gas diplomacy" as an important means in its relations with the states of the former Soviet Union,<sup>218</sup> or refer to oil/gas industry as "the major tool" for integrating the former Soviet states,<sup>219</sup> they point to the state's ability to utilize the energy companies for its foreign policy aims. Especially the manner and speed with which the Russian energy companies are taking the control of energy infrastructure of neighboring states and the way Russia manipulated the energy faucet seem to be the two main points that support such

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<sup>217</sup> Khripunov and Matthews, 30-35.

<sup>218</sup> Pappe, "Neftyanaya i Gazovaya," 2; Importat energy men among politicians is a usual occurrence in Russia. For instance, almost always, newspapers have the photo of the head of Gazprom besides presidents of Turkmenistan and Russia during official visits. Kobrinskaia, *Vnutrennie Faktory*, 284.

<sup>219</sup> Khripunov and Matthews, 40.

ideas. Russian oil and gas companies that are involved in the great number of energy assets in Ukraine either alone or with Ukrainian companies have played significant roles as lobbies.<sup>220</sup> This was mainly due to swapping Ukraine's debt for equities in enterprises. Since 1994 Gazprom has been very successful in taking over oil and gas infrastructure in Belarus, Moldova and Baltic states by the same method.<sup>221</sup>

According to Vagit Alekperov, Russian firms' expansion has a bearing on Russian foreign policy: "I am certain that Bulgaria, whose oil sector is almost entirely owned by Russian companies, will not conduct an anti-Russian foreign policy in the foreseeable future."<sup>222</sup> He said elsewhere that in the last two years the Russian government, instead of opposing foreign investment of the Russian firms supports them understanding that "close economic ties with... the nearest neighbors... serves to facilitate political ties."<sup>223</sup> Or, as a Gazprom executive put, there was no need to worry on the part of the Russian foreign policy makers, since the expansion of NATO to the East was to be "more than compensated for by the enlargement of Gazprom to the West."<sup>224</sup>

Beyond the visible hegemonic flavor of these speeches lies the endeavor to justify the economic expansion, it seems. Actually it is very clear in Vagit Alekberov's second statement. Russian state for a long time was not willing and, it appears, is not very much willing today to let those companies expand, in the face, it can be argued, of terribly underinvested Russian economy. In that sense, such claims that state spurs those firms to get control of the traditional imperial lands seems groundless.

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<sup>220</sup> Margarita Mercedes Balmaceda, "Gas, Oil and the Linkages Between Domestic and Foreign Policies: the Case of Ukraine," *Europe-Asia Studies*, no. 2 (March 1998).

<sup>221</sup> Actually, the author is of the opinion that not every action of Russian energy companies are motivated and guided by the state; the former are too powerful. Ibid.

<sup>222</sup> Grigory Volchek, "My razgovarivaem s Trutnevym na odnom yazyke," *Zvezda*, 4 April 2001.

<sup>223</sup> Olcott, 67.

<sup>224</sup> David Hoffman, "For Yeltsin, Business Prospects Outweighed NATO Threat," *Washington Post*, May 27, 1997.

Such a language, moreover, more than reflecting true intentions of the businessmen may well be the rhetoric that sells in Russian political and public arena. They must be very well aware that suffering from the syndrome of contraction, which is something unprecedented in Russian history since the very beginning, this economic expansion and related rhetoric has a psychologically very healing impact on the Russians. Being vulnerable to the political center in Moscow with their legitimacy problems, considering the general great power rhetoric being consolidated among the laymen and policy elites alike, and having the state as their important shareholder (especially in the case of Gazprom), it can be expected that the energy companies will tune to the prevailing general mode.

If instead of neo-imperialist tendencies of dominating its “lost territories” by economic games Russia just wants to get some control of the energy infrastructure of the former Soviet states with some policy consequences<sup>225</sup> that much can be expected of any state in its position. However, the theoretical framework of this thesis would expect that if the issue is the turning back to the cost-blind traditional domination, then the resource-finance groups would resist.

Moreover, taking state’s demands into consideration doesn’t always mean that they are making unprofitable investments. The two might be perfectly compatible. And if not, they may not last long. These companies are large and competitive in the international market, which means that right steps can bring long term benefits. In short, since they have long term opportunity cost, at the first possibility they will switch to more profitable business. The luring pressure and huge potential rewards of international market is too attractive to resist. To trade easy wealth to be acquired by decent and civilized manner in the international market to the much less in the isolated and oppressive imperial lands must not be appealing. Even if the state gets absolute control of those firms, as two options at the same time are difficult to reconcile, to expect principal changes in foreign policy may not have great probability.

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<sup>225</sup> Balmaceda.

Interestingly as in the case of subsidizing domestic economy yet at the same time trying to make it serve their marketization purposes (placing demands on the MIC for energy equipment production), Russian majors generally promote Russian interests in international arena, “including giving priority to investment in countries where Moscow has strong strategic interests, in the hope that this will speed up the creation of the domestic political and legal environment necessary for them to retain and expand their assets.”<sup>226</sup> What is more, their existence and power in those states doesn’t necessarily mean that they are arms of Moscow. In 2002 Ukrainian parliamentary elections, Lukoil together with Russian Aluminum and Alfa group was said to support pro-Western and pro-market Yushchenko, though some questioned the degree to which the Russian companies coordinated their activities.<sup>227</sup> And if Lukoil’s Alekperov was instrumental in smoothing the strained relations between Azerbaijan and Russia paving the way for Aliyev’s Moscow visit in January 2002,<sup>228</sup> this shows his importance more than being a “tool” of a state policy.

Actually, there is a kind of tendency where federal center is coming to terms with “reality” following the energy firms. One of the best examples in this regard was the tension between Russia and Ukraine in 1996. At that time while the two states failed to agree on the transit fees in the Ukrainian section of the Druzhba pipeline, many Russian firms obeyed with Ukraine’s demand to pay higher rates despite Russian Ministry of Energy’s demand that they do not do so.<sup>229</sup> Considering that 90 percent of Russian oil and most of its gas is exported to Western and Central Europe through pipelines crossing Ukrainian territory this was a rational decision for energy companies. It seems, accepting this option was rational for Russia too, which it eventually did. Ukraine doesn’t want to act according the wishes of the Russian political center. If the traditional option is to utilize all the means without considering economic consequences to make Ukraine do what Russia wants, another one is what

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<sup>226</sup> Olcott, 68.

<sup>227</sup> Andrei Zolotov, “Russia Counts Its Blessings in Ukraine,” *Moscow Times*, 3 April, 2002.

<sup>228</sup> Hill and Fee, 20.

<sup>229</sup> *Russian Petroleum Investor*, September 1996.

the energy firms achieved. In this option, though Russia is not politically satisfied, keeping gates to Europe generates enough revenue to satisfy it and Ukraine economically at no political cost. This should not be perceived as the worst option of all. Or let's take the case of Lukoil. Its "recent decisions reflect a consistent pattern of focusing on profitability, overall cost/benefit, and other fundamental concerns." This explains the withdrawal from the ACG, the greatest international project in Azerbaijan. "Neither the Caspian nor Azerbaijan per se was at issue, much less Russian diplomatic relations throughout the Caspian region."<sup>230</sup> At the beginning, Lukoil's entry to the Azerbaijani energy sector was seen as a compensation for the coming of the West to develop the offshore resources of Azerbaijan. For traditionalists even this was the worst possible scenario. And now Lukoil sold an important share of its assets! Interestingly, the state seems to concede. Lukoil's justification was that it wanted to concentrate its resources in Russia which now promised more return. Again the language is that of market implying that Russia as a whole stands to gain more. This language appears to be increasingly irresistible. But the oil firms are aware of the limits of pure economic rationale. Despite initial interest in the BTC pipeline that will connect Caspian oil to Mediterranean through Turkey, Lukoil kept silent due to official Russian opposition (it offered its own territory as an alternative). Of course, cost-benefit calculation is not always about economics. There was a very wide political consensus about this issue in Russia, which in turn was not vital in terms of Lukoil's pure economic interests. In such a case not to come up with an alternative was the very rational calculation indeed. Still, the reasons behind a relatively conservative stance of Russian resource-finance groups vis-à-vis former the Soviet Union (FSU) states will be analyzed in a more detailed way in the next chapter.

There have been instances where Russia used its energy leverage against CIS states. Often cited examples are Ukraine and Georgia. Deliveries of subsidized gas/oil to Ukraine<sup>231</sup> sometimes constitute a good example of the use of energy as a tool of

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<sup>230</sup> Douglas W. Blum, "Why Did Lukoil Really Pull Out of the Azeri-Chirag-Guneshli Oilfield?," *Ponars Policy Memo*, no. 286, (January 2003).

<sup>231</sup> This is the largest individual flow of indirect transfers within the FSU.

Russian neo-imperial foreign policy. Ukraine's refusal to comply with Russian political and strategic demands, in the case, for example, of disregarding CIS security system in favor of NATO and European one was one of the main reasons for problems in energy deliveries.<sup>232</sup> The same happened to Georgia several times, the state known for its overt opposition to Moscow's political demands. But regarding such interruptions, arrears in payments at least were invoked as a justification, though certainly they were not the reason. Since, it can be asked why Russians "remember" these debts at some particular times and not others. Yet still, those states that get Russian energy and do not pay, perhaps, must be careful in not complying with Russian demands. Or, alternatively, they should not buy what they cannot pay for. They expect too much from Russia. At least that Russia utilizes market language (non-payment), this in itself may be an indication of how important market considerations are becoming. And more importantly, if before Russia threatened by doing harm now it threatens by limiting its favor.

From time to time the Russian state might have diverted energy products from Western markets to the "near abroad," valuing political objectives in the former Soviet space more than hard currency.<sup>233</sup> However, data speak otherwise; if instead of "sometimes" we look at the general trend, Russia's oil and natural gas exports clearly show the shift from the "strategic" CIS to the more *profitable* economies of Europe.

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<sup>232</sup> It was Ukraine's control of Russian export pipelines, Russia's interest in Ukraine's stability and international pressure that made Russia to continue the delivery. Krasnov, Gregory V., Brada, Josef C., Implicit Subsidies in Russian-Ukrainian Energy Trade, *Europe-Asia Studies*, 5 (July 1997).

<sup>233</sup> Balmaceda.



Table 5 Shift in the Direction of Russian oil/gas exports from the CIS towards Europe

Region	1990	1991	1992	1993	1994	1995	1996	1997	1998
Crude oil (mln.t)									
CIS	.	104.0	72.8	42.9	32.8	26.1	20.6	17.1	19.2
Non-CIS	.	56.5	66.2	79.9	95.4	96.2	105.0	110.0	117.9
Total	235.0	161	139.0	122.8	128.2	122.3	125.6	127.1	137.1
Oil products (mln.t)									
CIS	30.0	23.0	17.5	10.0	8.2	3.5	2.0	2.2	2.6
Non-CIS	24.0	27.0	25.3	35.1	39.1	44.0	55.0	58.4	51.2
Total	54.0	50.0	42.8	45.1	47.3	47.5	57.0	60.6	53.8
Total mineral oil (mln.t)									
CIS	.	127.0	90.3	52.9	41.0	29.6	22.6	19.3	21.8
Non-CIS	.	83.5	91.5	115.0	134.5	140.2	160.0	168.4	169.1
Total	289.0	211.0	181.8	167.9	175.5	169.8	182.6	187.7	190.9
Natural gas (bn.m3)									
CIS	140.0	164.0	101.0	75.0	75.0	70.0	68.5	80.0	75.6
Non-CIS	19.0	83.0	88.0	96.0	110.0	122.0	128.0	120.0	125.0
Total	249.0	247.0	189.0	171.0	185.0	192.0	197.0	200.0	201.0

Source: Petra Optiz, Hella Engerer, and Christian von Hirschhausen, "The Globalisation of Russian Energy Companies-A Way Out of the Financial Crisis?," *International Journal of Global Energy Issues* (2002): 35.

## **CHAPTER 9**

### **INTERNATIONAL MARKET AND THE LIMITS OF STATE INFLUENCE ON THE ENERGY SECTOR**

Tool of the state argument has wider implication in the general context. There is a claim that as the Russian state increasingly finds no comparable means to utilize for its foreign policy goals but expanding energy companies, foreign investment to this sector will be blocked.<sup>234</sup> The need to subsidize domestic economy is shown as another reason why state should want to hinder foreign investment.<sup>235</sup> Beyond foreign investment this means that any development that loosens state control will not be welcome, market reform included. And there are observations that “since Putin assumed the Russian Presidency in January 2000, there has been what amounts to a creeping re-nationalization of the Russian oil industry.”<sup>236</sup> These points add up to support the “tool of the state” argument. If what is meant by nationalization is public control of international corporate citizens due to the unwelcome power of different persons in Russian politics then in principle fundamental changes may not be the case. Actually, the transition process from private hands to the public would be very problematic to organize at this point. It may be too late. But if the state eventually manages to pass the troublesome stage and controls (read: manipulates as a tool) such sectors, then in the face of the stakes and the opportunity cost of complying with the full demands of the international market to reap the most

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<sup>234</sup> Hill and Fee, 25.

<sup>235</sup> Smith, 4.

<sup>236</sup> Volchek.

possible amount of wealth, there would inevitably be considerable tension on the part of the resource sector leaning towards market inside and outside, and the state. Perhaps democracy would be required for such a tension to be felt. That is to say, in Saudi Arabia there is hardly such a tension, blocked by the “early” tension between autocracy and democracy.<sup>237</sup>

The very success that energy sector and the entire FIGs enjoy in domestic and foreign arena owes to their obeying market rules, and if deceived by this success the state tries to control them for manipulation for its political purposes (either indirectly or through nationalization) this means that it will strip that sector of the very characteristics that makes it successful; tighter the political hold less valuable they are. This issue brings us back to the holistic models. Political manipulation of the resource sector in the traditional Russian sense, within given international structure that Russia finds itself now is impossible. This doesn't mean that Russia cannot manipulate them. However, in case there is a manipulation some very visible changes in its foreign policy will be the case with accompanying huge costs. And unless the Russian state is prepared to change the entire model of political economy and foreign policy, there will be the pressure of the immense opportunity cost due to not obeying and benefiting from the international market which would be politically costly to bear in a democratic Russia.

Generally speaking, the “degree of reciprocal influence” argument can be categorized as those that claim that the state has a decisive influence on energy majors in domestic and foreign policy and those that do not agree, and of course as always, those “in between.” But what almost all such arguments miss is the theoretical relevance of introducing international market into the analysis. Resource sector in general is the most closely tied sector to the international market within which Russia finds itself. And since the former acts and internalizes the very characteristics of that market, the Russian state must have some limits in influencing it. Sure this is about the sector and not the reshuffling of the persons chairing them. Replacing Vyakhirev by Miller as the head of Gazprom, or Berezovsky's and

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<sup>237</sup> In Russia there is at least an electoral democracy.

Gusninsky's having to leave the country cannot be taken as the indicators of the power of the state against the sector in this context. The political center must find it very problematic when the kind of influence it contemplates contradicts the demands of the international market. Energy sector already very deeply embedded in there, wishful manipulation would be dangerous if not eventually ineffective and forceful manipulation would punish Russia harshly (economically speaking first of all).

"The Russian oil sector is a lot more like the United Kingdom's than it is like Mexico's or Norway's –let alone that of the former Soviet Union." Russia has extremely limited powers over how Russian companies "allocate their sales or investments." It controls "a rapidly decreasing amount of the country's energy resources and enjoys no monopoly over the Russian oil industry." The state has left this area to "a group of publicly traded companies eager to expand rapidly in a competitive international environment."<sup>238</sup> It is said that the governmental working groups established by Bush and Putin have no influence on "the market-driven business decisions that now dominate the Russian oil industry."<sup>239</sup> Petroleum Intelligence Weekly included 10 Russian companies among the top 50 worldwide. Only two of them and those of middle size, had a majority state ownership (Rosneft and Slavneft; the latter's share may be sold). Unlike OPEC countries where single company dominates, in Russia "where ownership is private and fragmented, the odds are higher that market forces, rather than cartel instincts, will determine behavior."<sup>240</sup> Private nature of the Russian oil industry hinders its behavior as a single unit to serve "national interest," in the sense of being utilized by the state.<sup>241</sup>

Actually, one of the main reasons of increasing interest in Russian oil sector is their private ownership and decreasing political interference. Ironically it is this feature

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<sup>238</sup> Morse and Richard, 28.

<sup>239</sup> Victor and Victor, 53-54.

<sup>240</sup> Ibid.

<sup>241</sup> Interestingly, when experts speak about state's influence on energy majors they increasingly refer to the amount of the shares held by the state. This is the language of the institutionalized market, and it must be a novelty in Russia where traditionally there was almost no formal limitation on political manipulation.

that increases Russia's importance in international politics. After September 11, when some circles in the US contemplated ending the supply dominance of the Middle Eastern countries, the frequent reference to Russia owed to market's dominance in oil sector in Russia unlike the former. The US-Russia rapprochement that followed was unmistakably related to this issue as well. The reason why OPEC was not successful in cutting production after September 11, the defenders of the idea claimed, was mainly Russia.<sup>242</sup> "Political leaders, as well as corporate leaders in oil and gas are portraying Russia's oil firms as stable sources of supply." This may result in both economic and political gains. "In economic terms, energy production lets Russia integrate itself into the industrialized West. In political terms, energy resources can be used to buttress Moscow's goal of becoming a key partner of the United States."<sup>243</sup> This indicates that Russian political and economic elites are aware of the stakes. Putin's pro-Western policy is backed by "the more successful and wealthier parts of the economic and financial circles, especially those interested in the development of the announced energy partnership with the United States and the EU."<sup>244</sup> OPEC countries, at the beginning fearful of FSU's entry to the oil market thought that the game was over after business unfriendly practices and below-expected level of resources there. However, new findings<sup>245</sup> and marketization of the business may prove them wrong.

Moreover Russia has some structural advantages against the OPEC countries and especially the main oil nation of the world, Saudi Arabia. The greatest weapon of this country and the OPEC at that, has been its ability to flood markets and cause price collapses. That is why Saudi Arabia has been able to make other oil producing nations to consider its wishes in setting up oil prices in the international market. However, there is an argument that Russia may not be vulnerable to this threat, and actually the recent failure to make Russia help to increase world oil prices was due to

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<sup>242</sup> Kiesing and Becker, 1.

<sup>243</sup> Morse and Richard, 17-18.

<sup>244</sup> Irina Kobrinskaya, "'Parallels' and 'Verticals' of Putin's Foreign Policy," *Ponars Policy Memo*, no. 263 (October 2002): 5.

<sup>245</sup> Sakovich.

this feature. Considering huge gas sales to Europe, quite large domestic market, ruble based oil business (the income and capital expenditures of Russian firms are ruble-based, hence these companies benefit from a ruble depreciation against the dollar) and less dependence of the state on oil than Saudis (according to Khodorkovskiy, whereas in Saudi Arabia oil tax is around 85 percent, in Russia it is 35 percent) it is claimed that the oil leader cannot use its deadliest weapon against Moscow.<sup>246</sup> Besides this, Russia may be the only country to challenge another advantage of the Saudi regime. The swing producer capacity of the Middle Eastern state, which is about 3 mbd, probably can only be matched by Russia among the remaining oil producing nations of the world.

Yet again, it is the market-friendly nature of the Russian oil industry that makes even these structural advantages something of value. As said, the “Energy Dialogue” that started between Russia and the US after September 11 should be evaluated in this light. For a long time the general belief has been that as the state is dominant in the gas sector it was more likely to be a tool of Russian foreign policy. Sure, less state control must mean less value as a “tool.” But if the main issue is Russia’s importance in the international arena then the very fact of decreasing state manipulation appears to have more positive consequences.

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<sup>246</sup> Natalia Serova, “Kasyanov Sdal SSHA Neftyanuyu Ortasl Rossii,” (“Kasianov Sell Russian Oil Sector to the US”) *SmiRu*, 6 February 2002; Morse and Richard, 28, 29, 31.

## CHAPTER 10

### UNEXPECTED LEVELS OF AUTHORITARIANISM ON THE PART OF THE RESOURCE-FINANCE GROUPS: STILL MORE TOWARDS THE CIS?

Though not acting as tools of the state in the FSU area either, the very features of the resource-finance sector that are eventually reflected in a peaceful Russian foreign policy in general, ironically, seem to partially account for a more authoritarian policies towards the former Soviet states. The parties these groups supported, either liberal or centrist, have “all advocated a similar mix of nationalism and internationalism, leading to preferences for pragmatic engagement with the West and moderate integration of the former Soviet states.”<sup>247</sup> The oil and gas lobby generally “favored a strategy of economic integration of the CIS, a preference which tallied with their support for slower and more moderate Russian economic reform.”<sup>248</sup> The fact is that, this “economic” and “moderate integration” carry more determined stand than what they literally mean; it is a kind of “anything short of forceful control” of the previous imperial lands.

Jeffrey Frieden and Ronald Rogowsky built a model explaining the relationship between domestic economic actors and a state’s foreign policy. The determinants of

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<sup>247</sup> Stowe, 56.

<sup>248</sup> Alex Pravda and Neil Malcolm, “Conclusion,” in *Internal Factors in Russian Foreign Policy*, eds. Neil Malcolm, Alex Pravda, Roy Allison, and Margot Light (Oxford: Oxford University Press, 1996), 297.

foreign policy preferences of actors are categorized under two headings: “asset-specificity” (the ease with which a given sector can shift its assets to other ones) and “international competitiveness.” The higher asset specificity and the lower international competitiveness, the more conservative the sectors are. Sectors with opposite qualities are to be liberal in their foreign policy outlook.<sup>249</sup> Robert Stowe comes up with the list of Russian economic sectors and their foreign policy attitudes trying to apply the model to the Russian case.

Table 6 Key Sectors of the Russian Economy and their Foreign Policy Attitude

	Agro-industry	Light industry	Heavy industry	Defense	Natural Resources	Financial
Description	Collective farms, private farms, agriculturally based industry	Non-durable consumer goods	Machinery, vehicles, other durable goods	Weaponry	Natural resource extraction and processing	Private banks, other financial institutions
Asset-specificity	High	High	High	Very high	High	Low
International competitiveness	No	No	No	Moderate	Yes	Yes
Political Orientation	Most conservative	Conservative	Conservative	Conservative	Moderately liberal	Most liberal

Source: Robert Stowe, “Foreign Policy Preferences of the New Russian Business Elite,” *Problems of Post-Communism*, no. 3 (May/June 2001): 52.

He is puzzled that Frieden and Rogowsky model doesn’t fit the Russian case very well because of some unexpectedly traditionalistic rhetoric and tendencies on the part of the liberal sectors, especially towards the FSU states. He develops an argument

<sup>249</sup> Jeffrey Frieden and Ronald Rogowsky, “The Impact of the International Economy on National Policies: An Analytical Overview,” in *International and Domestic Politics*, eds. Robert Keohane and Helen Milner (New York: Cambridge University Press, 1996).



that only economic factors doesn't suffice to explain the attitudes of economic sectors. They need to be supplemented by "cultural" factors as well.<sup>250</sup> How can this issue be handled in a more detailed way and within the theoretical framework drawn in this thesis? Why resource-finance groups are more conservative in general and regarding the FSU states than they would have been expected on the basis of mere economic criteria? And how does this relate to the Russian foreign policy towards the FSU states?<sup>251</sup>

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<sup>250</sup> Ibid., 50.

<sup>251</sup> Before analyzing this problem, the deficiencies of this model in the light of the basic criteria applied to determine an economic sector's stand regarding foreign policy in this thesis need to be noted. But first of all, there is simply a wrong entry in Stowe's table. Russian finance sector is *not* internationally competitive; this is a well known fact. That is why, for example, they have been against quick WTO membership. In that sense, even within Frieden and Rogowsky model they wouldn't be expected to be "the most liberal." This is a plain wrong perception and is not of very much interest here. The significant point in terms of comparing this model with the one in the thesis, lying bare the deficiency of the former is the importance of "the nature of the product and the general value assigned to it in the international political market." True, natural resource sector is a very asset specific, but the strategic value assigned to its goods in the international market offsets this characteristic. In that sense, it cannot be compared to agro/light/heavy/military industries on the basis of this criterion. That is why they are indeed liberal, instead of "moderately liberal." The latter is the logical result of the Frieden and Rogowsky model, but since "asset specificity" is not a sufficient criteria (even combined with international competitiveness) such a problematic result becomes the case. Or let's take a look at the military industry. Despite their "moderate" competitiveness they end up with being "conservative." It seems that Stowe tries to offset the fact of competitiveness (even more than moderate, I would say) by assigning to it "very high" asset specificity. Again, the source of the problem is the disregard of the general nature of the product in the context of international political economy dominated by the developed nations. As said before, because of the reverse strategic value or perhaps "strategic danger" of military commodities, the developed world not only closes its markets to it by relying on its own national companies but also makes it politically difficult (besides economically competing with it) for Russia to export to other countries, and blocks investment to it. And as military industry needs tremendous R&D spending to remain competitive, with its relatively small trade volume (compared to the overall productive potential) and lack of foreign investment it increasingly loses its competitiveness. This is not about aerospace industries and some sectors of nuclear industry. Western states, the US first and foremost, supported the cooperation of their own companies with such sub-sectors. The main reason was to create cleavages within military industry. Since, these are the sectors that can directly affect the global distribution of power unlike sectors of conventional weaponry. To cut short, satisfaction in some sub-sectors of the military industry cannot be attributed to the entire huge and lying-idle industry, for which "very conservative" would be a better label. To repeat, the lack of "the nature of product in the international political market" as an indispensable conceptual tool is what makes this model deficient from the very beginning. To complete the picture, since natural resource sector does not need very costly innovations and R&D spending to become competitive economically (which is politically competitive anyway regarding the stance of the developed nations, unlike military industry) and since its revenues from huge sales and eager foreign involvement create more than enough capital to sustain the required competitiveness, in this thesis it would be labeled as "very liberal" actually. The model and Stowe's conclusions can be criticized further, regarding the inextricable links between natural resource and finance sectors and so on. Yet all these criticisms don't decrease the value of the problem he raises.

The unexpected to a certain degree authoritarian rhetoric on the part of the resource-finance groups not only concerns Russian foreign policy but its internal political economy too, as would be predicted by the theoretical model of the thesis. And these have something to do with the general pattern of developments that befell Russia from the 1980s on. At the start of the reform process Yeltsin's team pushed too hard for market reform internally and liberal foreign policy externally. Yegor Gaidar in domestic economy and Alexandr Kozyrev in foreign policy drastically and absolutely changed the entrenched centuries-long trends. If the economic sphere was under the control of political one mainly to serve foreign policy aims directed against "enemies," now every possible attempt was undertaken not only to set the economy free but also make the foreign policy a means towards the economic end by a kind of absolute reliance and trust on the now-friendly Western nations.

Radical market reform called "shock therapy" was clearly intended to cut off the traditional relationship between politics and economics.<sup>252</sup> Gorbachev wanted to make his policy of détente with the West and internal liberalization go hand in hand while mobilizing "the traditionally Westernist liberal-minded intelligentsia." Yeltsin wanted much more: to create a middle class with private property who would in turn support internal/external liberal reforms and block would-be regressive trends. Anticipating backlash anyhow they tried to hinder the potential for the swift mobilization of the economic sphere by the state apparatus. "If nothing else, this helped to divide and to create uncertainty among producer interests, and to lower the temperature of opposition."<sup>253</sup>

Gaidar was acting like Bolsheviks with Marxist notion, which believes that "the economy provides the social base upon which society is constructed." He took radical steps "to dismantle central planning to the point where it would no longer be possible to put it back together again."<sup>254</sup> Marxism's radical conceptual tools were

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<sup>252</sup> Frye, 18.

<sup>253</sup> Malcolm and Pravda, 20.

<sup>254</sup> Pavel Smirnov, "'Chistoi' Vneshnei Politiki Ne Byvaet," ("There is No 'Pure' Foreign Policy") *Pro et Contra*, (Summer 1997): 6.

turned upside down to achieve entirely different aims than what Russia was doing about a century ago. Another theoretical framework for such actions appears to come from radical neoliberalism. For these “neoliberals,” the state in Russia was plainly regarded as the symbol and source of “inefficiency and corruption” that should be dismantled. Economic reform turned out to be means to destabilize state institutions responsible for governing the economy.<sup>255</sup> As if disgust for power and politics accumulated for centuries burst out in a short span of time and the excessive authority has been replaced with the lack of it. So much so that some argued that one of the fatal reasons of the failure of the economic reform was the lack of the political enforcement institutions to implement required rules.<sup>256</sup> Neoliberalism’s sole concentration on efficiency, and disregarding the reform of state’s economic bureaucracy and legal infrastructure were crucial reasons of failure. By disregarding the issue of “state institutional development, in the mistaken belief that institutional reform would develop endogenously as a result of economic reforms, neoliberal reformers misread the central puzzle facing Russia.”<sup>257</sup>

The USSR had shown the limitations of central planning but its postcommunist experience was equally striking evidence of the limitations of a dogmatic commitment to market principles, and it was not only in Russia that the response was a shift back towards a more balanced relationship between private ownership and state regulation, and towards policies that took more account of domestic circumstances...<sup>258</sup>

Like Gaidar’s belief in the mysterious force of equilibrium acting to perpetuate market which in turn was expected to heal the domestic politico-economic balance, in foreign policy issues, Kozyrev believed in a kind of inherent harmony in international relations guided by civilized and inherently good West. Therefore

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<sup>255</sup> Herrera, 141.

<sup>256</sup> See Vladimir Popov, *The Political Economy of Growth in Russia*, Program on New Approaches to Russian Security, Working Paper Series, no. 17 (Moscow: Davis Center for Russian Studies, Harvard University, April 2000).

<sup>257</sup> Herrera, 137, 159.

<sup>258</sup> “...than of the advice of foreign moneylenders.” White, 143.

leaving everything to them would be enough to get things right. He and Yeltsin aimed to continue to de-securitize Russian foreign policy, to get as much as they can from the West to revitalize Russian economy and to integrate it into the international market. According to Kozyrev, the new foreign policy must provide a political framework for the national business community.<sup>259</sup> Even today, this view wouldn't be challenged by the stark majority of the Russian political elite. Neither the view that good relations with the Western nations provide the crucial access to this end. "Economic imperative" was perceived "the key ingredient in the initial post-Soviet foreign policy;" that is why it was directed towards "the wealthiest" Western states. Still, they pushed too hard. So much so that Peter Shearman argues that focusing too much on economy, the ruling elite disregarded "other important domestic sources of foreign policy: the political, cultural and psychological." And it was these points that have been exploited by the opposition.<sup>260</sup> The thing went beyond even economic rationality. Even the most liberal political figures would criticize Kozyrev's unrealistic trust and consequent loss of bargaining position to the Western nations. As if after years of bloody struggle and defeat everything that stood behind the dramatic failure was discarded and everything that was believed to account for the Western victory was blindly imitated. "What failed in Russia was the "American model,"<sup>261</sup> an author argues. And in the foreign policy sphere what failed was a blind following of the US-led Western states. This double innocence could not last long. In a kind of Polanyian Europe, unleashed and socially blind forces of market wreaked havoc on the Russians.<sup>262</sup> In terms of socio-economic consequences what befell Russia was perhaps the worst situation ever endured by any modern nation that was not in actual war in the modern history. Sadly, this was happening in a turned-hostile international setting, where every step Russia took back was accompanied by the

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<sup>259</sup> Nikolai Sokov, "Nuclear Weapons and Russia's Economic Crisis," *Ponars Policy Memo*, no. 43, (November 1998).

<sup>260</sup> Peter Shearman, "Defining the National Interest: Russian Foreign Policy and Democratic Politics," in *The Foreign Policy of the Russian Federation*, eds. Roger E. Kanet and Alexander V. Kozhemiakin (Great Britain: Macmillan Press Ltd., 1997), 9-10.

<sup>261</sup> Klebnikov, 321.

<sup>262</sup> See Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston: Beacon Press, 1944).

aggressive moves of the Western states. Before Russians left Germany NATO began its expansion, ethnically/culturally the closest nation to the Russians in Europe, Serbians were subject to military operations, and the amount of financial help provided by the Western states and institutions was never satisfactory; at least these were Russian perceptions. To reverse internal political economic and foreign policy institutions at the expense of relative internal socio-economic stability and powerful bargaining position in foreign policy during Soviet years, and eventual humiliating disappointment would inevitably be expected to create a backlash. Of course, the first reformist team of Yeltsin was not only trying to increase the welfare of the nation. The ideological hatred to the past and rational fear of resurgence guided them as well if not more. Yet perhaps, pushing that hard to prevent the chances of regression to the old way of life, ironically, they actually increased it.

First response came with the parliamentary standoff in the autumn of 1993. The degree of the danger became clear with the success of ultra-nationalist Zhirinovsky's weirdly named Liberal Democratic Party of Russia, first in the party list vote in December 1993. The election made clear "the post-imperial trauma" and how dangerous it might be if monopolized by populists and leftists.<sup>263</sup> 1993 parliamentary elections accelerated "bipolar view" of Russia's international identity and Eurasian alternative to the unquestioned-at-the-beginning Western one. This marked "the polarization of the debate over Russian foreign policy" after 1993. After December 1995 parliamentary elections where communists, agrarians and extreme nationalists got 50 percent of the votes and where pro-governmental parties such as Nash Dom Rossiya fared badly, it became clear that the turn in foreign policy was wrong indeed, and that was given a chance to get formalized by the replacement of Kozyrev with Primakov on January 5, 1996.<sup>264</sup> The turn in domestic economic reform started to be moderated even earlier, if Gaidar's leaving the political scene in January 1994 was an indication.

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<sup>263</sup> Aron, 33-34.

<sup>264</sup> Blacker, "Russia and the West," 182.

Perhaps the apex of confrontation with the greatest chance for the traditional forces to retake over the control was the process leading to 1996 presidential election, under the rhetoric of the Weimar Republic: loss in a war, social and economic crisis and psychological humiliation.<sup>265</sup> Communist Zyuganov, the person representing traditionalism was far ahead of Yeltsin in opinion polls just a couple of months before the election. And it took millions of dollars of the financial-resource oligarchy if not more, together with the bulk of Russia's media outlets they commanded and the Western PR expertise to have Yeltsin reelected. Though radical reforms certainly created a greater backlash, after all it appeared that the calculations of the reformists were right. The new business elite sensed the danger of the coming of the old days and to save itself saved the new system.<sup>266</sup> But the greatest result of the process and the hard victory was the lesson drawn from past mistakes of radicalism, and eventual cooptation of discontent and moderation.<sup>267</sup> Almost on all cases of backlash traditionalist attitudes, from renationalization of economy to revitalization of military industrial complex<sup>268</sup> to restoration of USSR and conflict in relations with the Western world came to the fore. But each time a kind of middle way was the outcome. Actually the main contours of the middle way was becoming clear from 1994 on.

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<sup>265</sup> Alexander V. Kozhemiakin and Roger E. Kanet, "Russia and its Western Neighbors in the 'Near Abroad'," in *The Foreign Policy of the Russian Federation*, eds. Roger E. Kanet and Alexander V. Kozhemiakin (Great Britain: Macmillan Press Ltd., 1997), 33.

<sup>266</sup> Zudin, "Bizness i Politika," 1-3.

<sup>267</sup> This despite the fact that by the 1996 Presidential elections, it was clear that the military and security forces which has sustained the Yelsin presidency in earlier confrontations had been replaced by the financial and industrial powers of the Russian economy. Wallender, *Economization, Rationalization, and Normalization*, 2.

<sup>268</sup> "Renationalization Looming?," *INTERAVIA*, April 1996.

Table 7 Elite policy preference shifts in Russia: early 1992 compared to 1994.

	Domestic Policy	Foreign Policy
Economic sphere (conservatives, 1992)	Subsidies, price controls, Interventionism, corporatism, Stress on established sectors	Protectionism (possibly CIS-wide, export controls, arms exports to traditional clients
Economic sphere (liberal Reformers, 1992)	Rapid monetary stabilization, marketization and stabilization, and privatization, on liberal model	Cooperation with international financial institutions and aid-givers, low tariffs, world pricing
And later (Pragmatic reformers, 1994)	Steady continuation of economic reform, with safeguards	Continuing cooperation with IFIs, hard bargaining, arms exports
Political Sphere (Conservatives, 1992)	Strong centralized state power	Preservation of military strength, restoration of union or of 'Greater Russia'
Political Sphere (Liberal Reformers, 1992)	Decentralization, federalism, respect for minority and general civil rights, strict constitutionality	Demilitarization, alliance with the West, respect for sovereignty of former Soviet states
And later (Pragmatic reformers, 1994)	Federalism but with strong centre, reliance on executive power	Conditional cooperation with West, assertion of special rights and responsibilities of RF in former Soviet area

Source: Neil Malcolm and Alex Pravda, "Introduction," in *Internal Factors in Russian Foreign Policy*, eds. Neil Malcolm, Alex Pravda, Roy Allison, and Margot Light, (Oxford: Oxford University Press, 1996), 26.

Putin's coming to power was the culmination of this "pragmatic consensus," or of the third way between the two radicalisms. Putin, in a sense, is the very symbol of centrism, the average of radicals on both sides. A conceptual evaluation would be that after ages-long dominance of economic imperatives by political ones (authority>market) the primacy of economic rationale has taken over politics almost absolutely in the last years of Gorbachev and first years of Yeltsin for a while (market>authority), with ensuing foreign policy patterns. Yet starting from the 1993-1994 there started to emerge a certain balance between authority and market (market=>authority) and the change in Russian foreign policy starting from the mentioned dates was a result of this new structural development or to put more properly, of the modification of the "primacy-of-market-at-all-costs." Considering

historical institutionalizations and drastic failures of the reform it is not surprising that the “middle way” actually leans towards authoritarianism.

Financial-resource groups were the greatest “success” of the reform process and perhaps the main reason of its continuation. However, since their prominence was negatively related with the dramatic socio-political decline of the entire nation, as said, they were the ones that drew the greatest lessons on how to manage the discontent as well. In this light, though not immediately clear in terms of economic gains, the more authoritarian rhetoric that they have is about coming to terms with the general mood in Russia.

The attitude and actions vis-à-vis CIS states can be understood in this framework. In this overall consensus one of the easiest issues was that about the former Soviet states. However it has still more. Though there is no overwhelming support to revive the USSR by costly means, Rajan Menon maintains, “near abroad” is perhaps the sole place where we may see the Russian foreign policy not very much directed by cost-benefit calculations, like France in Africa and the US in Central and South America. Perhaps, Near Abroad is the most visible case where different views among Russian foreign policy community converge.<sup>269</sup> “Marketizing democrats whose position in regard to Russia’s role in the wider world was liberal, tolerant and pacific were quite likely to support armed interventionism and other kinds of energetic interference in the affairs of ‘near abroad’ states.”<sup>270</sup> “Views about the domestic political economy is far less clearly associated with orientation to foreign policy issues regarding Russia’s relations with the states on its immediate neighborhood, for both elites and mass publics.” In this case authoritarian tendencies predominate. It matters profoundly in Russia-West relations that those in power were liberal democrats, yet it mattered very little with regard to its periphery.<sup>271</sup>

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<sup>269</sup> Rajan Menon, “After Empire: Russia and the Southern ‘Near Abroad’,” in *The New Russian Foreign Policy*, ed. Michael Mandelbaum (USA: Council on Foreign Relations, 1998), 101, 103.

<sup>270</sup> Malcolm and Pravda, 26.

<sup>271</sup> William Zimmerman, *The Russian People and Foreign Policy: Russian Elite and Mass Perspectives, 1993-2000* (Princeton and Oxford: Princeton University Press 2002), 14, 216.



Table 8 Elite and Mass Orientations to the Political Economy

	Elites			Mass		
	1993	1995	1999	European Russia, 1993	Russia, 1995	Russia, 1999
Liberal (Market) Democrats	74.0% (148)	72.8% (131)	64.8% (136)	27.4% (341)	21.9% (621)	24.9% (459)
Market Authoritarians	5.0% (10)	5.6% (10)	5.7% (12)	7.2% (89)	5.8% (164)	6.1% (113)
Social (Non- market) Democrats	6.0% (12)	7.8% (14)	9.0% (19)	18.2% (226)	16.7% (473)	18.5% (340)
Socialist Authoritarian	4.5% (9)	3.9% (7)	10.0% (21)	14.8% (184)	13.7% (388)	15.3% (282)
Ambivalent	7.5% (15)	9.4% (17)	9.5% (20)	16.7% (207)	27.4% (779)	25.8% (475)
Immobilized	3.0% (6)	0.6% (1)	1.0% (2)	15.8% (196)	14.6% (414)	9.4% (173)
Total	100% (200)	100% (180)	100% (210)	100% (1243)	100% (2839)	100% (1842)

Sources: ROMIR conducted the three elite surveys and the 1993 mass survey of European Russia. The 1995 and 1999 surveys were based on national samples and conducted by Demoscope. Note: Actual number of respondents for particular cells shown in the parentheses. Quoted in William Zimmerman, *The Russian People and Foreign Policy: Russian Elite and Mass Perspectives, 1993-2000* (Princeton and Oxford: Princeton University Press 2002), 52.

As is clear from the table, there has been an increase in the percentage of the authoritarian (non-democratic) and socialist (non-market) attitudes at the expense of the decrease in the portion of liberal democrats in Russia in time. But from the beginning to the end authoritarian consensus regarding FSU states has attained more appeal than can be inferred by looking to the percentage of the authoritarian and socialist tendencies among the elites and mass population alike.

There are number of reasons that can account for this tendency. But for the purposes of this thesis it would suffice to repeat that unless there is a desire for forceful integration which would require a large scale mobilization of resources in the face of stiff opposition from the newly independent nations and the developed world, hegemonic behavior to a certain degree and short of the former method can be sustained without disrupting Russian internal political economy. Regarding the overall foreign policy of Russia, resource-finance groups are interested in blocking such problematic foreign policy ventures that may eventually end up with their disappearance. In that sense, as some states of the FSU can be manipulated by coercive methods *without* disrupting the internal political economic balance they are not prepared to spend political and economic capital to hinder it; nor do other liberals.

Though there are arguments that Russia wants to recover its power in the former Soviet Union space, a more acceptable view would be that “the current elite is more preoccupied with the restoration of a dominant Russian state than with a historic reorientation of Russia.”<sup>272</sup> And this much is acceptable for the liberals in the face of the prevailing general mood. Needless to add, the source of revenue for the sector in question too is beyond the boundaries of the FSU. “Connections with the West are economically important for Russia’s financial community, but the CIS has much less relevance.”<sup>273</sup> In the face of domestic psychological and even economic (since traditional methods can be said to create more return per unit effort in this region than market relations, due to the accumulation of years of cultural and material infrastructure) benefits this much hegemony can be tolerated. And political return gained by the liberals by trading tolerance for traditional forces’ hegemonic moves in the FSU to setting their own agenda on a strategic basis regarding domestic political economy and foreign policy can indeed be attractive. “The greatest incentive is to maintain Russia’s connections with the West,” but also there is “a need to appease

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<sup>272</sup> Brzezinsky, 9, 10.

<sup>273</sup> Stowe, 56.

nationalist sentiment.”<sup>274</sup> Thus resource-finance sector together with the representatives of the general liberal identity in Russia again decides on the cost-benefit calculation, yet this doesn’t necessarily end up with the libertarian attitude for the former states of the Soviet empire. Russian authoritarianism to a certain degree in some of the former Soviet states may well be the price for having a peaceful Russia in general; both liberals and the developed world seem to agree.<sup>275</sup>

Crucial in determining the basic contours of domestic economy and foreign policy resource-finance companies do not determine them always and everywhere. What is more, their existence on those lands on the basis of market relations is not enough in itself to wipe-out other institutions and tendencies. This especially concerns the military and the military industrial complex. When the state apparatus was under relentless pressure military was intact and perhaps the only institution to influence Russian foreign policy towards FSU region effectively. In early 1990s it was not ministry of foreign affairs but that of defense where decisions on foreign policy on the CIS were taken.<sup>276</sup> The strongly held nationalist beliefs of a large proportion of senior officers act as a constraint on the formation of the Russian international security policies, especially in relation to the CIS.” No one dares to alienate them while there is concurrent legitimacy problem.<sup>277</sup> Near abroad issues sometimes were determined predominantly by the military, unlike far abroad.<sup>278</sup> Despite radical declines the military establishment is powerful enough to exert “significant though un-coordinated” influence on the formation of foreign policy, especially in relation to the “near abroad.” The delaying the division of the Black Sea fleet with Ukraine and the withdrawal of troops from the FSU territories, assisting Abkhaz separatists and

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<sup>274</sup> Stowe, 56.

<sup>275</sup> There is a great difference between Baltic and former socialist bloc states in Europe on the one hand and the remaining former Soviet states. That the Western states pay a very special attention to the first region and related NATO and EU expansions mean that Russia treats them increasingly as other European states. The same cannot be said about remaining FSU states.

<sup>276</sup> Irina Kobrinskaia, *Vnutrennie Faktory*, 277.

<sup>277</sup> Allison, 249.

<sup>278</sup> Pravda and Malcolm, 299-300.

“massive transfer of weapons to Armenia” in war with Azerbaijan, probably “without knowledge or consent of political leaders,”<sup>279</sup> are handy examples. Unlike Russia’s global arms policy, with regard to the former Soviet Union arms exports are by no means commercialized. Here the priority principle is Russia’s power or hegemony games. This is illustrated very well by the weapons sales to the warring parties in Caucasus and Central Asia. In this part of the world, which Russia can (and “is allowed” to) control and set the rules of the game, its hegemonic intentions go on “writ small.”

What is more, the MIC has important reasons to seek “closer” relations with the former Soviet states. With the collapse of the USSR, Russia lost not only its best military installations, which logically were stationed along the boundaries<sup>280</sup> but also, and with more serious potential consequences, many valuable military plants as well. During Soviet times air defense S-300 PM systems were co-produced by 103 plants in Russia, Armenia, Belarus and Ukraine. Production of T-72 and MiG-29 involved 700 and 568 plants, respectively, spread across several republics. Nuclear-powered submarines were jointly produced by 2,000 plants, of which only 1,300 are now located in Russia, with more than 550 left in Ukraine, 83 in Belarus, 5 in Kazakhstan, 4 in Armenia, 3 in Moldova, and 2 in Kyrgyzstan.<sup>281</sup> Only nuclear industry was almost entirely based on the Russian territory, and was not seriously affected by the dissolution of the USSR.<sup>282</sup>

One of the most important aspects of cooperation with the CIS has been the reintegration of the defense industries of the former USSR. 1992 Mutual Security Treaty involved almost every aspect of cooperation in defense production. It was not

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<sup>279</sup> The arms sent to Armenia between 1992-1997, worth reportedly \$720 million, were a part of the pressure on Azerbaijan to accommodate Russia. Menon, 133.

<sup>280</sup> Simes, 208.

<sup>281</sup> *Russkii Telegraf*, 3 April 1998.

<sup>282</sup> Pavel Felgenhauer, “The Military Reform Card,” *The Moscow Times*, 22 May 2003. This can be said to be one of the important reasons of Russia’s surprising eagerness to continue to rely on nuclear weapons in the high-tech conventional age, which substitutes for the lack of the weapons it finds difficult to produce.

a coincidence that Russia's 1993 military doctrine specifically emphasized cooperation with the CIS. In April 1998, former states of the Soviet Union (apart from Baltic states, Turkmenistan and Moldova) agreed to upgrade their activities in this regard.<sup>283</sup> Russia sometimes subsidizes defense purchases of some CIS states in this light. The loss of some former Soviet plants means that Russia simply is not able to or finds it very difficult to produce some crucial weapons systems such as nuclear-powered submarines and submarine-launched ballistic missiles. Ukraine's Pivdenmash, for instance, was the former Soviet Union's greatest manufacturer of intercontinental ballistic missiles. Especially without Ukrainian cooperation, Russia cannot complete the manufacture of a sizable share of its military products.<sup>284</sup> Moreover, it is estimated that reestablishing co-production projects may cut current manufacturing costs for major defense products by as much as 30 percent.<sup>285</sup> Blank, tries to explain Putin's moves to reintegrate the CIS and to revitalize military sector within this context.<sup>286</sup>

Current exports and miniscule state orders are not enough to revitalize the defense industry. This means not only the loss of productive capacity but also the growing problems in the introduction of improvements. If research and developments would not continue then in the medium term Russia may lose a great deal of its share in the world weapons market too. Russian arms exports are one-sided, moreover. Aircraft manufacturers accounted for more than half of all arms exports last year, or \$2.5 billion. This results in weapons market's increasingly becoming sat to certain Russian weapons. Unable to introduce improved models Russia may decide to move to other weapons categories. There is an argument that if Russia does not intensify its promotion of aircraft carriers, nuclear submarines, as well as strategic bomber aircraft such as the Tu-22 Backfire, defense exports will plummet in 2005 or 2006,

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<sup>283</sup> "Russia's Weapons Trade: Domestic Competition and Foreign Markets," *Problems of Post-Communism*, no. 2 (March/April 1999): 42.

<sup>284</sup> Yuliya Latynina, "Ministry of Defense Industries Suggests Making Big Money on Technologies," *Segodnya*, 29 August 1996.

<sup>285</sup> "Defense Industry Wants to Unite," *Moskovskiy Novosti*, 7-14 April 1996.

<sup>286</sup> Blank, 2.

when most of the current aircraft contracts will come to an end.<sup>287</sup> Again, to produce some of these weapon systems might require the inclusion of some of the military plans in the FSU territories.

Though this may mean that to resume the production of strategic weapons to realize global ambitions Russia would need many crucial plants in FSU territories, as said, there are hardly such intentions. And in case there are, that would generate a stiff resistance on the part of the liberal sectors and circles in Russia and the wider world. However, in its less extreme form, to rescue its dying-in-an-increasing-rate defense industries and arms exports, Russia or the MIC may increase its activities for re-integration. At first glance it can be argued that at least that part of the cooperation directed towards arms exports may benefit everybody in a kind of business relations. But the fact is that a great deal of arms sales is paid by barter and debt repayment. In 1990s Iran paid only \$1 billion of the \$5 billion worth arms in cash; the remainder disappeared in the form of Soviet era oil-debt.<sup>288</sup> Besides this, bureaucratic pollutions bring about the loss of nearly half of the estimated revenues, as was the case with the \$3.5 billion revenue of 1996, which “boiled down” to about \$2 billion.<sup>289</sup> This, combined with the traditional methods of dealing with a partner embedded in the military institution may not result in any good for the FSU states. Though to expect dramatic moves is not very probable, this may well mean that a freer hand enjoyed by the traditional circles in the FSU will continue to be the case.

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<sup>287</sup> Pronina.

<sup>288</sup> Bukkovol, “Arming the Ayatollahs,” 31.

<sup>289</sup> Khripunov, “Russia’s Weapons Trade,” 40.

## CONCLUSION

By introducing international structure, especially the international market, it is possible to attribute to the resource-finance sector much more in accounting for a relatively peaceful Russian policy than is generally the case in similar studies. The natural resource sector's huge size, international competitiveness and perhaps, private nature create a very strong pressure for it to be integrated with the international market. So much so that, it becomes possible to argue that the re-nationalization of this sector may not change much in the face of the huge opportunity costs of staying away from the international market. These structural features of the Russian natural resource reserves seem to transcend sectional interests, acquiring a nation-level "meaning" and value. It is in this light that the difficulty of manipulating the sector (especially its energy branch) by the state can be understood. Being already embedded in the international market and benefiting or promising to benefit the entire nation (despite disgusting levels of corruption involved), leaving them alone with the market may be in Russia's best interests. Independent action of some related firms, for instance Lukoil's leaving a very important share of its assets in the "strategically important" Azerbaijan and the state's silence is a good example in this regard. The main topic of analysis is how much the sector in question affects Russian foreign policy. And again, within international market framework it becomes clear that though the resource-finance sector would like to have peaceful relations with its economic partners, the issue gets beyond the confines of the narrow "politics of international trade" and preferences of some actors. With the semi-independent pull to adapt to the rules of the international market, this sector reforms its internal structure, tries to create a familiar market environment to act comfortably within Russia and entrenches these in the rule of law.

At least, it is possible to say that the process has already begun. This in turn not only works against the main potential material basis of traditional national and international identity, the military–industrial complex, but also institutionalizes the autonomy of the economic sphere against the political one, blocking the arbitrary and cost-blind mobilization desires. Moreover, more than pursuing its concrete economic interests, it was shown that the resource-finance groups act to hinder the distortion of the balance in the internal political economy, especially preventing the artificial “insertion” of an enemy into the “new model of life.” That is why they are quite vigilant to prevent the securitization of the state’s foreign policy since such a move would militarize domestic economy and would require the overtaking of the private economic sphere by the “poor” political apparatus. It is at this context that resource-finance groups’ importance in terms of general peaceful nature of Russian foreign policy comes to the fore. In addition to this, with their success in the unfamiliar and unfriendly world of the winners, the sector is becoming a symbol of success, which in turn means that peace can only result only in more prosperity. The failed, war-prone, poor and oppressive old system finds it increasingly difficult to challenge thus emerging legitimacy of “the other.” Sure, one must be too naïve to speak about the legitimacy or affection towards resource-finance groups on the part of the average Russian and say, hatred to the military industry today. Just the stark opposite is the case. However, if to go beyond the confines of concrete economic sectors, and enter to the picture the general changes in the value system of the Russians in the given peaceful yet overwhelming international environment, things seem different. Being embedded in different worldviews both internally and externally, resource-finance sector and the military one are the material representatives of different identities. At such a level, as said, the power and legitimacy of the former increases much more. The last point of discussion was the unexpected authoritarian tendencies on the part of the representatives of the resource-finance sector. This was explained by the very radical reform process that brought about the emergence of these few extremely wealthy circles, perceivably at the expense of the socio-economic devastation and humiliation in the foreign policy arena. Considering the numerous attempts of backlash, it appears that resource-finance groups “rationally” chose to come to terms with the general political and public mode to find a consensus between radicalisms.



But regarding the CIS states there has been much more authoritarianism from the very beginning and even more interestingly, this authoritarian attitude was independent of general visions. As mentioned, the resource-finance groups and liberals in general are more interested in setting the strategic course of Russian political economy and its foreign policy. Short of forceful integration, Russian hegemonic intentions towards the region is not likely to distort the prevailing balance, and considering the special interests shown by the traditional forces to the region (which are loosing on the strategic basis) it becomes very rational on the part of the resource-finance groups and the liberally inclined people at that, to see the former Soviet states partly as the object of appeasement.

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