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Russia and the Caspian States in the Global Energy Balance

Russia is among the world's most important oil and natural gas producers and has the potential to enhance its status as a global natural gas supplier given its large proven reserves. The country also controls through geography or geopolitics the major pathways for the export of oil and natural gas from the hydrocarbon rich Caspian countries, which include Kazakhstan, Turkmenistan, and Azerbaijan and, to a lesser extent, Uzbekistan.

Russia's status as a current and future energy producer is close to unrivaled. It holds the eighth-largest proven oil reserves in the world, but ranks a close second in oil production to Saudi Arabia and is far ahead of most other world suppliers like Iran, Kuwait, Venezuela, and Iraq. Russia also holds the largest natural gas reserves in the world, accounting for some 1,680 trillion cubic feet (tcf) of reserves, or more than one-fourth of the world's total natural gas reserves. This is nearly double the amount of reserves of Iran, the country second behind Russia in natural gas reserves. Thus, Russia's position as a major energy supplier has great significance not only for its foreign policy, but also for its relationships with major energy-consuming countries.

Russian oil production averaged 9.98 million barrels a day (bbl/d) in 2007, or 12.2 percent of world output. Russia's number two position is extremely close to leading global oil superpower Saudi Arabia, which averaged 10.4 million bbl/d in 2007, or 12.7 percent of world output. However, one of the striking differences between Saudi Arabia and Russia as an oil power is that Saudi Arabia is a waterborne exporter and Russia is essentially a pipeline exporter of oil and natural gas. Whereas Saudi Arabia has the unrestricted option to redirect its exports among various markets such as the U.S. market, the European market, and the Asian market to achieve security of markets or to achieve geopolitical goals, Russia is constrained by dependence on the European market—and this fact of current geography and investment has restricted Moscow's energy geopolitical reach. This limit to waterborne access historically has led to under-optimized revenues, as well as constraints on Moscow's direct energy market influence.[1]

A key driver to Moscow's foreign relations is its desire to reestablish Russia's international prominence and reassert its traditional sphere of influence. Russian energy has been a major element in this push for renewed international power and status, with energy relations supplanting communist ideology and the Warsaw Pact as a primary pathway to a revitalized global role. Central to the President-turned-Prime Minister Vladimir Putin's vision for Russia has been the philosophy that development of Russia's strategic resources is the key to Russia's economic rebirth and its revival as a global superpower. Russia's energy concerns are a primary aspect of its national security, economic health, and means of engagement on the international stage.

Energy relations have given Russian leaders a platform for international influence and created openings for Russia to assert itself on the international stage. The country's vast resources brought senior Chinese leaders courting Moscow with favorable loans and other offers of cooperation. Russia's pricing "disputes" with Ukraine—which have now twice disrupted natural gas supply flows to Western Europe—have raised strong concerns in Western capitals. Moreover, the Kremlin has engaged in visits with the heads of state of most major oil and natural gas producers, including Iran, Saudi

[1] Morse, E.L. 2009. Closing keynote address presented at the James A. Baker III Institute for Public Policy conference, "Russia and the Caspian States in the Global Energy Balance," Moscow, Russia.

Arabia, Algeria, Libya, Nigeria, Venezuela, Qatar, and the United Arab Emirates. Moscow has also held talks with major natural gas producers about the possibilities of coordination of natural gas sales and marketing, either inside or outside the context of an international natural gas cartel. In addition, Russia's state oil and gas giants Rosneft and Gazprom have been actively seeking exploration, production, and transportation deals around the world. (See working paper, "The History and Politics of Russia's Relations with OPEC.")

I. Russia and OPEC

Moscow now regularly attends the meetings of the Organization of the Petroleum Exporting Countries (OPEC) in an attempt to exert its influence within the prominent international club of oil producers. Russia, which is not an OPEC member, has sought to influence OPEC by means other than becoming a full member. It has attended meetings as an observer and informally tried to influence deliberations. It has also tried to influence OPEC's decision making by promoting bilateral relationships with individual OPEC member states using investment, as well as aid and sales of arms and nuclear technology to develop stronger ties. For Iran, Russia's right to veto on the United Nations (UN) Security Council is an important carrot. Toward the Arab Gulf, pointing to the value of its regional military alliances (notably with Iran) serves as a veiled threat that Moscow could use its military friends to pressure key Arab energy producers such as Saudi Arabia and Qatar. Russia can also offer its ability to resist the United States as a plus to countries that might run amok with Washington. All these factors, combined with the large potential impact of its own energy strategies for its sizable resources, can be tapped to establish why other oil capitals should care what the Kremlin is thinking.

From Russia's point of view, its military and financial aid and oil and natural gas investment may be more intended to build friends inside OPEC—and to incentivize these allies within OPEC to push for policies inside the oil cartel to Moscow's liking—rather than to bring Russia directly into the organization. It is improbable that Russia would ever be granted membership within the organization without Saudi Arabia's tacit approval, and such a move does not appear to be in Riyadh's interests. Russia recently asserted that it has "such a significant position in the high society of world oil, a Russian factor should appear,"[2] putting it in competition with Saudi Arabia, which sees itself as (and arguably is) the primary power in the oil-producing world. Russian Deputy Prime Minister in charge of energy and Rosneft Chairman Igor Sechin, speaking at the opening of the OPEC conference in September 2008, made a point of reminding those present that Russia was on even footing with Saudi Arabia as the world's leading oil producer.

For sure, Saudi Arabia has no interest in ceding its leadership position within OPEC. And Russia is not in a strong position to challenge Saudi Arabia, which has a history of knocking out rivals through an oil-price-war strategy. With oil prices at least $30 per barrel below even the most pessimistic planning scenarios for Russia's initial 2009 budget, Russia's hard currency reserves are being rapidly depleted through an unsuccessful effort to support the ruble and through government monies spent on selected corporate bailouts ordered by the Kremlin. This means that Moscow may be far less resilient than it might have thought to a lasting downturn in oil prices, making a direct challenge within the OPEC context a risky endeavor.

In recent years, Russia has tried wooing Saudi Arabia in different ways, including investments in the kingdom's natural gas sector and offers of military sales. Saudi Foreign Minister Prince Saud Al Faisal acknowledged that the desert kingdom was in talks with Russia over the possible purchase of Russian weapons but, according to a report in the Russian daily *Kommersant*, made it clear during a Moscow trip in February 2008 that any deal was contingent on Russia curtailing military cooperation with Iran. During a subsequent visit by Saudi Prince Bandar Bin Sultan to Moscow in July 2008 in which a Saudi-Russian military cooperation agreement was inked, Bandar reiterated the Saudi demand to Russian President Dmitry Medvedev and Putin. A Russian government spokesman denied *Kommersant*'s claim that the Saudi deal was linked to Iran and said any attempt to tie cooperation with Riyadh to other issues was improper.

[2] Reuters, "Russia Wants to Influence Global Oil Price—Minister," September 25, 2008, http://www.reuters.com/article/rbssEnergyNews/idUSLP47710620080925.

Russia's refusal to cooperate on the Iranian nuclear issue could tip the scales on Saudi Arabia's emerging policies. If Saudi Arabia feels its interests are truly threatened, it has the same arsenal it has used in the past against the Soviet Union and Iran—including support for regional movements, militias or counterinsurgents, and the ultimate trump card of an oil price war. The slump in global oil demand, combined with recent expansions at the kingdom's oil fields, has left Riyadh with a large arsenal of spare production capacity and the ability to flood oil markets at will. Moreover, Riyadh's foreign financial reserves to withstand a prolonged drop in oil prices are substantial at $523 billion, making it one of the largest creditor nations in the world.

Besides the complications a pitch to join OPEC might mean for Saudi-Russian relations and oil geopolitics, it is unclear what Russia would gain from being a full-fledged OPEC member, instead of sitting as an influential observer with superpower status and an agenda to push. Moscow is receiving the benefits from OPEC without membership, giving it less incentive to join. OPEC officials complain privately that Russia wants to influence OPEC without offering up any responsibilities, contributions, or sacrifices that come with actual membership. While OPEC and other non-OPEC producers have done the work of slashing their oil output in the past to restore world prices, Russia, these producers say, reneges on its promises and maintains high output during price crises to benefit financially and gain coveted market share.

Some Russian analysts have suggested that the Kremlin uses its energy diplomacy to ends other than influencing OPEC deliberations. Some suggest that heads-of-states meetings with OPEC members or potential Gas-OPEC members function as a door opener, allowing the Kremlin to enhance its revisionist agenda of appearing to be a great power with multiple client, vassal, or at least allied states. One possible scenario would be if Moscow used such trade meetings (which also bring commercial—and personal—gains for the Kremlin) to become the key arms suppliers to U.S. and European oil and natural gas suppliers, thereby attaining for itself—by means of infiltration and alliance—the ability to threaten the stability or security of Western energy supplies.

Beyond its relations with OPEC, Russia has been seeking to create coordination and alliances among major natural gas producers. Gazprom deputy chief executive Alexander I. Medvedev has suggested that a gas troika of Iran, Qatar, and Russia consider joint "projects that could be implemented by the three countries in gas production and transportation." However, Gazprom, the Russian state natural gas monopoly, has had trouble gaining traction in this globalized mission. Russian economic academic analysis shows that a global natural gas cartel may have little economic viability given the relatively small elasticity of and varied sources for substitute supplies, as well as the array of competing fuels such as oil, coal, nuclear power, and renewable energy. So far, Gazprom has failed to create convincing partnerships that could serve as the basis for cartelization in natural gas. In current markets, Russia and Qatar have been visible supply competitors. Spare receiving capacity at some European terminals has meant that 10 to 15 additional cargoes of liquefied natural gas (LNG) per month could be mobilized to replace as much as 5 to 10 percent of Europe's Russian pipeline imports through Ukraine, as happened during the Russia-Ukraine dispute last January. (See working paper, "The History and Politics of Russia's Relations with OPEC.")

Ironically, an effective collaboration among top natural gas suppliers like Iran, Russia, and Qatar in today's market might provide only limited increases in economic rents, while, at the same time, running the risk of ceding further future market share to Iraq, other nascent players, and rising North American supply.

To investigate a scenario where three of the largest natural gas producers—Russia, Iran and Qatar, the so-called "Gas Troika"—coordinate natural gas export activities, the Baker Institute World Natural Gas Trade Model is used to analyze options for the three producers. Under this scenario analysis, each of the three producers seeks a similar higher return, relative to the reference case, on exported natural gas volumes. This is compared to a reference case scenario, where all existing and possible export routing options are open to development and use based on commercial factors with no geopolitical constraints. The exercise shows that all three members of the coordinating Troika produce less natural gas, but with only minor, short-lived gains in prices. Instead, alternative supplies come into markets from a variety of other sources, including North America, North Africa, Australia, and other Middle Eastern countries such as Iraq. Under this Gas Troika scenario, Russia loses market

share in its pipeline sales both to Europe and in new exports to Asia relative to the reference case. Both Iran and Russia also wind up with lower LNG sales under the Gas Troika scenario, while Qatar's losses of market share are regained over time.

Overall, analysis shows that natural gas supplies sourced from the Middle East and Iraq, in particular, play an important role as an alternative to heavy future global reliance on Russian natural gas. Developments in Iraq to move gas through Turkey could present a serious threat to Russia's market share in Europe. In fact, the Baker Institute analysis reveals that the pace of Iraqi natural gas export capability is the single largest factor affecting Russia's ability to maintain its dominant position in the European market. More generally, the importance of the Middle East cannot be understated, as supplies sourced from that region are the main counterweight to Russia. However, this also indicates that coordinated action by Russia and the Middle East could pose an energy security dilemma for consuming countries as natural gas increases in importance as a primary energy source. (See working paper, "Scenarios for Russian Natural Gas Exports.")

Iran and Russia are natural competitors for access to European gas markets, and, perhaps under different geopolitical circumstances, Iran could serve as a rival transit pathway for Caspian energy exports. But for now, Russia has found that it could enhance its geo-strategic power through collaboration with Iran and vice versa. Moscow is supplying Iran with military equipment and nuclear technology and has been one of the major players blocking UN sanctions against Iran over its nuclear activities. This Russian strategy achieves several goals simultaneously. Iran's nuclear activities, supported by Moscow, prevent trade between Iran and many industrialized energy consuming countries, thereby thwarting Iran from gaining opportunities to compete with Russia in the energy sphere. Iranian natural gas exports to Europe are essentially blocked by U.S. economic sanctions policy in protest of Iran's nuclear program, which is viable due to Russian technical assistance. Hence, Russia gives military and technical aid to Iran, which then ensures that Iran's natural gas will not compete with its own. Moreover, the tensions between the United States and Iran over its nuclear program also give international oil markets the jitters, buttressing oil prices and, thereby, enhancing Russian oil revenues. Finally, Russia's relationship with Iran is also threatening to other important Middle East energy suppliers, such as Qatar, which shares a large border natural gas field with Iran and Saudi Arabia, the latter of which has experienced terrorist attacks and civil unrest fomented with Iranian assistance. Recent Shiite unrest in Saudi Arabia's oil-rich Eastern province and holy city of Medina underscores the inherent risks.

Iran has hinted that its main interest in collaboration with Russia and Qatar on natural gas would be to gain access to Russia's natural gas pipeline network to Europe. Iran's long-term interest in the European market is out of step with Moscow's interests and could eventually provide an opening for the West to offer a diplomatic carrot (increased access to European and Caspian energy markets) with which to tempt Iran into a compromise solution on Tehran's nuclear standoff with the West. (See working paper, "The History and Politics of Russia's Relations with OPEC.")

II. European Natural Gas Scenarios

As discussed above, Russia, as an energy exporter, is overly dependent on pipeline deliveries to Europe. And, Russia's energy diplomacy, while successful in achieving some of the country's short-term objectives, has had the counter-effect of raising alarms in Europe, which is now actively looking to diversify away from its heavy dependence on Russian energy supplies. Russia has damaged for the foreseeable future its previous reputation as a reliable energy supplier and is now viewed as an erratic partner on the global energy stage. Russia's carrot-and-stick "I'm with you but also against you" approach to both its energy customers and its fellow producers may have internal logic within the Russian domestic context as enhancing Russia's external appearance of international power, but it goes counter to the history of the energy markets, which have repeatedly punished energy providers whose rent-seeking behaviors try to bet against market response. The Algerian gas export experience is a case in point. Algeria's state energy firm, Sonatrach, tried to use its leverage on Italian, French, and U.S. markets in the 1970s to force higher prices, only to lose market share and damage its supplier reputation into the 1980s

and beyond. Algeria's pricing disputes with U.S. buyers eventually created a market opening for new producer Trinidad and Tobago. In oil markets and especially in natural gas markets, fuel supply competition and demand destruction will eventually wipe out short-term gains achieved through undue interference in either energy transit corridors or energy markets.

Already in 2009, LNG import capacity into Europe will approach 28 percent of total annual natural gas demand, which is up significantly from 2000 levels. As soon as 2011, LNG import capacity in Europe could amount to almost 40 percent of annual demand, as import capacity could nearly triple from its 2000 levels. The pace at which LNG import capacity is expanding in Europe has been influenced by security of supply concerns. Each time Russian supplies are cut, no matter how briefly, the perception that alternative sources of supply will be needed increases. Europe is not only shifting toward competing LNG suppliers, it is building natural gas storage and pushing for renewable energy sources to replace hydrocarbon fuels. European Union (EU) heads of state also voted in December 2008 to help fund natural gas and power interconnectors as part of an economic stimulus package. But the EU could do a great deal more to integrate the internal electricity market in Europe to enhance supply stability and flexibility through cross-border trading.

Beyond the risks that Russia will use its natural gas exports as a geopolitical lever, there is also the risk that Russia's domestic industry problems and currently restricted access to external capital will prevent Moscow from developing sufficient additional natural gas resources to meet its future contractual commitments. To date, strong growth in domestic demand and exports has required Russia to increase its imports of natural gas from Caspian states. One factor that may alleviate this problem in the short term is the effect that the global economic crisis is having on demand. To the extent that demand in both Europe and Russia is reduced, it delays the onset of any impending natural gas shortage in Russia.

The global recession has probably dampened growth in natural gas demand but it has not changed the fact that more than half of Gazprom's production comes from mature fields in West Siberia that are declining at an average rate of 0.7 tcf per year, according to a recent International Energy Agency report. The credit crisis has made it more difficult for Gazprom to pursue plans to develop new fields and altered the timeline for when they might be needed.

In the meantime, however, Gazprom has been increasingly relying on imports from Caspian states to make ends meet. U.S. and European policy has encouraged bypass routes for Caspian natural gas to go more directly to Europe, and China has aggressively pursued natural gas deals with Turkmenistan and other regional players. This competition for Caspian natural gas has helped the Central Asian states get higher prices for their commodity. But the so-called "Great Game" in natural gas routing has not borne much benefit to Western interests and has, at best, antagonized some of the players involved.

In 2005, Gazprom entered a joint venture to construct the offshore pipeline Nordstream to transport natural gas through the Baltic Sea from Russia to Germany. Gas supply is projected to come from the Yuzhno-Russkoye oil and gas reserve in the Yamal Peninsula, and the Ob-Taz bay and Shtokmanovskoye fields, though a decision to move forward with the latter Shtokmanovskoye development is on hold until early 2010. Gazprom has also announced plans to upgrade production and transmission systems in Eastern Siberia with a goal of exporting to China. Despite these announcements, the pace of development on such projects has been slow, causing analysts to question whether the future of Russian natural gas exports is secure.

To consider the scenarios for the European natural gas market, we use the Baker Institute World Natural Gas Trade Model to analyze options for Russian natural gas. In the reference case scenario, where all existing and possible export routing options are open to development and use based on commercial factors with no geopolitical constraints on any Russian or Caspian routes, projections are that Russia remains the largest single natural gas producer in the world through 2040. Russia is also the largest single supplier of natural gas to the European market, primarily by pipeline, although it does see a slightly diminished market share over time as LNG and other pipeline supplies provide more competition. Interestingly, based on commercial considerations, European consumers eventually support the proposed Nabucco pipeline to carry natural gas from the Caspian states to Europe

via Turkey, as a way of lessening dependence on Russia. This reference scenario implies, however, that Turkey only becomes a significant corridor for natural gas imports to Europe once Iraqi supplies are developed.[3] The Caspian countries export natural gas primarily through Russia. In a world propelled only by commercial forces, exports to Western China via Kazakhstan do not appear economical and therefore do not take place.

In a second alternative scenario, the model is used to examine the impact on Europe if Russian reserves on the Yamal Peninsula and Kara Sea are never developed. The decline in overall Russian production becomes more pronounced over time and eventually reaches more than 6 tcf per year by 2040. Russian production in the southwest and east rises slightly, but the increased production, especially in the southwest, is not sustained. The Caspian countries exhibit a persistent positive supply response, but fall short of fully offsetting declines in Russia.

To make up the supply differences, Middle East producers bring additional supplies of LNG. The most prominent among these are Iran and Qatar, although production also responds positively in the EU and North America. Ultimately, under this scenario, natural gas prices to Europe wind up considerably higher, especially at the German-Austrian border. Prices in Beijing also rise substantially beyond 2030 as higher-priced imported LNG replaces natural gas, which was exported to Western China from West Siberia in the reference case, as it is now diverted to Europe.

Reduced pipeline flows from Russia to Europe in earlier years are offset, to some extent, by increased LNG imports to Europe. LNG imports into Western Europe rise collectively by as much as 0.256 tcf per year, or 700 million cubic feet per day, which is similar to the capacity of an average-size LNG import terminal. Higher demand for LNG cargoes for Europe means added competition for U.S. and Asian LNG buyers, which tends to raise natural gas prices everywhere, not just in Europe. This is likely to increase domestic production in North America while lowering demand, thereby reducing North American LNG imports.

[3] The reference case assumes that political turmoil in Iraq prevents development there until 2015.

In a third scenario, we consider the effects of an abrupt but temporary suspension of roughly one-third of Russian natural gas exports to Europe in the year 2010. The idea is to simulate a four-month cutoff of Russian supplies to Europe that could be prompted by political choices or as the result of a severe physical shortfall.

The immediate impact is large increases in annual European prices (by more than 90 percent at the German-Austrian border and almost 10 percent in the United Kingdom). But while the resulting price spike generates large rents for Russia in the short run, the scenario highlights the longer-term risks for Russia. Europe responds to the short-term disruption by increasing imports from elsewhere. Demand growth also generally slows making the supply shortfall less significant. While the ability to replace supply is limited by available infrastructure in the short term, the cutoff changes the growth and distribution of natural gas demand within Europe for many years to come. Ultimately, the shock triggers investment in alternative sources of supply that render Russian exports to Europe permanently replaced. Therefore, Russia sacrifices future revenue for short-term gain. Big winners from the scenario are U.S. natural gas producers. The supply/price shock of a Russian cutoff in 2010 stimulates increased U.S. natural gas production, which then persists for the next decade. The temporary increase in prices stimulates new investments that have continuing effects. (See working paper, "Scenarios for Russian Natural Gas Exports.")

Under a fourth scenario, where the construction of pipelines from central Asia to Europe that bypass Russia is accelerated, Russia loses substantial market share in Europe between 2013 and 2028. Caspian producers export more natural gas to Europe using the Nabucco pipeline. Since its opportunities to sell pipeline gas are constrained in this scenario, Russia winds up exporting more natural gas by pipeline to Asia and as LNG from Murmansk over the long term.

III. The Georgia War, the Economic Crisis, and Russia's Internal Stability

Russia has also acted decisively to reassert its influence over its "near abroad," culminating in its armed conflict with Georgia in August 2008. Russia's "success" in Georgia, for the foreseeable future, sent the message that Russia is willing to play

hardball and is willing to cut off energy supplies to achieve its objectives. The conflict has helped Moscow consolidate its domination over Caspian oil and natural gas transit routes, though it has also encouraged Europe to focus more attention on alternative supplies. The EU voted in December 2008 to offer $5.4 billion in grants to help fund natural gas and power interconnectors in Europe, including financial aid to the Nabucco pipeline, which would bring Caspian natural gas to Europe via routing that bypasses Russia.

In recent years, Russia has moved assertively to redress its previous worries that it had lost control over its own energy export corridors, a fact of life in the 1990s and into the 2000s that was driving Russia's national insecurity.[4] It has announced the intent to develop new pipeline routes (in particular the Nord Stream and South Stream pipelines) that avoid recalcitrant transit states like Ukraine and give Russia more direct access to European customers. It has also squeezed transit countries through financial and other means. In more than one case, Russia has cut oil or natural gas supplies during commercial transit fee or trade disputes to reassert its interests in Belarus, Ukraine, Lithuania, and Georgia. The events, while having commercial roots, also sent the message that Russia is willing to play hardball to achieve its objectives.

But for all of Russia's success in flexing its muscles using its strong energy position in its "near abroad," problems remain under the surface. Russia is learning the hard way that enjoying the powers of being a petro-state comes with the unpleasant realities of being a petro-state—that is, a nation highly dependent on volatile commodity markets. Not only has Russia's economic future shifted suddenly negative with the vagaries of the global recession and falling energy demand in the West and East, but the political intrigues that come from trying to control state energy rents are breeding the kind of internal instability and corruption that weaken the Kremlin's legitimacy inside Russia. Moreover, the financial crisis has highlighted the inherent instability in the current tandem system of government with a powerful prime minister (Putin) sharing power with the current president (Medvedev).

Russia's slide into serious economic crisis has begun to evolve into a social crisis that has forced the Kremlin to renounce its reforms and concentrate on maintaining the status quo. During Putin's presidency, the Kremlin was able to consolidate the position of the ruling corporation that Putin had put together, while at the same time trying to regain some of the geopolitical status Russia had during the Soviet period. But the current economic downturn will be a serious test for the ruling tandem system that has developed neither conflict-resolution mechanisms, nor the ability to operate in a pluralistic society. Russia's reform slogans have faded into the background, giving way to anti-Western rhetoric aimed at mobilizing public opinion in support of the regime.

Some Western analysts have interpreted the emergence of the ruling tandem as a sign that Russia is starting to move toward a more pluralistic power system. In reality, the asymmetrical leadership that has emerged in Russia has nothing in common with liberal democracy. For the Medvedev-Putin tandem to work as a presidential-prime ministerial regime along the lines of France or Portugal, it would have to be institutionalized. That is to say, the informal deal between two politicians with unequal political resources would have to be transformed into a set of clear rules established by the constitution. This, in turn, would require reforming the super-presidential constitution and creating the foundations for a strong prime minister and party-based government and also establishing the mechanisms for resolving inevitable differences between the prime minister and the president. There is no evidence that anyone in Russia is about to undertake such radical reforms, and there is the impression that the authorities themselves see the current tandem as a temporary phenomenon.

The now diffused nature of the Russian dual actor power system and its unclear decision-making mechanisms are, if not paralyzing the Russian government bureaucracy, then at least rendering it very confused. The "power vertical" built by Yeltsin and Putin does not fit well with a dual political influence at the top. While Medvedev and Putin are making successful efforts to work in coordination, conflict is inherent in an unclear delineation of powers between the president and the prime minister and the spheres of their responsibilities.

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[4] Amy Myers Jaffe and Robert Manning, "Russia, Energy and the West," *Survival* 43, no. 2 (Summer 2001) 133–152.

But the logic of the asymmetrical leadership and inevitable redistribution of power on the lower levels of the political system are creating problems exacerbated by the restlessness of the elites around the Kremlin. Lower-level leaders are making contradictory statements about policy direction, leaving a lack of clarity in Russia's overall strategies. The financial crisis has made this crack in the ice a far greater problem.

When the general Russian economic situation was favorable, the tandem regime was quite successful at sorting out the issues of continuation and stability, but the current economic crisis has brought the regime new trials to face. As the economic situation worsens, the decision-making process needs to speed up, and the ruling tandem system is not set up to meet this kind of rapid response to new challenges. The decision-making process at the top (and, thus, down through all the levels) is slower because the dual-power form of government requires coordination between the prime minister and the president, and also because neither leader has a convincing plan for overcoming the crisis. The situation is becoming more unstable, as strikes and spontaneous protests have begun to break out, with anti-Kremlin slogans gradually emerging alongside economic demands. According to the Russian Interior Ministry, more than 2,500 public and political actions related to the worsening social conditions have been held in Russia since the beginning of 2009, and even some members of the Kremlin's inner circle have started to publicly express their skepticism about the effectiveness of the anti-crisis measures undertaken by the government. Protectionist trade measures are unlikely to prove popular, as the demonstrations in Vladivostok so clearly showed. The Russian government had to bring in troops from outside the region to put down the protests, as local troops were unwilling to attack local civilians in what was a very popular local cause—the import trade of Asian automobiles.[5] (See working paper, "The Medvedev Presidency.")

The Kremlin continues to be concerned about its ability to keep faraway regions linked to the central government. In recent years, the Kremlin has made clear that the central government should control regional development strategies in energy-rich regions, especially where energy transit routes are concerned. Putin and his team have a notion of which regions are key to the overall development of Russia's future, and East Siberia is a region of particular concern in Moscow given its vast natural resource wealth, its declining population, and its proximity to China. The risk of this region falling under Chinese control at some point in the future is a preoccupation of the Russian leadership, and it has affected the autonomy of the region and the oil companies operating there. Regional and local governments are required to coordinate their development strategies with Moscow, as some energy firms learned the hard way.

Putin's political reform, which gave Moscow the power to appoint regional governors, rather than have them be elected locally, is just one of the mechanisms used to solidify central government control over economic development in the energy regions of the Russian Far East. Article 71 of the Russian constitution gives the federal government control over not only federal taxes and levies but over funds for national economic development. Prior to Putin's election, development funds were generally channeled directly from the federal coffers into regional budgets. But, after 2000, Putin added another level of bureaucracy to channel the funds through regional branches of the federal treasury department. This new structure gave the Kremlin considerable power to influence regional development plans, given that most regions did not have substantial monies for development projects beyond federally allocated funding. Putin also created presidential envoys to coordinate the regional activities of federal ministries.

While regional governors and envoys must do the Kremlin's bidding and ensure that the region's economy meets Moscow's expectations, regional elites have been battling to protect some autonomy of decision making in setting regional development plans. This has meant that even the bureaucrats sent to the regions by Moscow have recognized that they must serve multiple constituencies—including business and political interests in the region—if they are going to successfully accomplish mandated duties. Despite the Kremlin's desire to influence oil, natural gas, forestry, and aluminium industries in the Irkutsk, that region's political life exemplifies

[5] Isabel Gorst, "Car Import Curbs have Russians on the Streets," *Financial Times*, December 21, 2008.

political pluralism. The region's politics are heavily influenced by a set of powerful, local corporate and business interests, and these constituencies managed to join forces to have a Putin-appointed governor dismissed at the will of local authorities.

With the central government now having fewer resources to dole out, the regional governments will be more likely to retain a greater level of autonomy, and regional elites are eager to make their own efforts to attract investors. But the days when a governor from the Russian Far East could make a deal with an international company for development of a particular oil field are probably gone for the foreseeable future, as both the Kremlin and the regional governments are focused on long-term local economic sustainability.

Ultimately, regional governments still must concern themselves with attracting federal resources and support for local development plans and infrastructure. But, despite all the efforts to the contrary, Putin's new federal structure has been unable to remove the regional political flavor and political competition of strong local interests in influencing outcomes. The idea that the Russian Far East should have power is so deeply entrenched in many parts of the region, that the center's efforts to squelch autonomy would be hard won, if it could ever be accomplished. Moreover, with the economic crisis looming, federal authorities might just decide it makes political sense to allow regional leaders to reclaim a higher level of local decision making—and, hence, accumulate a greater share of the blame if economic conditions in the regions do not right themselves. (See working paper, "Russia's Regions and Energy Policies in East Siberia.")

Between the challenges of coordinating the bureaucracies of the Russian president and prime minister, and the equally daunting challenges of trying to hold together the regions, Russia's ruling system seems unstable to the outside world—with conflicting public statements and policy directives about a wide variety of topics. This translates into corresponding uncertainties in issue areas where the Kremlin is active on the world stage. If the Kremlin is confused about its agenda with OPEC, for example, then energy markets read that confusion as a wild card to oil market trends, with conflicting signals coming from Moscow creating problems for other players in the energy security arena. Russia is also sending mixed signals about its interest in a gas cartel.

In the case of relations with Europe, the situation is even more complex. Russia wants to defend its right to play by its own rules within the space it deems to be inside its sphere of influence, while at the same time being treated as a friendly, third, equal partner in a tripartite partnership with the United States and EU to rule a new world order. This contradictory formula implies a proposal to the West to return to a balance of power—but under terms in which Russia controls its "near abroad," and the West refrains from its previous aggressive expansion of the North Atlantic Treaty Organization (NATO) to Russia's borders. While the EU backtracked to a more conciliatory line in 2008, and tried to avoid actions that could rub the Kremlin the wrong way, this approach did not prevent worsening relations between Russia and the West. With the Russo-Georgian war, and the subsequent Ukraine natural gas cutoff, Russia and the West ended up in a state of political confrontation anyway. In fighting Georgia, Russia attempted to demonstrate that the United States would have to accept its new rules for engagement. Medvedev put forward Russian foreign policy principles, including Russia's right to take action beyond its borders to "protect the lives and dignity of Russian citizens wherever they may be," and to pay "special attention to specific regions or 'zones' where Russia has 'privileged interests.'" The Georgia invasion was a demonstration of Russia's desire to reestablish the historic buffer zone around its motherland.

IV. The Financial Crisis and Problems in Russia's Oil Sector: Implications for Production

During the second term of his presidency, Putin implemented a wave of consolidations in Russia's oil industry designed to reassert state control over this vital sector and relegate privately owned firms and regional companies to the will of the Kremlin. This was accomplished through government prosecutions of privately held firms for tax evasion, as well as through the orchestration of strategic mergers intended to subordinate privately owned firms to Russia's two state-controlled energy giants, Rosneft and Gazprom. Behind Putin's plans for the energy sector were two stated major goals: the use of a state-directed strategic resource policy to foster economic development, and Russia's emergence as a

21st century-style global power on the foundation of its energy wealth.

But Putin's critics have argued that the Russian leader had additional goals: to consolidate his own personal power and the power and wealth of his inner-ruling circle.[6] Prior to Putin's presidency, Russia's oil oligarchs were gaining in political importance and threatening the power of the Kremlin to control fully Russia's economic and foreign policy.[7]

It is clear that Putin is a strong Russian nationalist and a strong advocate for the rebirth of the Russian land, stretching currently from the Baltic Sea to the Pacific Ocean, and for a renaissance for the Russian people. There is no question that this nationalist ideology and commitment to the greatness of Russia drove him to emphasize state supervision of the development of Russia's strategic resources as the key to Russia's economic rebirth and its revival as a global superpower.

The current economic crisis poses a threat to everything that Putin and his ruling circle has stood for since he came to national prominence in late 1999. It is also hard to know how to evaluate the long-term impact of the Russian government's decision to bail out some of Russia's biggest companies and oligarchs, such as the money loaned to keep Oleg Deripaska of Basic Element (which includes aluminum giant Rusal) to keep shares from Russian corporations from being transferred to Western banks when these companies were at risk of default. Down the road, this might make the state more effective at setting a single national policy for all of Russia's strategic resources. This is the Russian White House's stated goal, rather than to seek a permanent transfer of ownership. For now, at least, it keeps key sectors of the economy in continued operation—a critical issue when medium-sized and large enterprises are offering unpaid furloughs or shutting down entirely because of the economy. While in the long run this could push Russia towards needed reforms, growing social stress may make reforms harder to accomplish.

The economic turmoil created by the global financial crisis has negatively impacted many of Russia's key energy companies, bringing the dual blows of both a squeeze on credit and lower oil and natural gas revenues. Four Russian companies—Gazprom, Rosneft, Lukoil, and TNK-BP—appealed to Medvedev in October 2008 seeking loans to refinance their foreign debts and allow them to continue to expand foreign investments. The call for help from Russia's oil giants signaled an end to their previous strategy of tapping internal revenue and international capital markets to fund expansion and opened the possibility for further consolidations in the Russian oil industry that would put the Kremlin even more firmly in control of the sector. According to Russian investment bank Renaissance Capital, Russian oil and gas stock shares lost over 23 percent between January and August 2008, with some firms losing over 40 percent of their value. State-controlled and politically favored Rosneft suffered the least, with a drop of 11 percent in the value of its shares, whereas, at one point, Gazprom shares had lost as much as roughly 70 percent of their worth.

Russian energy policy and industry consolidation in recent years has centered on building up the assets, size, and strength of the major Russian state energy entities Gazprom and Rosneft, while protecting their potential contribution to the Russian economy, and shoring up their power against foreign competitors. With the Gazprom takeover of major Russian oil firm Sibneft, for example, Russian government-controlled and owned companies became responsible for about one-third of the country's total oil output. Gazprom has also weighed in on foreign oil investment in the Sakhalin Islands, most recently by blocking ExxonMobil Corp. from plans to build a pipeline to export natural gas from its Sakhalin-1 field to China. Russian authorities disallowed the company's budget proposal, saying the natural gas must be sold for Russian domestic use.

The outlook for Russia's large privately held domestic firms such as Lukoil and TNK-BP is also uncertain. The conviction and imprisonment of former Yukos chairman Mikhail Khodorkovsky and his business partner Platon Lebedev, and the subsequent hemorrhaging within the Yukos oil and gas empire, signaled a significant move by Putin to ensure that the state controls the energy sector. It has subsequently dissuaded other Russian oil giants

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[6] For a detailed analysis of this see Boris Nemtsov, Nezavisimyi Ekspertnyi Doklad, "Putin I Gazprom," Moscow 2008.

[7] See the Baker Institute's "The Energy Dimension in Russian Global Strategy" working papers by Martha Olcott, "Vladimir Putin and the Geopolitics of Oil" and Nodari Simonia, "Russian Energy Policy in East Siberia and the Far East," October 2004, available at www.rice.edu/energy.

from confronting the Kremlin head on. At the end of 2007, seeing the handwriting on the wall, even successful Lukoil set up a joint exploration company with Gazprom Neft (the oil arm of Russian gas giant Gazprom), giving the state behemoth a majority 51 percent controlling stake in the new venture. The deal gave Gazprom Neft, which has already taken a 50 percent stake in producer Tomskneft, access to and influence over Lukoil's hefty reserves. There has also been growing speculation that either Gazprom or Rosneft might be interested in buying into TNK-BP, which currently has a large private Russian shareholder, Alfa Access Renova. Other firms rumored to be potential takeover targets are Russneft and Bashneft.

High oil prices gave the Kremlin the prestige and self-assurance to broaden its grip over the energy sector in recent years, and now falling oil prices are offering a similar opportunity should the state decide to force a new round of consolidations. Some smaller Russian independents have been hard hit by low prices and the credit squeeze. Russian independent Sibir Energy appears to be in trouble from growing indebtedness of its key Russian shareholder Shalva Chigirinsky, who is reported to owe $192 billion in real estate loans to the state-owned Sberbank. Again, the problems may lead to a change in ownership structure for the firm, including a possible buy-in for Gazprom Neft. Already, Urals Energy is handing over ownership in its Dulisma field in East Siberia to Sberbank to cover debts to the state bank. In addition, Russneft shareholder Deripaska is also looking at selling his shares in the Russian independent to pay back a $3 billion loan to Sberbank. Russneft's situation is complicated by its purchase of a 50 percent stake in West Siberian producer ZMB from Yukos in 2005—a transaction which Rosneft claims was illegal.

Low oil prices, debt restructuring, and consolidations, as well as ongoing financial market problems, will likely mean that Russian oil production could fall significantly this year, following a less-than-stellar 2008, when Russian crude oil and condensate production fell for the first time in almost a decade. Russian production stood at 9.7 million bbl/d in early 2009. Surgutneftegas, Gazprom Neft, Slavneft, and Bashneft were already seeing production declines in 2008 (between 5 to 7 percent in the case of Surgutneftegas, Gazprom Neft, and Slavneft). TNK-BP saw a 1.2 percent drop in output in 2008 and is expecting a similar size decline in 2009. Now, most of the Russian majors are starting to announce spending cuts, despite the cash flow benefits of a drop in the ruble-U.S. dollar exchange rate, which reduces the costs of spending inside Russia. Gazprom Neft announced in mid-February that it is expecting its production to fall by 4.4 percent in 2009 resulting from spending cuts of about 20 percent. Lukoil is talking about cutting its investment spending by 50 percent to as low as $4 to $6 billion. TNK-BP has also been reported to be making spending cuts of $500 million. Rosneft took out a $15 billion loan from China Development Bank in February. The delay in the launch of Rosneft's giant Vankor field in East Siberia will make it harder for Russia to post average production gains in 2008 and the field now is not expected online until well into 2009. (See working paper, "The Future of the Russian Oil Industry.")

Analysts are projecting that spending cuts will translate into overall production declines. Russian output so far this year is down almost 1 percent from year ago levels. Investment bank UBS is estimating that Russian production might see a decline of 2 percent this year, under an oil price scenario of $60 a barrel. So far, such a price forecast for the year looks optimistic. Some analysts have projected even sharper declines of 5 percent or more, depending on oil price trends.

V. Russia and Its Near Abroad

Russia's perceptions of its direct national interests has never wavered from the position that the "newly independent" post-Soviet states should, and would naturally, fall into the sphere of Russian interest; rather, the Kremlin's means and capacities of implementing that policy have evolved and strengthened over time. However, unlike the South Caucasus, where Russia is a stakeholder in the frozen conflicts that affect each state, Russia's use in Central Asia of its security agenda to pursue energy sector goals has largely been achieved through promises of security assistance. In many cases, the Central Asian states fear each other more than they do Russia, creating openings for Moscow such as the Collective Security Treaty Organization (CSTO), a military alliance headed by Russia and including the states of the Caspian region. CSTO creates institutional guarantees for Russia's exercise of soft power.

While Russia has not departed from a strong desire to monopolize exploitation, ownership, and transport of Caspian oil and natural gas, Moscow has lacked the capital and technology necessary to acquire a commanding position in the ownership of energy resource assets in Central Asia. And, while Russia has been a hard bargainer on the prices it will pay for purchasing Central Asian energy (gaining a discounted rate for many years), over the last year or two, Moscow has been forced to offer more global, market-based purchasing prices. This is partly because of the challenge to Russia's transport monopoly posed by China's new Central Asian pipeline system, which will start in Turkmenistan and cross Uzbekistan and Kazakhstan, before extending to the Chinese border. The U.S. effort to support new pipelines from Baku to Ceyhan, Turkey, and Baku to Tbilisi, Georgia, also played a role in creating competition to Russia's lock on Caspian resources by giving Kazakhstan an alternative to the Caspian Pipeline Consortium (CPC) which transverses Russia and Georgia.

But in the "Great Game" chess match of giving Caspian oil producers an alternative pathway not controlled by Mother Russia, Russia's security standoff with Georgia revealed the vulnerability of these U.S.-sponsored lines. It is far more reasonable to assume that the Russians offered competitive prices to the Kazakhs, Turkmen, and Uzbeks for their natural gas in March 2008 (years after the U.S.-sponsored lines were in place) in response to counter competition from China. Unlike Russia, China has succeeded in gaining line fill guarantees for their new pipeline. If the output from existing fields is insufficient to meet Chinese purchase agreements, China has the right to develop greenfield projects as a joint license holder, or to gain an option of existing output that is being sold to other customers, such as Russia. (See working paper, "Russia, Central Asia, and the Caspian.")

China's success demonstrates that the Georgia invasion has not transformed Russia's power in Central Asia where carrots still have to be offered along with sticks. Some 20 years after the Central Asian states achieved independence, Russian oil companies still own very few equity holdings in Central Asian oil and natural gas deposits. Rather, American companies predominate as the main foreign investors. And China may be seen as a better counterpoint to Russian hegemony, given Beijing's lackadaisical approach to human rights problems (in contrast to U.S. diplomacy).

VI. Implications for United States Policy

The United States and, generally speaking, the global economy, are best served by open, transparent energy trade that is predictable and stable. Sudden, unexpected shifts in energy supply or pricing can create economic dislocations such as the world has seen repeatedly since the 1950s. The lesson of the oil boom and bust cycle is that all players—energy consumers and energy producers—eventually lose out in the long run from extreme energy market instability. Russia is no different, having more than once had volatile movements in oil prices and seen its own economic fortunes laid to ruin.

The problem is that the current pattern of Russian assertion through energy diplomacy, "buffer zone" interference in energy transit corridors, and nontransparent ownership restructurings within its own energy sector will not lend itself to stable or predictable energy supply and pricing trends.

The United States needs to face the reality that Russian policy may be a source of instability in energy markets and fashion policies to reduce the impact of Russian actions on affected markets. Lowering the growth in energy demand in the United States is one very effective manner to do this. Building cooperative coordination in demand management strategies between the United States, EU, China, India, and Japan would be even better. An increase in corporate average fuel economy standards (CAFE) in the United States to 50 miles per gallon could trim 6 to 7 million bbl/d off U.S. oil import requirements by 2025, lessening U.S. exposure to the kind of oil price volatility that Russian policies might generate.

Favorable U.S. tax and environmental rulemaking on domestic exploration for offshore natural gas and ample shale gas resources in the United States are also important to contain Russia's leverage over the increasingly global natural gas trade. The United States could do more to acknowledge the positive impact its natural gas resource development has on the global natural gas balance and promote U.S. natural gas domestic supply by opening currently blocked areas on the U.S. continental shelf for resource development and providing favorable tax conditions to sustain investment in more expensive

onshore shale gas. If the United States had a more exploration-friendly policy for natural gas, it could afford to grant waivers for U.S. resources to enter the export market, providing Europe with an additional, secure source of diversified supply.

In addition, the potential development of local gas shale supplies in countries such as Ukraine and Hungary will contribute to diversification of supplies. Rather than focus on expensive and impractical new pipeline schemes (such as the Nabucco line) that appear to be years away, the United States and Europe need to refocus their attention on market liberalization—not only in Western Europe, but also in Eastern Europe and Central Asia. The introduction of transparent, market-based pricing for the entire Former Soviet Union (FSU) region would make the development of domestic shale resources in Ukraine and other Eastern European countries far more commercially viable. Domestic fuel subsidies all across the FSU have created many of the economic distortions that are hampering energy flows and energy security throughout the FSU and Europe.

Negotiations for such a reform trend could come as part of the EU-Russian energy dialogue, perhaps in the context of greater EU efforts in its own domain to further liberalize its natural gas trade and expand natural gas and electricity interconnections among EU members. The EU should also expand its efforts to build and utilize natural gas storage—perhaps creating a strategic natural gas reserve inside the EU, or even involving the International Energy Agency system, which includes the United States. The U.S. Gulf Coast has ample storage potential, and, with the right U.S. domestic exploration policies, a supply bubble of U.S. domestic natural gas could emerge to allow the United States to fill strategic stockpiles. In addition, Europe could take greater advantage of diversification of fuel for power generation from renewables, hydroelectric, nuclear, and coal by accelerating expanded electricity transmission connections and related market liberalization. This would allow the exportation of electricity among EU members who can generate power without recourse to Russian natural gas.

For its part, Russia needs to consider what kind of partnership arrangements and different rules of reciprocity it will need to become a truly global supplier of energy resources, instead of a constrained, vulnerable supplier to one key market—Europe.[8] With the potential for domestic European shale gas and plentiful gas resources that can be developed in the competitive fringe, including the Middle East, Russia needs to reconsider whether a Gas-OPEC is the practical solution to its single-destination market problem—or whether engaging in a cross investment, truly reciprocal, reformed market that includes Russian and Western companies with open access would better ensure Russia's revenues, market share and long-term interests. The most important long-term interest, to rebuild Russia's economic strength, needs to look beyond the kind of brief, short-lived boom that Russia experienced and ultimately squandered over the last five years.

To counter Russian interference in the energy sectors in its "near abroad," the United States also needs to consider new approaches. Over the past 15 years, the United States has engaged in countless diplomatic initiatives to press for the development of oil and natural gas pipelines that bypass Russian territory. Much U.S. reputational and diplomatic prestige has been expended on this diplomacy. But for all its efforts, the United States has few lasting accomplishments, even for pipelines that were actually built. For sure, the proactive U.S. multiple-pipeline diplomacy antagonized Moscow. As Russia's military invasion of Georgia demonstrated, U.S.-backed infrastructure—including the BTC pipeline from Azerbaijan to Turkey, a parallel natural gas line, the BTE pipeline from Azerbaijan via Georgia to Erzurum, and the CPC pipeline from Kazakhstan—operates only under the conditions of Russian largess. Although there was little direct Russian military interruption of oil and natural gas transport along the BTC and BTE pipelines during the first days of fighting in the 2008 Russo-Georgian war, the operation of Georgia's ports was seriously disrupted, making apparent the risks that either accidental or deliberate damage could take place at Russia's hands.

Thus, for all the United States' good intentions, U.S. pipeline diplomacy has not managed to reduce the dependence of the Central Asian states on Russia to transport their energy. China's long-term purchase agreement for Turkmen gas stands to date as the only truly alternative market to Russian

[8] Morse, "Russia and the Caspian States."

leverage, and it is this agreement that helped the Central Asian states to obtain higher prices from Moscow for their natural gas exports. The lesson the United States should take from the Russo-Georgian conflict is that priority, high-level diplomacy should have been expended not primarily on energy corridors but on conflict resolution in the Caucasus—where the United States and the EU could have made a larger contribution to resolving the territorial and ethnic conflicts before they erupted into a humanitarian and strategic crisis.

U.S. technical assistance in the Caspian countries, rather than locking in mainly on pipeline geopolitics, could also focus on energy efficiency. This would complement a move away from subsidized fuel pricing and the introduction of distributed renewable energy as a means to relieve poverty and create economic opportunities in remote and rural areas. This could be done as part of the International Monetary Fund's financial stabilization packages for the countries of the region—perhaps through the offering of discounted lending for projects that facilitate a transition from subsidized hydrocarbon fuel.

The United States might also find that, in establishing diplomatic talks with Iran on forging a compromise on its nuclear program, Iran may be receptive to initiatives that would open up commercial opportunities for the export of its natural gas to Europe and transmission of Caspian energy. An open dialogue would at least allow the United States to investigate the natural competitive interests between Iran and Russia. It would be in U.S. strategic interests to avoid a strengthening of the two countries' collaborations against U.S. interests. The United States has concrete reasons to resolve the regional conflicts that could come about from an Iranian pursuit of nuclear weapons. Breaking up an Iranian-Russian axis would be useful in accomplishing this.

Moreover, U.S. assistance to Iraq should include technical and other support to get Iraqi natural gas flowing to Turkey and then on to Europe—as a means to help both Western Iraq, which has generally freed itself from insurgency, and to diversify Europe's pipeline options for alternative natural gas supply beyond expensive LNG projects. And if we are concerned about the vulnerability of Eastern European countries, such as Poland and Ukraine, we should be prepared to help finance projects that will help them diversify their natural gas supplies.

U.S. President Barack Obama has assumed the presidency at a low point in U.S.-Russo relations. Early signs indicate that the new administration wants to lower the rhetorical temperature between Moscow and Washington and seek out areas—notably the threat of terrorism—where the interests of the two countries converge. The Obama administration has also proposed a new round of U.S.-Russian strategic arms reduction talks. Such negotiations are long overdue. The nuclear arsenals of the two countries—numbering into the thousands of warheads—far exceed any plausible strategic purpose.

But there is little evidence that the policies of the Obama administration will mark a radical break with those of its predecessor. The administration continues to support expansion of NATO to include Ukraine and Georgia. It is also committed, at least in general terms, to the deployment of missile defense in Eastern Europe. Russia policy under the Bush administration seemed to suffer from a kind of bipolar disorder: Early over-optimism led to later disenchantment. To the extent that the Obama administration enters without either, it will be better able to identify areas of cooperation based on mutual interests—arms control, combating international terrorism, and stabilizing Afghanistan to name a few—while using careful international diplomacy and smart energy policy to contain the fallout from differences.

In considering how to handle NATO expansion to Georgia and Ukraine, the United States should move very carefully. The risks of NATO expansion were highlighted by the Russo-Georgian war of 2008. The crisis underscores that NATO needs to insist that potential new members must, as a prerequisite, first fully control the territories within their international recognized borders, as well as the importance of a stronger U.S. and EU approach to conflict resolution in the FSU. Appropriate assistance to do so might make more sense than extending NATO membership immediately to countries who might be encouraged by NATO backing to plunge into confrontation with Moscow. (See working paper, "Emerging U.S. Policy Toward Russia.") Washington is also moving in the right direction by trying to use its missile defense plans as a bargaining chip in negotiations with Moscow over reducing strategic weapons and ending

military assistance (including sophisticated missile technology) to Iran.

The ongoing global economic and financial crises have introduced a new uncertainty into developments in Russia, world financial markets, and broader geopolitical relationships. We are already witnessing the greatest systemic financial crisis since the Great Depression. While the scale and duration of the global economic turndown are unknown, Moscow, Washington, and other capitals are assuredly facing a situation unimaginable even two years ago. One of the hardest questions of all is to predict what will be the impact of the global economic crisis on Russia itself. There is no question that the loss of income in the oil and gas sectors has threatened the stability of the system created by the current ruling elite in Russia. That is one of the reasons that the Kremlin is not pushing back as regional governments and elites demand more responsibility in the economic direction of their regions. This creates a buffer zone of sorts between the masses and the edifices of power in Moscow.

It is far less certain now whether Russia can sustain itself in the role that Putin and his inner circle has in mind—a state that is able to use oil and natural gas to play a dominating role on the global stage. Russia's current economic turmoil makes it a far weaker adversary to challenge the leadership mantle in the oil market currently held by Saudi Arabia and its Gulf-Arab neighbors. And declining oil and natural gas demand in the West, as a result of economic contraction, will weaken Russia's efforts to make bedfellows by offering to organize resource rent-seeking alliances with fellow, like-minded producers. In a contracting market, energy-producing countries might feel more inclined to try to defend the market share they still possess to stave off even further losses in state revenue from falling prices. So while Russia still wields considerable market power from its sizable share of the European market, it will have to consider how to utilize that influence during a global financial meltdown. The answer might not be the same as it has been for the past several years.

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