

## Russia and the G7 - Politics, Economics, Security and Energy

by

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*I took a speed reading course and read 'War and Peace' in twenty minutes.  
It involves Russia.*

Woody Allen, American movie actor, comedian, & director

This paper, **Russia and the G7 - Politics, Economics, Security and Energy**, concludes my Bachelor of Arts in Philosophy & Economics at the University of Bayreuth. I would like to thank everybody who has assisted me in my studies, especially Prof. Dr. Sebastiano Bavetta (London School of Economics, University of Palermo) who has agreed to be the examiner for this paper and allowed me to elaborate a topic of my own choice. I would also like to thank friends and families for their encouragement during writing this paper.

Right now, five minutes before finishing this paper, I also feel as if I have taken a speed reading course on Russia. Because the topic of the G8 summit and Russian's membership is so broad and complex, I tried to scan as much material as possible and get my inputs from as many books, articles, newspaper clippings, and online sources as were available. This did not make it easier – I am not an historian, nor a political scientist, nor a diplomat. I am also not an econometrist or a statistician. My strength is to see patterns and processes, but linking that in a coherent matter was not easy. If I had to rewrite the whole paper, it would probably look very different – but that would take another eight weeks. Yet, I see my paper only as a starting point for further research on the topic.

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## List of Abbreviations

CEO	Chief Executive Officer
NGO	Non-Governmental Organization
Bcf/y	Billion cubic feet per year
Bcm	Billion cubic meters
Bcm/y	Billion cubic meters per year
CEE	Central and Eastern European Countries
COMECON	Council for Mutual Economic Assistance (in German RGW: Rat für gegenseitige Wirtschaftshilfe) of the countries in Eastern Europe and the Soviet Union
Duma	Russian Parliament
EBRD	European Bank for Reconstruction and Development
EU	European Union
FSF	Financial Stability Forum, created by the G20 and consisting of the head of the G20 central banks
G20	Meeting of the finance ministers and central bank governors of Argentina, Australia, Brazil, Canada, China, the European Union, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States.
G5	Core Group of the G8 consisting of France, Germany, Japan, United Kingdom, United States of America
G7	Group of Seven, Summit of Head of States of Canada, France, Germany, Italy, Japan, United Kingdom, United States of America
G7/G8	Refers to both the G7 and the G8
G8	Group of Eight (G7+Russia)
Gas	Natural Gas (Refers not to Gasoline, the American English term for car fuel)
IMF	International Monetary Fund
LNG	Liquefied Natural Gas
LPG	Liquefied Petroleum Gas (Propane, Butanes)
NATO	North-Atlantic-Treaty Organization
NGL	Natural Gas Liquids (Ethane, Propane, Butane, Pentane)
OECD	Organization for Economic Cooperation and Development
P8	Political Eight – Meeting of the G7 with Russia to discuss political terms
Tcf/y	Trillion cubic feet per year
USD	US-Dollar
WTO	World Trade Organization
WWII	World War II

## A - Introduction

### 1. Motivation

The wish to write a paper that addresses a current problem in world politics was shaped during my studies in Philosophy, Economics, and Sociology in Bayreuth and Leuven. The idea to write a paper on Russia and the G8 framework emerged after attending a simulation of the G8 summit in St. Petersburg in April 2006. My fascination with Russian culture, history, and people fuelled this idea.

#### G7 Analysis

The G7 and Russia are both 'emotional' topics. The G7, an institution where the seven most industrialized countries meet, is often made responsible for all the problems on our planet. Climate change, poverty, violent conflicts – are they caused by the egoistic pursuit of interests of the G7 countries?

Before writing this paper I also felt that because of the G7 countries' economic and political power they ought to do more for the global welfare. I think I now have a more realistic impression about what is possible and what is, at the moment, impossible. With my paper I want to make it easier to understand the motives, constraints, and opportunities of the G7 and thus give realistic recommendations on what the G7 could improve.

#### Russia Analysis

I have the same aim for my analysis of Russia. Among Russians and foreigners I often encountered either strong supporters or strong opponents to Russian politics. Is Russia a superpower that has taken its rightful place among the other seven powers? Or is Russia misplaced because of its lack of democracy, its failing market economy and its often confusing domestic and foreign politics?

Surely the perception of Russia in the West is often very negative: poverty of many and enormous wealth of few, violence in the Chechnya conflict, biased media and judiciary – the Russian political leadership is accused of a long list of failures. The defenders of Russian leadership refer to the achievements and point at the difficult transition process.

I do not want to excuse or defend Russia's weaknesses, but at the same time I want to make it easier to understand the motives, constraints, and opportunities of Russian politics.

#### Energy Analysis

My third motivation emerged during the research for the paper. Explaining Russia's admission to the G8 by a reference to historical, political, institutional, political, economical, or security-related aspects often seemed inconclusive - something was missing. In my opinion the missing link is energy security.

The Western countries are moving out of the oil age and towards the gas age – which creates new interdependencies. The interdependency between Western Europe and Russia is particularly fascinating. The export revenues of natural gas are an important income source for Russia. Western Europe, on the other hand, increasingly relies on safe gas supplies from Russia. However, it seems that gas production in Russia might soon reach its climax together with the climax in world oil production – while demand for both energy sources is rising due to the growth in emerging economies like China and India. Thus, both Western Europe and Russia have presently vital interests in shaping the energy markets of the future – and, I believe that Russia's admission to the G8 allows for both sides to better influence future energy markets. With my paper I want to make it easier to understand the impact of energy on the politics in Western Europe and especially on the politics in Russia.

### 2. The Question: Why did Russia join the G7?

#### Public Claims

In July 2006, Russia will host the summit of the so-called G8-countries. The head of states of Canada, France, Germany, Italy, Japan, United Kingdom, United States of America, and Russia will convene in St. Petersburg to discuss issues of global importance and of relevance to the eight countries. For the first time in the history of the G7/G8 summit Russia hosts the meeting.

Although Russia was closely involved in the summits since 1992 and has participated as an official member in the G7 institutional framework since 1999, the 2006 hosting of the summit confirms Russia's status as a full member of the G8.

When Russia became an official member of the G7 (which henceforth was called G8) in 1999, five main reasons were brought forward:

- First, after Russia's political and economical transformation, Russia belongs to the concert of superpowers represented in the G8.
- Second, Russia's admission enhances the G8's ability for global governance.
- Third, Russia's admission to the club of influential democracies stabilizes the political landscape in Russia and promotes the development of democratic institutions.
- Fourth, Russia's admission supports economic stability and, given the size of Russia's market economy and its trade relations to the West, its integration into the economic decision-making structure is beneficial for the G8.
- Fifth, Russia's involvement enhances the ability of the G8 to address security threats posed by disintegrating states, the proliferation of weapons, and the emergence of global terrorist networks.

#### Superpower?

What is the situation in 2006? As mentioned earlier, the Western public has heavily criticized the Putin administration for various issues: the handling of the military conflict in Chechnya, the treatment of NGOs and minorities, the media control by the Kremlin administration, the apparent biased process against Yukos CEO Mikhail Khodorkovsky, the relations to the Central Asian Countries, the energy dispute between Ukraine and Russia, and the support of the authoritarian Belarus President Lukashenko. While the G7 countries have had their disputes on economic issues among each other, never as much criticism on each other's domestic and foreign policy emerged within the G7 than now emerged within the G8. The criticism seems to isolate Russia from the West and casts doubts on Russia's status as a Western superpower. I will discuss this in detail in Chapter B – the Historical Dimension.

#### Global Governance?

At the same time, increasing criticism concerning the G8's global governing ability has surfaced. Given urgent global social and environmental problems, and given the apparent failure to create a coherent institutional set up for the world economy, it seems that the admission of Russia in 1999 did not enhance the governance ability of the G8. I will discuss this in detail in Chapter C – The Institutional Dimension.

#### Democracy?

Russia's democratic record does not excel. The central power concentrated in the Presidential administration has grown immensely since President Putin became president. Pluralism of public opinion, diverse political parties, and independent media ownership are threatened. Racism and violence against minorities is increasing.

There is no doubt that the political system of Russia is stabilizing. The political conflicts between Duma and Kremlin, characteristic of the Yeltsin administration, have ceased. Yet, this stabilization was achieved at the expense of civil and democratic rights that the West often claims to defend. It seems that G8 admission did not promote democracy in Russia. I will discuss this in detail in Chapter D – The Political Dimension.

#### Market Economy?

Russia is far from being an influential economic player despite steady growth and economic success in the last years. Its trade relations with the West are dominated by raw materials like gas and oil and differ considerably from the trade relations of the G7 countries among each other. Ongoing reforms are incoherent and Russia seems to lack essential institutions for a market economy.

The help given to Russia up until 1999, such as loans through the IMF and rescheduling of debts, casts doubt whether Russia has been or will be an equal partner in the global economy for the G7. Even though Russia became a partner in the Paris Club, the G20, the IMF, and soon the WTO, it is unclear whether Russia's admission to the G8 will in the long run make Russia an economic power (again). I will discuss this in detail in Chapter E – The Economic Dimension.

Global  
Security?

Russia's admission allowed the G8 to further address security issues. Russia contributed to the fight against terrorism led by the G8 and prominently by the USA. It helped to calm down the conflict in the Kosovo. The proliferations of weapons was addressed but not halted. Yet it is questionable whether the G8 admission of Russia was necessary for these developments and if the security strategy of the G7 countries was considerably altered by the admission.

It is also sometimes argued that the G8 admission was a trade-off for the expansion of NATO but for various reasons such a trade-off seems unlikely. Nevertheless, the security dimension is important to understand Russia's admission to the G8. I will discuss this in detail in Chapter F – The Security Dimension.

Benefits and  
costs

The explanations of Russia's admission to the G8 do not seem to be sufficient. But what prompted the G7 to admit Russia to their institutional system? The West surely did not let Russia join for altruistic reason or for being nice to Russian leadership. There's no such thing as a free lunch – costs and benefits have to be assessed.

The costs of adding a member to an existent group are increased bargaining costs and transaction costs (stemming from a more complicated decision-making process). The benefits of an enlargement are the possibility of new coalitions and the reduction of implementation costs. Costs and benefits of an enlargement are often not equally distributed among the members of a coalition. For strong players within a coalition, it is possible to receive more benefits than sharing costs – a pivotal player can even free-ride on the other members in a coalition. Do we have to ask ourselves which country has benefited most from Russia's accession?

I do not think so. Decisions in G7/G8 are made unanimously (which would discourage free-riding) but the host has a strong influence on the agenda of the summits (which encourages free-riding). This mechanism has created a path-dependency: further steps of enlargement can not be made against the will of all G7/G8 countries but only for considerable political costs a step towards integration can be reversed. The question then becomes: in whose interest was it to enter a path dependency faster? Did energy security prompt the Western European countries to enter a path dependency with Russia? I will try to discuss this question in detail in chapter G – The Energy Dimension.

### 3. Approach

Focus on  
Institutions

I particularly focus on the economics of institutions and rational behavior of actors within these institutions. Institutions are (political, economical, administrative, and cultural) functions which consist of decision-rules as well as decision-agendas (so institutions determine what *can* be decided and how something is decided). Together with the preferences of rational actors they determine what *is* decided.<sup>1</sup>

In the context of this paper I assume that the people working in an institution make decisions based on a pure, *rational* cost-benefit approach and that they want maximize their own future utility in the most efficient way.<sup>1</sup>

To simplify the analysis, I also assume that the institutions themselves are rational actors working within the constraints of a larger set of institutions. For instance nation-states are rational actors within the larger set of the international institutions.

When I focus on the economics of institutions, I try to discuss reality and not utopia. In particular, I want to discuss what *real* constraints, costs, and benefits shaped the decisions leading to the current situation of the G8 and Russia. I want to base my criticisms not on how others or I would have liked the decisions to have been made.

When I focus on the costs and benefits of decisions, I want to take into account what decisions were *possible* and *feasible*. However the question of possibility or feasibility is, in the end, always a subjective criterion – so I can base my own judgment only on the common sense

<sup>1</sup> On the importance for the research of institutions for economic analysis see Ericson (2002), p. 4; Cuddy (2000).

shared in the scientific literature.

Rationality

A rational actor in an institution should make his decision based on the costs and benefits of his options. If he has complete knowledge about the pay-off-vector of his options, then he should ignore the history leading to a decision since costs and benefits of previous decisions are already distributed. Especially, he should ignore his own previous decisions even if past decisions contradict with present decisions. And he should assess the benefits and costs of options compared to other possible options and not compared to impossible options.

However, in an environment of uncertainty due to limited knowledge, extrapolating from the past can help to judge better the pay-off-vector of a decision. Signaling a consistent policy (or some sort of political 'vision' in which present and past decisions do not contradict each other) can reduce the costs of implementing decisions. The costs and benefits of options are often directly related to the approval by the public – if an option is more approved by the public because of short-term benefits despite higher long-term costs, then to be in favor of this option is easier. These three 'irrational' aspects are particularly relevant (but not only) for Russia: personal visions of decision-makers, appeal to history, and appeal to non-possible options are serious constraints in the decision-making setting.

Firstly, it matters whether the decision-maker can portray his decision as a necessary outcome of some sort of political vision. Putin's vision of bringing Russia back into the league of great powers is a good example. Claiming such a vision for his politics, Putin secured support from the Russian parliament and population. It seems that people often prefer less uncertainty about future political developments – even though the public claim towards certain goals (and thus the self-binding to certain decision-paths) might exclude other more beneficial options.

Secondly, decision-makers can gain support by appealing to historical decisions or past outcomes of decisions. Putin, for instance, has appealed to the former superpower status of the Soviet Union to underline his geo-strategic decisions. It seems that past distributions of costs and benefits evoke some kind of notion of distributional justice that can help to justify claims on current distributions of costs and benefits – even though an appeal to past distributions of costs and benefits might also exclude beneficial options.

Thirdly, the costs and benefits of options are often weighed against the costs and benefits of impossible options. This is not necessarily done so by the decision-makers themselves but by the public's approval or disapproval concerning certain decisions – because the public has limited knowledge on what is possible and what is not possible. This particularly can be found with regard to the G8 decisions – they are often being criticized for bringing about exactly the kind of problems that they want to solve. The criticism does not rest on the question whether the solutions *without* the G8 are better compared to the solutions *with* the G8, but how the G8 *ought* to have decided in an ideal world without constraints. For decision-makers the comparison between 'ought' and 'is' determines how much the 'is' receives support, therefore the evaluation of impossible options can constrain possible options.

The  
'Russia  
Company'

In general, such constraints are incorporated into the decision-making calculus of the decision-makers. However, such 'irrationalities' might lead to sub-optimal decisions; for instance, allocation of property rights which prohibit competition and reduce over-all economic efficiency. Such sub-optimal decisions are a constant threat to the individuals making the decisions – since those groups in society that have to bear the costs of sub-optimal outcomes will surely protest against such decisions. To insure themselves against such threats, political decision-makers have to enter some kind of corporate coalition with decision-makers in the other public spheres, such as private businesses, media, military, or NGOs. In Russia, the most stable coalition consists of political decision-makers in the presidential administration and economic decision-makers in the industrial sectors exporting raw materials. They form what I would call the 'Russia Company' – an institution aimed at securing the status of these two groups of actors. Therefore, in my analysis I will try to highlight how the 'Russia Company' developed in Russia and interacted with the G7.<sup>ii</sup>

## B - The Historical Dimension

### Was Russia admitted to the G7 because Russia belongs to the concert of Western superpowers?

#### 1. Superpower

##### Definition

During my research for this paper, I asked friends and colleagues about their opinion on Russia's admission to the G7. They often referred to Russia's nuclear weapons and Russia's seat (including the veto right) on the Security Council of the United Nations. Additionally, President Yeltsin explains Russia's influence in the world as a reason for the G7 membership:

*"It is obvious that a country is not admitted to the G8 because of political goodwill. Russia belongs to the most influential countries in the world. It can offer unique possibilities: immense natural resources, advanced technologies, a huge domestic market, qualified workers, and a dynamic society."<sup>2</sup>*

He claims that Russia's seat in the G7 was deserved by Russia's superpower status.<sup>3</sup>

What is a super-power? What is meant by saying that the USA is the only super-power on earth? What is meant by saying that China, India, Brazil and Russia are emerging super-powers? What is meant by saying that the G8 functions as a forum for the concerted diplomacy of the super-powers?

It is difficult to define a super-power by reference to its abilities. Is it the countries' military, economic ability, or political ability? A definition like *'A super-power can do what it likes!'* is not very satisfying since even the United States have to take into account political and economic constraints of other countries when implementing their policies – they can not do what they want most of the time.

Another definition *'A super-power can change global and local institutions at its will!'* is equally unsatisfying because even the United States of America can not change global and local institutions at will. In fact, most global institutions can not be shaped by one country alone. International treaties like the WTO treaty are very 'conservative' institutions – they can only be changed if all members (sovereign nation-states) agree.<sup>iii</sup>

I suggest instead the following definition: *'A super-power is a country that utilizes the political, social, economic, and cultural institutions of other countries in accordance with its interest.'* A super-power meets no factual resistance when trying to utilize institutions of other countries.

##### Western Power

What then is a *Western* super-power? Surely, the term Western power refers to the antagonism between the Soviet Union and the United States. The consensus of Western powers (democratic market economies, political pluralism, and private property rights) was contrasted with the political consensus in the East (command economies run by institutions of central power, collective ownership). Did Russia become a *Western* super-power after the disintegration of the Soviet Union and the introduction of the Western consensus?

In a historical perspective, Russia has been a Western super-power for the last five hundred years. Already, the Muscovites dukes claimed to inherit the cultural and political institutions from the Byzantine Empire (hence the title of the Russian Ruler being Tsar after the Roman title Cesar) and thus preserving the heritage of the Eastern Roman Empire.

The establishment of the Russian Empire through Tsar Peter I and Catherine II made it possible to utilize European institutions for Russia's own interest during most of modernity. Even though Russia is often seen as peripheral actor from Europe, Russia has always mingled in European affairs. Several times in European history the Russian empire could ensure that the political and economic institutions in Europe were shaped in accordance to Russia's interest: most prominently after the Vienna Congress in 1815 and after the end of WWI in 1918. Russia could claim

<sup>2</sup> See Yeltsin (2000), p.135

<sup>3</sup> For a discussion of Russia as a superpower see Goldgeier (1992), Adomeit (1995), Blank (2002), Rumer (2003).

to be part of the European concert of power.<sup>4</sup>

These are some good arguments for seeing Russia as a Western super-power. Nevertheless in the following two sections I want to discuss how history, geography and attitudes made Russia unique in the concert of Western superpowers.

#### 2. Russia's Geography

##### Territory and Transport

Covering eleven time-zones and an area of 17 million square kilometers Russia has been the largest country in the world stretching over 11.5 percent of solid territory on Earth for more than two centuries. The distance from West to the East (about 9000 kilometers) and from the North to South (4000 kilometers) and the natural resources (raw materials, minerals) on Russia's territory are without doubt assets for the country. They allowed providing raw materials, goods, and commodities to neighboring economic areas and Russia profited from the added value generated by exploitation of raw material, industrial manufacturing, and trading of goods.<sup>5</sup>

However, not sheer existence but accessibility determine the demand for a country's products. In the case of Russia, the size of the territory has been often more an obstacle than an asset. Extreme climates in the North and South made exploitation of resources, production, and transportation of goods often very difficult. For a long time rivers could only be used for North-South-Trade (in the European part of Russia) and South-North-Trade (in the Asian part of Russia) – and not for the East-West trade which would have provided the added value. Most lakes and seas which made up Russia's borders were inaccessible for trade, only the Southern seas, the Baltic Sea and the eastern Seas could be used for erecting ports and fleets. The distance and inaccessibility of resources made transport costs very high. To overcome hurdles for trade required an enormous input of capital and labor. Only with the advent of train transportation and aviation, transport costs could be reduced. Often these projects could only be carried out by a strong central power that could mobilize the necessary input.<sup>6</sup>

##### Climate and Production

Russia is situated in various climate zones with a huge variety of flora and fauna, from arctic ice-fields to sub-tropic climate in the south. Yet, almost half of the territory is situated in the permafrost regions in the north making the average temperature in Russia -5.5° C. Most of the territory consists of steppe and prairie, the fertile soil can be found in a relatively small area (Black Soil Area) in the central part of the European Russia. Therefore, the climatic and biological diversity did not increase the country's wealth but forced most of the economic activity to the European Part of Russia.

The climate made agricultural production a difficult and laborious undertaking. The work of Russian peasants in the summer months was hard while in the winter months the climate took its toll and forced economic inactivity. Serfdom – peasants bound to the soil of their dukes – prevailed until the middle of the 19<sup>th</sup> century and was often the only possibility to cultivate the soil. The mixture of hectic production and forced inactivity has shaped social institutions: to mobilize the social capital often required coercion on part of the central government.

##### Population and Ethnicity

Most of the population of 145 million lives now in the European part. Compared to Western Europe, the population density is still low for most of the territory. 70 percent of the population is concentrated in the urban areas and especially the metropolitan areas of Moscow and St. Petersburg.

There are more than 160 different ethnic groups and indigenous peoples. 80 percent of the population is Russian. Like other multi-ethnic nations, this cultural diversity added sometimes to

<sup>4</sup> On Russia as an European Empire see Braithwaite (2000). On East-West-Antagonism see Körber (2001)

<sup>5</sup> The information from this chapter is taken from Hohmann (1998), Donaldson (1998), Hopf (1999), Hohmann (2001), Rumer (2003), Goldman (2003).

<sup>6</sup> Examples of enormous mobilization of social capital were the establishment of the Black Sea Fleet in the 18<sup>th</sup> century or the building of the Trans-Siberian-Railway in the 19<sup>th</sup> century.

the costs of ruling the country and gave rise to ethnic tensions and secessionist motives – some of them still very relevant today.

The size of the Russian population has decreased during the last decades following the demographic trend of most major industrial countries. Together with the immigration from Eastern and Central Asia and the emigration of Russians towards the West and the growing metropolises the demographic pressure is increasing in Russian society.

In the past, such demographic pressures were often overcome by resorting to coercion from the central power, like forced re-settlement. While the demographic problems of today are of course very different from the demographic problems of the Tsars, demographic problems and ethnic diversity have always caused challenges to the central power – which was often answered by reinforcing the grip of the central power on the regions.

#### Territory and Security

Russia borders thirteen countries on two continents. Throughout its history, Russia perceived either economic or security threats on its borders – which led to border disputes or the desire to expand political control in order to settle border conflicts. The costs for maintaining armed forces in the various parts of Russia, often under extreme conditions, were a major burden on the public budget and could also only be overcome by a strong central power.

In summary, the geography increased both the transactions and implementation costs of political and economical decisions. Often, only the central power had the possibility to bear such costs.

### 3. The Central Power in Russia's History

#### Challenge of Geography

The Russian territory challenged political control: how to reduce the implementation costs of governing? Geography, climate, and ethnic diversity prohibited the development of a decentralized state with an intricate network of balanced powers like in Western Europe. Often only the strengthening of the central power reduced implementation costs.<sup>7</sup>

The reason can be found in the foundation of the 'Rus', the earliest Russian state that evolved in Kiev in the 10<sup>th</sup> century. Even though the Kiev Rus was on a beneficial economic path and evolved slowly as a regional power, internal dissent led to a weak state that became the prey of a Tartar invasion in 1240. However, the Grand Dukes of Moscow refused to continue paying tribute to the Tartars, established a strong rule within their boundaries and eventually reached independence from the Tartars in the 14<sup>th</sup> and 15<sup>th</sup> century.

#### Expansionism

Here I want to draw a comparison with the idea of the 'Russia Company' mentioned earlier. The involvement from the Muscovite State to the modern Russia is in this respect similar to how modern companies evolve. The *vertical* integration of (political) power reduced implementation costs of decisions. This allowed spending resources on the *horizontal* integration of political power through expanding the territory. Economies of scale strengthened the central power and, at the same time, increase the governing costs which made it necessary to further strengthen the central power.<sup>8</sup>

The strategy of horizontal and vertical integration was used by all rulers of the Russian kingdom (and after Peter I the Russian empire). The clashes on the Western border with the Polish-Lithuanian and Swedish rulers were the result of such a strategy, but by the 18<sup>th</sup> century the Western frontier was stabilized. The southern and eastern frontier remained less fixed – using the Kazaks as a moving buffer towards the rulers of central Asia, the tsars continuously expanded the Russian empire eastwards and southwards. Both voluntary and forced settlements provided the ground for establishing the rule of the state in the newly acquired territories which

<sup>7</sup> The following chapter is inspired by Buss (1989), Nutter (1992), Donaldson (1998), Mandelbaum (1998), Hopf (1999), Splidsboel-Hansen (2002). On the importance of central power see Nitschke (2004)

<sup>8</sup> Sergei Medvedev in Hopf (1999), pp. 16n uses the terms Culture One and Culture Two to describe these two characteristics of Russian Foreign Policy. Culture one refers to the Horizontal Integration, Culture Two to the Vertical Integration of Power and distinguishes these two trends by referring to a number of historical examples.

was firmly in place by the end of the 19<sup>th</sup> century both in Central Asia and Siberia.<sup>9</sup>

There is a striking difference between the eastward expansion of Russia on the Asian continent and the westward expansion of French, British and later American colonialists on the American continent. The latter one depended heavily on the private initiative from settlers. For the American settlers the new territories promised real economic gains and political independence. The Russian expansion eastwards heavily depended on the initiative of the state because fewer economic advantages were to be gained and political independence was no perspective.

#### Dominance of Central Power

Because the vertical and horizontal integration of power was so effective, no counterweight to the Tsars powers emerged. Unlike in Western Europe, the Russian aristocracy had no claim to the land given by the Tsars and could be replaced at the will of the tsars. Only if the aristocrats remained loyal to the central power could they maintain control over their land – so opposition to the Tsars was not a beneficial strategy for the Russian aristocracy.

The Russian merchants (unlike the merchants in Western Europe) also did not develop as a counterweight to the Tsars because their property could be seized at any time. Their only way of protecting their acquired property was to become state employees themselves – again opposition to the Tsars was not a beneficial strategy for Russian merchants.

The Russian peasants had no incentives to resist the rule of aristocrats because they also had no specific property: first, they belonged to a certain village and could not leave the land – unlike in Western Europe the Russian cities did not provide freedom for the peasants. Secondly, within a village they had no assigned property and access to soil was rotated among the village peasants every couple of years – which forfeited them the right to build up any wealth of their own. Thus, structures among the peasant to oppose Tsars or aristocracy did not develop.<sup>10</sup>

The Russian Orthodox Church did not counterbalance the Russian Tsars either. The church's position within Russian society depended on the protection from the Tsar. The Tsar was portrayed as the leader legitimized by God and as an inheritor of the Byzantine spiritual and political legacy. Therefore, opposition to the Tsar was not a beneficial strategy for the Russian clergy.<sup>11</sup>

In Western Europe the merchants organized themselves in guilds which eventually formed the economic and cultural basis of the industrial society. The aristocracy organized themselves to provide the financial basis for the evolving capitalism. The Protestant Church gave rise to the ideas of enlightenment and capitalist ethics. Innovations freed working force from agricultural labor and enabled the cities, through craftwork and trade, to create wealth. Entrepreneurship, emerging capital markets, and civil rights combined with the vast potential of the working force gave rise to modern capitalism. Modern capitalism, while indubitably creating social problems, helped to overcome economic scarcities and organized economic society more effectively.

Russia only had the central power to overcome scarcities. The Russian Tsars organized the industrial development, established trade, built the army and the fleet, exploited the natural resources, and, in short, organized all aspects of society. Since there was no counterbalance to the central power, the central power could only rely on itself to overcome scarcities in the Russian economy.

Of course there have been gradual reforms to introduce elements of decentralization: the abolition of serfdom in 19<sup>th</sup> century and liberal freedoms introduced at the beginning of the 20<sup>th</sup> century helped create some power-balance within Russian society. Yet, these institutions were initiated and maintained by the central power and were not a development of opposing forces within the society. Even the revolutions in 1905 and 1917 did not discontinue the general trend for resorting to state control for overcoming scarcities. Instead, they reinforced the social and political structure of the Russian Empire within the Soviet Union (even though other groups of

<sup>9</sup> For a discussion of Russian expansionism between the 11<sup>th</sup> and the 19<sup>th</sup> century see Braithwaite (2000)

<sup>10</sup> There is an interesting recollection of a German salesman who went to the Siberian peasants in the 19<sup>th</sup> century. Due to the distance to the Central Power, the Siberian peasants had much more economic and civil freedom than their counterparts in the European part of Russia. The German salesman describes how this led to a prosperous and independent peasant class which showed all signs of the medieval rising citizenry. See Goehrk (2005)

<sup>11</sup> Murray (2001), pp. 72n

people were in power). And to some extent, these Tsarist structures are still visible in modern Russian society.

**Focus on Leaders**

In Russia, the dominance of the central power led to a personal cult around the leader that could not be found in Western Europe. The Russian clergy, as mentioned before, supported this strategy because they too relied on the central power for their own advantages. Therefore, the decisions of the Tsar had an almost god-like character: he could not fail to make the right decisions. The personal cult around the leader continued in the Soviet Union and in modern Russia (and even President Putin enjoys a similar cult around his person) and clearly is at contrast to the decreasing personal cult in Western countries.

The resistance of the Tsars to adopt ideas of enlightenment can also be traced to the maintenance of central power. While European monarchs in the 19<sup>th</sup> century eventually embraced the ideas of enlightenment, because it provided the fertile ground for technological revolutions, the Tsars strongly rejected these ideas for fear of weakening the central power.<sup>12</sup>

**Foreign Policy**

The desire to intervene into the domestic affairs of countries in the immediate neighborhood of Russia can be explained through the dominance of central power as well. Stemming from the schism of the Christian Church in the 11<sup>th</sup> century, Russia believed it had inherited the East-Roman Empire and subsequently got involved whenever Orthodox-Christians were involved in political conflicts. The same explanation was used during communist times for the intervention on behalf of communists in political conflicts in foreign countries. Today, the Russian government intervenes on behalf of the Russian minorities in the vicinity of Russia, such as in the Baltic States and in Central Asia. In Russia, Isolationism and Protectionism took the reverse form of what was meant by these terms in the West: Russia isolated itself from outside influence but kept an aggressive foreign policy for protecting its interest in countries within their sphere of influence.

## 4. Attitudes and Public Opinion

**Private Economic Activity**

The strong central power, unbalanced by any other power, shaped the social institutions. Administration, business, church, and judiciary were linked to the central power. The revolution of 1917 only replaced one autocracy with the next one and the Soviet Communist Party became the new central power. Agricultural and industrial facilities became state property and trade was organized through the central administration. Institutions that formerly supported the Tsars, like the Orthodox Church, were considerably weakened or even dissolved. Censorship in all aspects of public life (media, theatre, literature, science) strengthened the Communist Party.

The strengthening of the central power was successful in mobilizing social capital for the rapid industrialization of the Soviet Union. However, the Soviet Union inherited its strong reliance on central power from the political structure under the Tsars. This reliance on central power shaped the attitude towards public and private institutions and is still effective today.<sup>13</sup>

Living in the Soviet Union created a paradoxical attitude towards economic activity and the rule of law: On the one hand, all economic activity was organized by the state; therefore any private entrepreneurship was suspicious. Already during the Tsarist period, private entrepreneurship was seen as a disgraceful activity for the political elite. Private profit was made within the administration working for the central power. The idea that private entrepreneurship generates social welfare never anchored in Russian society. Such distrust towards the desire for private profit carried over into the Soviet state. Private economic activity (which in the West is often regarded as necessary, legitimate, and even desirable activity) was often seen as exploitation of the workers class.

<sup>12</sup> The same resistance to outside influence can also be seen in the attempt of the Russian president to cut back the influence of NGOs and the criticism towards the involvement of international institutions in Russia. Carothers (2006)

<sup>13</sup> For an interesting account of Russian-Orthodox Business Ethics see Buss (1989). The classic description of attitudes of the Soviet human is of course Mehnert (1959). For a description of attitudes towards Russian democracy and market economy see Höhmann (2001), p. 201n, Ledeneva (2001), Mendelson (2006a, b)

The same negative attitude prevailed towards the financial markets. Already in the 18<sup>th</sup> and 19<sup>th</sup> century little paper currency was in circulation and the financial market was virtually non-existent. Financial transactions were organized by groups outside of the social hierarchy (such as the group of 'Old believers' ('Altgläubige') – a sect of the Orthodox Church that separated in the 17<sup>th</sup> century). In Soviet times private capital markets also did not exist so attitudes towards those financial intermediaries did not improve. Today, Russian attitudes towards Bankers and Stock Market Brokers (which are necessary intermediaries of the private capital market) are still negative. Bankers are often seen as corrupt and greedy pursuers of private wealth.

**Law**

The negative attitude towards inequality as a result of successful private economic activity is one side of the coin. The other side of the coin is private economic activity outside of the legal framework to satisfy demands unfulfilled by the official markets. Already during Soviet times black markets existed and many state industries made use of so-called arbitrators which organized scarce resources and often ensured that the economic plans could be fulfilled.<sup>14</sup>

Since private entrepreneurship existed outside of the realm of legal economic activity, the adherence to law lost its moral status. During Soviet times already there existed an attitude of 'The Law is for those up there but not for us'. However, such an attitude towards law greatly increases implementation costs of legal procedures, positioned economic activity in a context of great uncertainty, and increased incentives for corruption (both in public and private institutions). Economic activity increasingly relied on informal institutions and personal networks. However, this only enforced the idea that any position (be it inside the government or inside private business) should be used also for the private accumulation of wealth. This only continued an economic attitude already developed during the Tsarist era: since the Russian soil was the property of the Tsar, no attitude for general welfare developed.

## 5. Is Russia a Western Superpower?

Social institutions are important for the effectiveness of a society. The Russian geography made a central power absolutely necessary for overcoming scarcities and mobilizing social capital. In the history of Russia no counterbalance towards the central government developed. Attitudes towards law and private economic activity created obstacles to private entrepreneurship.

Of course some of these phenomena can also be found to various degrees in the Western countries. In Russia these phenomena are particular strong and they prohibit that Russia continuously utilizes the social institutions of other countries – since they pose considerable barriers between the institutional setting of Russia and the institutional setting of the West. Because of these differences I would be hesitant to call Russia a Western superpower.

However, these institutions had another effect: during the Tsarist and the Communist era up until today all strategic resources (such as oil and gas) were exploited through the central power or by economic actors close to the central administration. The private wealth accumulated in those activities caused complaints but never violent protests - because everybody knew that it was a necessary condition for overcoming scarcities. This institutional setting created the 'Russia Company' – a close conglomerate between state and state-centered industry.

<sup>14</sup> For an interesting account of Soviet attitudes since the 1930ies see Mehnert (1958). Mandelbaum (1991), p. 16 refers for instance to fast-food restaurants opened in cooperation with Western chains in the end of the Gorbachev era. While consumers loved to eat there, the owners of such restaurants were publicly condemned by the political elite.

## C - The institutional dimension

Russia was admitted to the G7  
to enhance the G8's global governance ability.

### 1. Legitimacy

From the last chapter it became clear that Russia is not a classical Western superpower – too many differences due to different historical and cultural experiences exist. However some scholars have argued that from the point of view of the G7, Russia's admission helped the G8 to become more diverse and, thus, more representative. Being more representative increases their legitimacy and an increased legitimacy helps the G8 implementing their decisions because they meet less resistance from actors outside the G8.

To answer the question whether Russia's admission increased the G8's legitimacy, it is necessary to analyze the decisions made by the G8. The experience of thirty-one G8 summits has shown that the most important role of the G8, besides deliberating policies among head of states, has been the initiation of policies within other international institutions such as IMF, World Bank, and WTO. Critics sometimes question the legitimacy of these policy inputs and accuse the G8 that these institutions only fulfill the interests of the G8. There is no doubt that the G8 has a considerable influence in these international institutions. The G8 countries together have a major share of the votes in the IMF and World Bank. But Russia's admission did not greatly enhance the voting weight in those institutions – therefore, regardless whether the criticism is valid, Russia's admission certainly did not increase the power to initiate policies within these institutions.

A second criticism concerning the G8 refers to the content of the decision. The G8 countries are sometimes accused of a policy summarized under the (simplifying) term Neo-Liberalism. Especially G8's emphasis on market solutions, private property rights, and the reduction of the role of the state is criticized.

Yet, one could rebut such criticism by arguing that the G8 in fact wants to strengthen the influence of the state (or more specifically national governments) on world economy. According to some scholars, the G8 can be understood as the ongoing attempt to steer the global transformations of political, economic, and social institutions. Interventions in the global market through regulation and international law can be explained by the desire to avoid market failures and disruptive evolutions of the markets (such as currency crises).

This attempt is often referred to as global governance. In this chapter, I want to discuss whether Russia enhanced the G7's global governance ability. At first glance one could say that Russia's geographic expansion, its history, its seat on the UN Security Council and other influential international institutions, its nuclear weapons, and its natural resources would qualify Russia as contributor to global governance. However, we must ask ourselves if this is sufficient to be a contributor to global governance.

### 2. G7 and Global Transformations

The term 'transformation' refers to changes of political, economic and social institutions. The term 'global' indicates that these changes can either be found in more than one region, are caused by global processes or can only be controlled using international institutions.<sup>v 15</sup>

Global transformations are not a phenomenon of modernity only – nor are the answers of the governments (cooperation and coordination of policies) inventions of modernity. At least since the advent of nation states after the Peace Treaty of Westphalia, the political leaders systematically coordinated their political instruments with each other. The Concert of Powers in the 19<sup>th</sup> century and the League of Nations before WWII are indicators of such coordination. However, political coordination was mixed with violent confrontations between the superpowers – the famous quote of war, as the continuation of diplomacy with other means, indicates the attitude of the nation-states to their political options.

<sup>15</sup> For a discussion of global governance in relation to the G8 see Hajnal (2000), Kirton (2001b), Gstohl (2003), pp. 9n, Kirton (2004); Gstohl (2004)

### Reasons for Global Institutions

Already during WWII it became clear that the increasing interdependence of the industrialized nations made global cooperation and coordination the *only* feasible method of steering global transformations – global military confrontation became too costly. Yet the most industrialized countries could not face this challenge by themselves only – the independence of former colonies and the involvement of international law made it necessary to involve other countries as well. However, the need to involve other countries did not limit the ability of the industrialized countries to create global institutions in which they were the dominant actors.

Soon after WWII, political (United Nations), economic institutions (OECD, World Bank), financial institutions (IMF, Bretton-Woods-System of fixed currency exchange rates), and military institutions (NATO) were created by the Western superpowers. The Soviet Union also established equivalent institutions with the countries in Eastern Europe.

The Western post-war global institutions relied on the United States of America: both in economic and political terms. NATO ensured US presence in Western Europe, the Bretton-Woods-System linked the industrialized economies to the US economy, and the GATT-System allowed the emergence of global trade patterns shaped by US trade.

### Challenges to US- Hegemony

At the beginning of the 1970ies this system showed first signs of malfunction. The economic development of Western Europe and Japan were not reflected in global institutions led by the US only. Trade relations, the currency regime, and the capital market had to be adjusted to the new emerging global situation. Direct meetings between the head of states of the most industrialized countries posed a solution to the waning US hegemony. The G7 summits were created in 1975 as an institutional framework for the economic coordination.<sup>16</sup>

### 3. The Institutional Framework within G7

What made the G7 an institution? No formal decision-making rules laid down in an international treaty created the G7, no central administration, and no G7 headquarter existed.<sup>17</sup> However, the term 'institution' used in economics refers to a set of (in this case informally agreed) rules. These rules can be understood as a function from the behavior of actors to the outcomes for each actor - such as promises for rewarding confirmative behavior ('If you do X, you get Y') and threats for discouraging defection ('If you don't do X, we punish you with Y'). Together, with the actors' preferences and their available resources, these sets of rules produce an output for members of the institution as well as non-members. To understand the special quality of the G7 institution, the actors and the decision-rules have to be analyzed.<sup>18</sup>

### Actors

Who were the actors of the G7? Primarily the head of states from Canada, France, Germany, Italy, Japan, United Kingdom, and the United States are the actors within the G7. Heads of other states and international institutions regularly visit the summits. The personal encounter allowed the participants to develop trust in each other, get to know each other's domestic constraints and thus reduce coordination costs – the deliberative function of the G7 summits.<sup>19</sup>

The summits were prepared by so-called "Sherpas". These close advisors to the head of states met throughout the year for preparation and follow-up of the meeting and had the task to give the head of states room for negotiation and ensure continuity of politics. However, since 1975

<sup>16</sup> Kirton (1999a) discusses the weaknesses of the American hegemony.

<sup>17</sup> Hodges (1999b), p. 69 says that each institution has a cafeteria.

<sup>18</sup> For this chapter my sources are Hajnal (1999); Bayne (2000), Bayne (2001), Freytag (2001), Bundesbank (2003)

<sup>19</sup> Canada was present since 1976, the President of the European Commission since 1977, if the presidency of the European Union fell outside the G7, the country holding the presidency was also present (Belgium in 1982 and 1987, Netherlands in 1986, 1991, 1997), in 1989, 1993 and 1996 leaders from developing countries were invited to parts of the summit, in 1996 the heads of IMF, IBRD, WTO and UN were invited. Kirton (1999b), p. 47. The importance of the personal character of the meetings can be best understood by the following quote from British Prime-Minister Callaghan: "The numbers attending are small and compact. Discussions are businesslike and to the point. We do not make speeches at one another. We talk frankly but also as briefly as we can, and a lot of ground is covered." Putnam (1987) p. 44

the summit was never just an informal gathering of influential politicians. A large number of accompanying administrations developed in the form of ministerial meetings. Starting with the meetings of financial and foreign ministers, by the end of the 1990ies almost all ministers met regularly in the G7 framework. A large number of task force and ad-hoc groups were created to work on specific policy fields and support the ministerial groups.

**Decisions and Output**

Agreement by consensus was the only form of decision-making. If a consensus cannot be reached then either a decision was not taken or the wording of the agreement remained ambivalent. The G7 framework had no formal way of ensuring implementation of the decisions; it could neither punish nor reward the follow-up on decisions. But on an informal level, the G7 member states pressured each other to comply with agreed decisions.<sup>20</sup>

As early as 1977 conflicts emerged about the path of the G7: the most visible being the one between those leaders who wanted to strengthen the institutionalization of the summit and those who wanted to keep the informal approach. During the 1990ies and up until now a dual strategy persisted: the meetings of the head of states are tending towards more informality, the system of ministerial meetings towards more formalization.

The final declarations as well as the statements on specific topics were the most visible outputs. They included commitments by each G7 member to address certain problems. Do they portray the achievements of the G7 summit well? Probably not –often non-material goods were provided to the G7 members, such as a better understanding and better policy coordination because membership was restricted and unanimity ensured that each member had the same impact on the outcomes of the summit.

#### 4. G7 as a Center of Global Governance

The G7 summits in the 1970ies and in the 1980ies mostly dealt with economic and financial issues but they did not act as a center for global governance. The economic coordination in the late 1970ies and throughout most of the 1980ies was very efficient – together, the G7 created a new trade regime, stabilized the financial markets, and responded to economic crises caused by the increase of the oil price.

The G7 summits allowed the industrialized countries to strengthen their influence on international institutions by coordinating their own policies. By spending time on bargaining with the members of G7 they could save time bargaining with the other countries in the international institutions.

**Reasons for a Center of Global Governance**

How did the G7 become a center of global governance? Firstly, no other center of global governance existed. Although the G7 tried to reform the international institutions, they never attempted to systematically structure the global institutions. The United Nations, NATO, IMF, and World Bank often had overlapping competencies but diverging interests. Since these institutions were not part of one coherent institutional framework, they were not accountable to each other or to a higher authority: they were technically only accountable to the member states. Yet, no single country and (surprisingly) not the G7 were able to implement a coherent framework of accountability.

Secondly, the policy coordination had spill-over effects on actors outside of the G8 framework. The decisions of the G7 summits had an increasing impact on other non-members which held the G7 accountable for these impacts.<sup>21</sup> Not only countries outside of the G7 but also NGOs, corporations, and media attributed responsibility to the G7. Because the G7 seemed to be *responsible* for the state of world affairs as well as being *able* to bring about changes, the G7 became for both critics and supporters the center of global governance.<sup>21</sup>

In the eyes of supporters and opponents, the G7 would have the task to:

<sup>20</sup> See for instance the explanations of Russian G8 Sherpa Sidorov in Körber (2001), p. 27

<sup>21</sup> For a list of critics and supporters see Kirton (1999b), p. 45, Gstohl (2003), p. 332, Bayne (2005)

- Find and implement solutions for global emergencies, be it natural catastrophes, economic crises, or political conflicts (*reactive function*).
- Provide global public goods, such as a stable global ecosystem, a stable global political regime, and a stable global economic system (*provisionary function*).
- Address unequal distribution of wealth, combat poverty and diseases, and stimulate global growth and innovation (*dynamical function*).

**Assessment**

As said before, the G7 coordination in the 1980ies was quite effective in fulfilling the functions in the field of economics and finance. This success gave the leaders the possibility to focus more on other political issues. The increasing agenda, the additional participants, and the wide range of topics stressed this trend. By the end of the 1980ies the G7, in many ways, tried to act like a center of global governance: it tried to react to global emergencies, it tried to provide global goods, and it tried to give impulses to global development.

Of course compared to what one would have wished for, it can be questioned whether the G7 was successful because many global problems (like environmental degradation, poverty) remain unsolved until today. Critics have argued that the G7 summits were even responsible for these global problems and it has failed to establish a world order in which the seven most industrial countries could not shape the world according to their wishes.

Regardless of the validity of such criticism, it is clear that an institution requiring unanimity will only abolish itself if it can be replaced by an arrangement that improves the status-quo for all members. Since the G7/G8 created and continues to create benefits of improved coordination for the members it will continue to exist.

Secondly, one has to compare the G7/G8 to other methods of policy-coordination available within the constraints of international economics and politics. They are constrained by national sovereignty: no world-government is available and global agreements have to be supported and implemented by the nation-states. Policy-makers in nation-states respond to domestic pressure of interest groups and only economic and political pressure of other countries and international institutions can yield the policy results that are globally desired.

The G7/G8 countries are sometimes accused of using economic and political pressure to ensure their own interest. Such a view presupposes an antagonism between policy makers receiving political pressure and the G7/G8 countries exercising political pressure. Such an antagonism maybe existed in the Eastern hemisphere where there were real diverging economic interests between the Soviet Union and its satellite states. However, the amount of coercion used by the Soviet Union in the Eastern hemisphere was never implemented by the G7/G8 states.

The foreign pressure of the G7/G8 (even on its own member-states) allowed domestic policy-makers to reject domestic pressure and bind themselves to international commitment. Such a voluntary commitment was the main advantage of the policy coordination in the West compared to the East. The half-voluntary, half-forced coordination was more efficient than the coordination in the East and indirectly caused the disintegration of the Eastern block.

Thirdly, the economic development of other countries such as China, Brazil, or India was a direct result of the economic coordination of the G7. The development of global financial and commodities markets was supported by the world-wide accessibility of information, communication, and transportation technology - which only was possible through the economic coordination within the G7/G8.

However, on other issues (environmental issues, combat against trafficking of drugs, international crime, and money laundering) it became clear that the G7 could not solve these problems without involving countries like Russia, China, Brazil, and India. In addition, the international institutions, while in the 1980ies successful in implementing the decisions made by the G7, faced important challenges as well: the IMF had to be restructured as the service centre for financial architecture, the WTO faced the difficult negotiation of agriculture, intellectual property and services, the World Bank had to implement standards of good governance for their development work, NATO had to develop a new global security design after the disintegration of the Soviet Union, and the UN needed to reform its central bodies to incorporate the new powers.

So, to remain a center of global governance, the G7 needed to reform itself. One method of reform was the involvement of Russia.<sup>22</sup>

## 5. Russia's Involvement in the G7 Framework

### Political Background

Russia's admission to the G7 framework has to be understood against the background of political and economic changes in the early 1990ies. The most prominent political change was the disintegration of the Soviet Union, which led to a collapse of the Warsaw pact and the end of the Cold War. The so-called East-West divide ceased to be political and became an economic divide. Because of large economic problems and urgent help needed for transition, it was in the best interest of the Soviet leadership in 1990 to contact the G7 countries and seek economic and political assistance.<sup>23</sup>

While the first official contact between the G7 framework and Russia took place in the final months of the Soviet Union, the economic and political relations to the Soviet Union were on the agenda of the G7 summit already in the 1980ies (mainly related to energy trade and security issues). The Soviet leaders several times tried to intervene in the discussions on the G7 level: Brezhnev wrote to French President Giscard before Venice I to divide the leader's opinion over the Afghanistan invasion in 1979, Gorbachev wrote to British Prime-Minister Thatcher before Tokyo II to signal that negotiations on arms control could be taken a step further. However, meetings between the G7 leaders and Soviet leaders only took place on the bilateral level, not unilaterally in the framework of an international institution.

After the end of the Cold War, attempts were made to allow such a unilateral meeting. Atali, the Sherpa of the French president Mitterrand, wanted to encourage Gorbachev to seek a place at the G7 summit in Paris 1989 but the other G7 countries, led by the USA, rejected Atali's proposal. At the G7 summit in Houston in 1990, however, the Germans and French helped the Soviet Union to a prominent place on the agenda by discussing financial and economic help to Gorbachev in assistance for his reforms. Still, the Americans remained skeptic of the will of Gorbachev to prolong political and economic reform and the G7 leaders could only agree on asking international institutions to initiate scientific studies on the Soviet economy and how to help the transition.

Clearly unsatisfied by the G7 response and under increasing domestic pressure, in 1991 Gorbachev wrote a letter to the French president Mitterrand stating that he wants the Soviet Union to join the other G7 countries at their meeting in London. A participation in the summit as a whole was not possible, but bilateral talks between Gorbachev and the G7 summit leaders were held directly before the summit started.

### Systematic Partnership

In 1992, the Soviet Union had disintegrated, Gorbachev had stepped down as Soviet president, and Boris Yeltsin became the Russian president. Luckily for the Russians, Germany would host the next G7 summit. The G7 had been always very skeptical to admit new members since the format of the summit only worked within a small circle of leaders. Yet, the host of a summit could always influence the role of new members because once inside the G7 framework, countries could only be uninvited at considerable political costs. At Rambouillet in 1975, the French invited the Italian government because they held the presidency of the European Community and Italy could not be uninvited henceforth. In Puerto Rico in 1976, the US invited Canada because of their North-American partnership and, from that time, Canada could not be uninvited

<sup>22</sup> See Kirton (1999a), p.7, Watanabe (1999), p. 96, Cohen (2001) for challenges to the G8's global governance ability. One of the theories relating to the institutional dimension of Russian admission to the G8 is the question of China's admission to the G8. While the topic of China's involvement in the international community is too broad to be discussed here, I want to mention that some authors have put forward the idea that Russia's admission marked only the first step towards integrating China- for instance Kirton (2001). For economic relations between China and Russia see Wischnick (2000)

<sup>23</sup> For the involvement of Russia or the Soviet Union in the G8 process see Putnam (1987); Höhmann (1994), pp. 7n., Mandelbaum (1996), p. 57; Kirton (1999), pp. 3n; Daniels (1999), p. 107; Kirton (2002), Talbott (2002), p. 232-234; Bayne (2005), pp. 3, 27-54, 185. Some authors have labeled Russia's strategy to be involved in the G8 as Salami-Tactics: because British-Prime Minister Major had invited Gorbachev in 1991, not to invite Russia in 1992 would have been a severe setback to post-Cold War reconciliation. Bayne (2000)

from the summit. The Japanese backed Australia's invitation to the G7 summit but the first G7 summit in Japan took place in 1979 and by then the format of seven leaders was already well in place (after Rambouillet, Puerto Rico, London I and Bonn I).

The German government knew that the extent of Russia's participation would determine Russia's relationship with the G7 for a long time – it could also never be uninvited easily. Nevertheless, Russia's participation seemed essential. The solution was to have Yeltsin take part in a separate meeting with the G7 leaders but stay outside the G7 framework during financial and economic discussions. Russia was at first only invited for discussions on political and security issues related to Russia's role in the region. However, from that point in time, Russia took part in all G7 summits as a regular visitor for political discussions with the G7, which was then called the P8 (Political 8).

In Munich, financial help for Russia was agreed: in total 24 billion USD linked to the observance of the IMF conditions – but due to Russia's failure to fulfill these conditions, not much of the help materialized.

After the change of US-leadership in 1992, Russia became more systematically involved. This is attributed to the personal relationship between Clinton and Yeltsin. Paradoxically, the agenda of the summit moved away from Eastern-Europe and Central Asia. Therefore, at the following summits (Tokio III in 1993, Naples in 1994, Halifax in 1995 and Lyon in 1996) Russia could not contribute much, even though these summits addressed important global topics such as the reform of international institutions (at Naples in 1994) or development (at Lyon in 1996). The only significant contribution was Yeltsin's 1995 proposal in Halifax to host a conference on Nuclear Safety in 1996. The reason for this lack of contribution was clearly due to the domestic and economic problems the Russian leadership faced.

### Membership

In 1997, at the summit in Denver, the host US-President Bill Clinton invited Yeltsin to fully participate during the whole time of the summit (which was then called the Summit of Eight) – which meant that Russia participated in all economic and political debates of the leaders. Yet, Russia remained outside of the G7 framework for most of the ministerial meetings and especially those of the finance and foreign ministers.

In 1998, at Birmingham, Russia became an official member of the G8. But still, Russia did not join the important ministerial meetings such as the meetings of the finance ministers. The host, British Prime Minister Blair, tried to involve Russia on issues such as crime, employment, and the millennium bug. However, since Russia was heading toward a severe currency and debt crisis it could not contribute much. On the contrary, at the next summit in 1999 in Cologne, Russia asked for considerable financial support to overcome this crisis. The G7 leaders were first reluctant but then linked the help to Russia to the most important foreign policy issue at the G7 meeting: the ethnic conflicts in Kosovo. Russia had considerable political influence there and was needed to ensure some stability in the region. The G7 answered Russia's security commitment by encouraging the IMF and World Bank to provide more financing and even relief of foreign debt inherited from the Soviet Union.

Consequently, the Okinawa summit in 2000 saw the emergence of a revitalizing Russian economy, stronger political stability and the first appearance of Vladimir Putin as Russia's president. Putin explained his economic reforms and asked for support but debt relief at that time was out of question since the Russian economy was steadily recovering. In the literature, we again find the claim that Putin's pragmatic approach to foreign and economic policy, and his strong coalition with German chancellor Schroeder, strengthened his position at the G8 summit. For instance, the political pressure on Russia to ratify the Kyoto protocol could be delayed until Genoa in 2001. Russia agreed to the ratification in 2001 but did not ratify the protocol until October 2004 – which shows that Russia had enough political strength to protect their own industries for a long time from the effects of the Kyoto Protocol.<sup>24</sup>

At the summit in Kanaskakis in 2002 the G8 agreed that Russia would host the summit in 2006

<sup>24</sup> The Kyoto Protocol did not become effective until Russia had ratified it. Was it a good decision to delay the ratification of the Kyoto protocol? I have heard of various examples which show that the modernization of the Russian industry (which would cut down on CO2-Emissions) could have been helped by trading emission rights to the Western countries. For instance Danish companies have modernized power stations in Russia in trade for emission rights – with both countries profiting from the deal.

and became more involved in the ministerial meetings of the finance and economic ministers. Foreign policy issues such as the war in Iraq heavily dominated the summits in Evian in 2003, Sea Island in 2004, and Gleneagles in 2005. Again, in the literature we can find references to Putin's attempt to arbitrate between Schroeder and Chirac on one side and Bush and Blair on the other. By then Russia was already accepted as a full partner at the G8 summit.

The agenda of the St. Petersburg Summit in July 2006 will mostly focus on energy and education. However, already a whole range of political and economical aspects are turning up and it will be interesting to see how Putin handles his job as host.

## 6. Russia and G8 Governance

It is puzzling how Russia emerged as an accepted partner within the G8 even if it could contribute so little so far. The economic, political, and security dimension will be treated in later chapters; here I want to discuss whether Russia contributed to global governance.

The strength of the G8 is to improve policy coordination because domestic constraints are recognized and coordination costs are reduced. Has the G8 caused a reduction of coordination costs? Returning to the original question of legitimacy one could argue that Russia has helped reduce coordination costs because its status in the world has made it easier to implement some of the decisions taken by the G8, especially related to security issues.

One of the great strengths of the G8 framework is the emergence of ministerial meetings and working groups that develop strategies to implement devised solutions. Such strategies are initiating global standards, assigning funds to tackle a specific problem, or initiate decision-making processes within other institutions. Often these initiatives were made possible by allowing cross-issue deals linking unrelated but disputed issues to each other and thus achieving gains for all sides. In fact, Russia's contribution to this process is to allow more cross-issue deals and therefore it has contributed to G8 Governance.<sup>25</sup>

Yet, reflecting on my arguments in the previous chapter, one can see that the G7 countries, despite great varieties in their political system, have a common approach that Russia does not share: they rely mostly on non-governmental actors (such as markets, civil society) for overcoming scarcities. In Russia, scarcities are overcome through state-intervention. For the coordination costs this seems to be a problem: in fact a strong central government in Russia reduces the coordination costs for the G8 as a whole because non-governmental actors cannot influence the bargaining process.

However, the differences between the G7 and Russia increase the implementation costs of decisions. The global impact of the G8 depends on the acceptance of their initiatives within the wider global community. The failing domestic support of global trade – despite its success – and the emerging protectionism are witness of what happens if non-governmental actors are not considerably involved in the decision-making process. The influence of actors outside of the G7 governments can be meaningfully channeled through the ministerial administrative process. Mass demonstrations in Genoa, Seattle, Prague, or Gleneagle maybe have changed the perspective of leaders but manifest changes of policies can only be achieved in the negotiations within the ministerial process. Non-governmental actors can alter these negotiations by encouraging leaders and ministers to leave their special national perspective.<sup>26</sup>

Yet if one country – Russia – does not allow the influence of non-governmental actors within this process, or even discourages such an involvement, the legitimacy is threatened. Thus, the emergence of global governance beyond what is happening today seems to be unlikely.

<sup>25</sup> See Bayne (1999), p. 21, Bayne (2005), p. 219 for a discussion of Russia's contribution to the G8 summit. See Gstöhl (2003), pp. 329n for a discussion of the internal functions of the G7/G8 summits.

<sup>26</sup> On G8 legitimacy see Gstöhl (2003), pp. 123n and 333n

## D - The Political Dimension

### Russia was admitted to G7 to promote democracy and political stability in Russia

#### 1. Political Institutions in Russia

In the previous chapter I have already indicated that the profound differences between Russia and the G7 did not help to enhance the G8's global governance ability. Maybe one should discuss Russia's admission from another perspective: did the admission to the G7 enhance the governance ability of Russia? In the following chapter I want to discuss some characteristics of the political institutions in Russia and how the G7 assisted the development and stabilization of these institutions.<sup>27</sup>

The political constitution of the Soviet Union was centered on the Communist Party and the Supreme Soviet; therefore, it guaranteed a strong central Soviet power. However, in the middle of the 1980ies the economic and political crises could not be solved by further strengthening the central power. Gorbachev responded by introducing *some* economic liberties (perestroika) and increasing civil liberties (glasnost).

While weakening the central power these instruments against the expectations of the Soviet leadership did not solve the economic problems. Instead, it re-established the central power of the Soviet republics which slowly gained independence from the Soviet leadership.

In fact, the constitutional crisis of 1991, the coup d'état against Gorbachev, the defeat of the insurgents by Russian President Yeltsin, the independence movements in the Soviet Republics, and even the struggle to establish the CIS (Commonwealth of Independent States) in the early 1990ies can be understood as a conflict between the central power of the former Soviet Union and its republics. The dispute was finally settled in favor of the Soviet republics, which could gain political independence from the Soviet central power. However, within the Soviet republics, the dispute between central power and opposition was often not decided in favor of the central power.

This was particularly true in Russia. President Yeltsin and the group of young reformers of Prime-Minister Gaidar quickly started to create the economic institutions necessary for a market transition. However, the constitutional set-up of the new Russian federation tilted the political balance towards Parliament and Supreme Soviet. A majority of members in both houses were in opposition to market transition. The dismissal of Gaidar in December 1992 and his replacement by Chernomyrdin, a politician with one leg in the Soviet era and one leg in the reform movement, indicated how weak the Russian President had been despite popular support. In September 1993, the conflict came to its peak with the occupation of the Parliament building by Yeltsin's political enemies and their defeat with the (reluctant) help of the military.

The new constitution proposed by President Yeltsin, approved by the referendum in December 1993 and with minor changes still valid in 2006, resembles much the constitutions of Western democratic systems. In the constitution Russia is a federal republic with (at the moment) 88 subjects on sub-federal level. Regular elections are held on local, regional, and national levels and the most important political positions (including the President) are limited to two terms. The freedom to form associations and political parties is guaranteed.

On the federal level, the people in anonymous and equal elections directly elect the president and the representatives in the first chamber of Parliament, the Duma. The second element of the bicameral system of legislation is the Federation Council in which all federal subjects are represented. Both the Duma and Federation Council control the government which is nominated by the president but has to be approved of by the Parliament. The state budget and all legislation have to be approved by the parliament as well.

Civil rights, like freedom of speech, freedom from discrimination, and private property rights are also provided for by the constitution. The constitution also guarantees social privileges like free education, housing, medical care, and protection against unemployment. An independent judiciary system to control and enforce these rights was created by the constitution. The military

<sup>27</sup> Some arguments on reasons for the West to assist Russia in its democratic transition are given in Mandelbaum (1991), pp. 25n., Cox (1994), pp. 644n, Höhmann (1998), p. 11

and the secret service are under civil control through the government. In short: the constitution provides for a system of the checks and balances similar to most Western democracies.<sup>28</sup>

## 2. Political Reality in Russia

Continuing  
Political Crisis  
from 1994  
until 1999

The written constitution is one thing but political reality is another. The 1993 constitution did not manage to strengthen the central power of the presidential administration but instead reinforced the political opposition between parliament and president.

The president's policies were confirmed by the electorate with the 1993 referendum on the constitution, the 1996 presidential election, the 1999 parliamentary election with Yeltsin's chosen Prime-Minister candidate Putin, and the presidential election in 2000 with the new President Putin. However, in the 1993 parliamentary elections the supporters of the President only won by a small margin and in 1995 even lost the elections to the majority of conservative forces (nationalist and communist parties). Between 1993 and 1999 the opposition was much better organized than the supporters of the President and could install enough pressure on the President to force him to change government policies and personnel. Between 1994 and 1999 five prime-ministers (Chernomyrdin, Kiriyenko, Primakov, Stepashin and Putin) served under President Yeltsin. The changes in the government resulted in contradictory economic reforms swerving between market shock therapy and the conservation of state-run economy. The conflict in Chechnya between 1995 and 1996 and the financial crisis of 1998 bear witness of President Yeltsin's weakness. Paradoxically, Yeltsin always managed to stay in power. What were the reasons for the political crisis?

Mixed Signals  
from the  
Electorate

The primary reason for this constitutional power gap is, on the one hand, the authority of the President as the head of state and commander of the Russian forces, while, on the other hand, the authority of the Parliament as 'representative' body of the Russian population. The President is elected separately from the parliament Duma which allows the voter to give mixed signals towards the leadership – support in presidential elections and opposition in parliamentary elections. In other countries (like France or the US), various instruments for avoiding such power gaps evolved.

Weak Prime-  
Minister

The prime-minister, responsible for the day-to-day affairs of the administration, is not elected by the parliament but instead is proposed and dismissed by the president. The position of the prime-minister is very weak and has been used as a scapegoat whenever the president faced strong domestic opposition.

The cabinet is constitutionally responsible to the prime-minister but, in fact, it is directly responsible to the president – in the 1990ies cabinet ministers which went in opposition to the president (or just became popular enough to possibly defeat him in upcoming presidential election) often faced prompt dismissal.<sup>29</sup>

<sup>28</sup> For a history of the economic reform see section on the history of Russia's economy later in this paper. For a description of the constitutional crisis in the early 1990ies see Mandelbaum (1991), p. 11n. Most of the following descriptions of the Russian political system stems from McFaul (1997); Höhmann (1998); Herd (1999); Robinson (2000); Herd (2001); Alexeev (2001); Tompson (2002); Goldman (2003); Åslund (2005), von Derschau (2006). For the military's role in Russian constitutional conflicts see Brusstar (2005). For a description of the current media system in Russia see DeSmalele (1999); Kolstova (2002); Becker (2004). For many accounts of unfair jurisdiction see Politkovskaya (2005). Talbot (2002), p. 86n is interesting for the American perspective on the changes in Russia and motives why US-President Clinton backed Russian President Yeltsin in all political crises of the 1990ies: Talbot explains this by a reference to the personal relationship between Clinton and Yeltsin, but also because of the fear of other groups coming to power.

<sup>29</sup> Yeltsin in his memoirs even admits how the popularity of politicians like Primakov or Lebed made him consider their dismissal from their offices, see Yeltsin (2002).

Weak  
Parliament

The parliament has a very weak position to influence the composition of government since after three refusals of a nominee the president can dissolve the parliament and call for elections. The President can also dissolve the parliament after one year. He can also bypass the parliament and call for a referendum. He can initiate legislation through the parliament but can also rule through decrees circumventing the parliament. The president can also veto parliament legislation. The Duma, together with the Federation Council, needs a two-thirds majority in both houses to override a presidential veto. The parliament cannot impeach the President unless it can successfully prove a major crime such as treason or fraud.

Weak  
President

The lack of influence on the administration and the government has prompted the parliament to contradict any efforts of the government to *govern* the country; the president often had no other choice to *rule* the country and exerting his political will. With ruling I refer to appointing administration officials, commanding the military and initiate political processes through presidential decrees. Governing refers to issuing a coherent set of rules and the ability to reform existing political and economic institutions. While ruling is short-term, governing is long-term decision-making.

The disability to govern in case of a dispute constitutes a serious weakness for the President. Paradoxically, this weakness does not contradict all that has been previously said about the power of the president. The president is the central authority but without any power – while the parliament receives neither power nor authority.

Weak  
Regions

The constitution assigns shared and exclusive powers to the regions: the national level is responsible for jurisdiction, the court system, taxation, energy, foreign, and defense politics. The regional level has the responsibility to maintain law and order, protect natural resources, public health, social policy, education, and economic relations.

The legislation issued by the regional authorities during the 1990ies often contradicted national legislation. This was caused by an increasing political independence of the regions accompanied by an increasing economic dependence. The governors of the regions were elected by the people (previously they had been installed by the President) but the budget was determined by the tax regulation of the national level. Only those regions that had vast natural resources could implement their policies without the financial support of the national level.

After Putin became President in 2000, one of his first political moves was to reestablish political control over the regions. He weakened the powers of the Federation Council and the governors by creating seven supra-regional districts with a supra-governor who has to monitor the regions and report to him if regional administration contradicts national legislation. This is especially important because Putin de facto can remove any regional governor accused by the federal prosecution of having committed a crime.

Government  
Corruption  
and Tax  
Evasion

An incoherent set of norms allows a great discretion by the administration. Incoherent tax and tariff regulations for example allow loopholes and contradictions which can be exploited both by companies to avoid taxes and government officials to collect bribes. In fact, both problems are just two sides of the same medal – they are the result of the inability of the government to ensure proper enforcement of a tax code.

But even with a proper tax code issued by the federal level, possibilities for tax evasion exist. The regions have the possibility to contradict the federal tax code by issuing their own tax code. Thus, making tax evasions legal, the federal budgets were even further diminished. Putin's strive for control of the regions and to withdraw regional legislation that contradicts federal legislation is aimed at exactly this problem.

Need for  
External  
Support

If each political dispute ends up in political disarray, political leaders have to look for outside support. President Yeltsin needed support in the 1996 presidential elections and found this support in the oligarchs. The oligarchs, a group of business leaders, became increasingly involved in the Russian government and have shaped the economic landscape henceforth.

They supported the possibility of tax breaks, which then resulted in shrinking government revenues and, in turn, to an inability for the government to correctly fund the welfare system, pay pensions and provide a proper healthcare. Again, widespread poverty and increasing wealth of a few oligarchs are two sides of the same coin – the government's need to incorporate influential groups.

During presidential campaigns it became increasingly evident how the influence of interest group shaped the outcome of elections. President Yeltsin in his memoirs presents this as if they had no other opportunity. When speaking about the elections of 1996 he writes:

*"In principle it was a normal election campaign. We met with all influential groups. Do you want to survive? Help us! Do you want to continue your bank business? Help us! Do you want freedom of speech and private television? Help us!"<sup>30</sup>*

However, often it was the other way around – only the support from private interest groups could stabilize the presidential administration. Because the oligarchs own large shares of the media landscape, the possibility to influence the public via television, and newspapers depended on the connections between media owners and presidential administration.

Other interest groups, like the military or members of the former secret service organizations, also have, at various points in time, been able to assert their influence on the presidential administrations.

Political  
Stability

Of course, all governments are to some extent dependent on the support of media and other external actors. What makes Russia different is the degree of external support needed for political stability. It seems that, compared to the other G7 countries, the presidential administration and external actors are much more interdependent.

Yet, compared to other transition countries, such an assessment seems hardly surprising. One would expect such institutional set-ups from transition countries; especially those with a history of political-economical conglomerates found in former Communist countries. Due to the lack of space I cannot discuss this in detail here but surely one would also find similar interdependencies in other transition countries. However, this would support the thesis that Russia is still on the path to a democracy and still has a long way to go.

Surprisingly, despite the continuing political crises and the constitutional power gaps, Russia has been remarkably stable. Violent upheavals, mass strikes, radical subversions of political power did not occur. Even the transition of political power from President Yeltsin to President Putin went smoothly, given the enormous political and economic changes in the last two decades.

The reason for the stability was that all major stakeholders in society had a strong vested interest in the preservation of the society as a whole. Especially those parts of society where the revenues were gained – the gas and oil exporting industries – had an interest that the institutional set-up would ensure the continued political relations with the West.

### 3. The Impact of the G8 on Democracy and Political Stability

Twofold  
Approach of  
the G8

In the last chapter I argued that the effectiveness of the G8 policies is connected to its legitimacy. An undemocratic and instable Russia would surely undermine the effectiveness of the G8. Therefore, one could argue that it was in the interests of the other seven countries in the

<sup>30</sup> Yeltsin (2000), pp. 30n

G8 to promote stability and democracy in Russia.

How can the international community promote democracy and political stability in a sovereign country? The lack of a coherent global institutional framework prohibits any direct intervention. Even more, none of the G7 countries can directly intervene in the domestic affairs of Russia without causing a diplomatic crisis.

The strategy from 1991 onwards used by the G7 and by Russian leadership was twofold. The first element was outlining a path of creating political and economic institutions for Russia's integration into the world community. The second element was to ensure that any deviance from the path is only achievable at heavy political costs.

There is a variety of strategies available to the international community to alter the pay-off structures for political leaders (at least in theory). The international community can attach political or economic support to following the path towards a democratic market economy. They can encourage (domestic or foreign) opposition towards leaders that have left the path to a democratic market economy. The international community can also use drastic measures such as threatening a country's territorial integrity by military means or exclude a country from international institutions.<sup>31</sup>

As the previous sections showed, the crucial political problem in Russian society is not the functioning of democratic institutions but more the implementation of coherent policies. This threatens the ability of the G8 to implement the second element of their strategy: ensuring that the political leaders did not deviate too much from the path to democracy.

In both strands of the G8 policy coordination process (the informal meeting of the head of states and the ministerial process) only the first strategy seems feasible to ensure coherent policies. The exclusion of Russia from the G8, as well as the encouragement of opposition, would severely damage the whole process of G8 coordination.

Within the G8 the ministerial rounds could develop common standards for certain domestic areas – but, since the G8 has no means of enforcing these standards, this instrument is rather blunt. Secondly, the G8 leaders can strengthen the Russian leadership against domestic opposition. This instrument has been used a few times: the G7 leaders have publicly shown their support by assigning precarious issues to Russian leadership such as the hosting of the conference on nuclear safety in 1996. The withdrawal of such support is less feasible and the G7 leaders have in the past been very reluctant to do so.

It is important to underline at this point that neither of the two elements of G8 strategy require a democratic, market economy. In fact, the path leading from a command economy to a market economy could not detour the critical phase of a transition economy and there is no guarantee that the development does not stop there.

Creating a pay-off structure that punishes deviation from the path is not necessarily linked to democratic institutions. Even if it sounds paradoxically, it is the exact opposite. For democratic institutions to develop, political opponents should utilize a wide opinion space. In Russia, a very narrow opinion space was created that effectively shut down any political competition. It concentrated the power in the hands of the president. However, one of the main achievements in Russia is political stability and in later chapters I explore why this was important.

<sup>31</sup> See for instance Cox (1994) on measures adopted by the Clinton Administration to support Russia: mobilizing international support, persuade major lending institutions to be more sympathetic towards Russia's need, encourage American investment.

## E - The Economic Dimension

**Russia was admitted to the G7 to promote the establishment of a Russian market economy integrated into world economy.**

### 1. Transition and Economic Integration

In the previous chapter we have seen that the admission of Russia to the G7 supported political stability but not necessarily the development of democratic institutions. In this chapter I want to discuss the alternative thesis that Russia was admitted to the G7 to support its transition towards a market economy and its integration into the world economy.

It is difficult to analyze the state of country's economy on a few pages – and even more difficult to analyze Russia's economy and its enormous changes. Russia's evolution from an almost medieval and barely industrialized agric-economy to a fully industrialized command economy took more than 20 years. Its transformation into a service-oriented market economy cannot be expected to be finished after 15 years. Challenges like the collapse of the Soviet economy and the vanished trade relations with the former COMECON countries had to be addressed by the political leaders, flexible prices and wages had to be introduced, the tax and tariff regime had to be reformed, private property rights had to be installed, and accumulated foreign debts had to be serviced.

The Russian transition path is unique and had no precedents. Other countries of the Eastern hemisphere facing transition have opted for a more gradual approach or had more beneficial institutional setting. In China, for instance, central political institutions (like the Chinese Communist Party) stayed in power during the transition period. The Baltic States and the CEE countries could rely on the promised integration into the European Union. Russia, on the other hand, lost its main political institutions and had no perspective of integrating into the European Economic Community soon.<sup>32</sup>

#### Motives of the G7

For the G7, the transition of Russia's economy was important for various reasons. Russia, as the legal successor to the Soviet Union, inherited most of the economic infrastructure, resources and, most importantly, the foreign debts. The G7's support to Russia ensured that debts would be paid and access to resources would continue.

Another reason for the support was trade relations. The Soviet Union was the centerpiece in the economic relations of COMECON. After the abolition of the COMECON, the trade relations suffered and the former COMECON economies looked to the West for new trade patterns. Nevertheless, Russia's regional economic strength continued to shape the economic relations to the former command economies in Central and Eastern Europe. The G7 had an interest in strengthening trade relations with the former Soviet Republics and the Eastern European countries; however, it could not do so at the expense of Russia's trade relation. The G7 support ensured the continuation of the trade relations of Russia to its neighbors.

Finally, the G7 wanted to ensure that Russia's economic growth would eventually benefit a large majority of the population. Not for altruistic reason though - Russian domestic demand for commodities would increase import and support the economic growth in the G7 countries.

### 2. Russia's Soviet Economical Legacy

Until the middle of the 19<sup>th</sup> century, Russia's economy was dominated by agriculture. Russian trade and industrial production increased only slowly and often only on initiative from the state. However, in the second half of the 19<sup>th</sup> century up until WWI, Russia saw a rapid industrialization which created the social tensions that led up to the October Revolution.

After the October Revolution the Soviet industrialization increased once more. Large projects (infrastructure and exploitation of natural resources) mobilized large inputs that drastically increased outputs as well. From the 1940ies to the 1960ies the fast-growing Russian economy helped to increase the standard of living.

<sup>32</sup> On differences between Russia and the CEE economies see Mandelbaum (1991), p.15

#### Character of Soviet Economy

The command economy functioned remarkable well even though it had no markets and had to work without flexible prices and wages. However, the information about the production matrix and the consumption demands were very sophisticated. In fact, the command economy was often remarkably flexible because input and output patterns were changed within planning periods. Although the Soviet Economy faced the same problems that large multinational enterprises face today – enormous information and coordination costs - it managed to compensate the information costs through ever increasing inputs.<sup>33</sup>

The decisive difference between large Western industrial conglomerates and the Soviet Economy was the operation of a political calculus. Such a calculus favored, first of all, the construction of large military-industrial complexes aimed at maximizing military strength. From an economic point of view, there is nothing fundamentally wrong with large spending on military purposes. Even though military spending diverts resources to a sector that is largely unproductive military research can outweigh these costs. If military innovations transform into civil innovations then military spending can be quite efficient for an economy. However, in the Soviet economy, because military research was of strategic importance, military innovations were seldom used for commercial purposes – there was no transfer mechanism from military to civil innovations.

The high inputs could not substitute technological and procedural innovations in the industry. Despite tremendous scientific successes in the Soviet Union most of the innovations were only reluctantly introduced into the production process. This was also partially due to the soft budget constraints of Soviet industry; the second consequence of the political calculus used in Soviet economy. Inefficient companies did not leave the market but were subsidized through redistribution within the command economy. The aim of directors was not primarily to cut prices for increasing profits since both prices of resources and products were fixed; the aim was to fulfill the plan. Innovations had to follow the logic of fulfilling the plan and, since innovations often first need high investment costs, the transaction costs of implementing innovations were too high.

The third consequence of the political calculus was the assignment of social welfare function to the state-owned companies. Childcare, health care and the privilege of holidays were administered within the industry. The central role of the state-owned companies later during transition made it difficult to restructure the large industrial complexes into the smaller companies.

#### Export Dependence

The Soviet leadership knew of problems related to the efficiency of the Soviet economy. But for political reasons they could not afford to publicly depreciate the Soviet Economy fearing the loss of central power – similar to how a CEO of a Western company cannot publicly depreciate his own company without damaging the value of his company. Yet, in Western economies private capital markets will attempt to evaluate a company's real situation and pressure for increased efficiency; especially if the company's ownership is traded on stock markets.

In the Soviet economy, the owners (the Soviet population) could not achieve real information about their economy's situation. Given the optimistic statements on the Soviet economy, unsurprisingly the demand for a higher living standard and the demand for consumption goods increased. The industrial output, on the other hand, was far away from providing enough commodities for the consumption preferences. The Russian leadership needed to increase exports of raw materials, especially energy resources, to finance the import of commodities. The rising demand for raw materials in the West supported this strategy up until the end of the 1970ies.

During the 1980ies two mutually reinforcing effects threatened this strategy: first, the oil production within the Soviet Union decreased. Lacking investments in infrastructure to explore new oil fields and decreasing exploitation volumes from old fields reduced the amount of exportable oil. Secondly, the world prices for oil drastically decreased. The Soviet Union could not pay its

<sup>33</sup> Mandelbaum (1991), p. 9 defines a command (or „planned“) economy: Decisions relating to type, quality, quantity and costs of production as well as wages are not determined by the market (demand and supply) but by a planning agency using a political calculus.

foreign debts or continue the import of commodities. The Russian leadership under Gorbachev introduced limited entrepreneurship and partially decentralized economic decision-making structure. But his economic reforms weakened the central economic planning capacity while not improving the transmission belts of innovation within in the Soviet society or strengthening the budget constraints. Production decreased further and, together with the political developments in the late 1980ies, political and economic institutions became destabilized.<sup>34</sup>

#### Disintegration

For the Soviet republics the political and economic union represented by the Soviet state did not payoff. The destabilization of political and economic institutions increased costs for maintaining the institutions; however, these costs overtook the saved bargaining costs. A necessary condition for the union's existence was gone. Unsurprisingly (successful) independence movements erupted in all Soviet republics and soon led to the demise of all Soviet institutions.

The disintegration of the Soviet Union made Russia the largest country on the former Soviet territory. But to the Russian leadership the same economic capacities were available to him as they were to his Soviet predecessors – the only difference was popular support for economic reforms. However, the political dilemma already described in the previous chapter played an important role: the President had power for economic *changes* but coherent economic *reforms* could be blocked by the Parliament and the Supreme Council (the remainder from the Soviet Republic Russia). The only feasible method was the fast but often incoherent introduction of market institutions, privatization, and liberalization of trade, prices, and wages.<sup>35</sup>

### 3. Economic Reforms and their Effects

#### Obstacles

The reformers of the early 1990ies had to work in an economic background that made coherent reforms very difficult.<sup>36</sup> The obstacles were:

- a collapsing domestic market for commodities because of the failure of central authorities to organize the market and increasing reliance on barter economy to organize trade relations
- an inefficient industrial sector because of state-control, lack of investments and lack of competition (however, with large potential revenues from export-oriented raw-materials)
- budget deficits because of interest payments on foreign debts, lack of tax revenue from tax evasion, and an increasing barter economy

#### Trade Liberalization

The aim of the reformers was to create markets and urge companies to compete in the markets and become more efficient. The first step was the liberalization of domestic and foreign trade. During Soviet times, the monopoly on foreign trade rested with the ministry for foreign trade but already during the Gorbachev era this monopoly was reduced. Now all the industries whose prices were competitive on the world market diverted their output towards the export.

At the same time the demand for imports of commodities increased. In an open market economy with flexible currency rates, diverting production toward exports and increasing imports have no direct effects on the economy. Since imports have to be financed through exports, the

<sup>34</sup> For a description of the Soviet economy in the late 1980ies and early 1990ies see Mandelbaum (1991); Feiguine (2004), pp. 44-45. Ericsson (2002), p. 4 describes the rising budget deficit (Soviet budget deficit was 2.5 percent of GDP in 1985, 8.5 percent in 1989 and 12 percent in 1990) and the counter measures introduced by the Gorbachev government.

<sup>35</sup> European Commission, IMF, World Bank, EBRD, and OECD as well as many Western advisors had proposed the following 'shock therapy': cut budget spending, issuing government bonds to reduce money supply, devalue the currency, liberalize prices and wages, privatize state-companies, break up monopolies, establish private-capital markets, establish private property. They also endorsed to build a common trade zone and a common currency for the former Soviet republics. World Bank (1990), European Commission (1990), Mandelbaum (1991)

<sup>36</sup> For a description of the Russian transition economy see Evers (1996); Sabelnikov (1996); Granville (1998); Höhmann (1998); Hishow (1999); Hishow (2000); Meier (2000); Gregory (2000); Ellmann (2000); Ferguson (2000); Höhmann (2001), pp. 120n, 134n, p. 145n.; Cuddy (2002); Höhmann (2003); Meier (2003); Hishow (2003); Kaitila (2003); Broadman (2004); Hishow (2005); Ivanenko (2006); Gluschenko (2006). On the importance of the gas and oil sector see Rautava (2002), Kolodziej (2006), Kalcheva (2006).

currency rate and the domestic price level will simply adjust to the new ratio of imports and exports. However, the Russian economy had neither flexible currency rates nor flexible prices – therefore, the trade liberalization destroyed even those trade relations that were still left from the Soviet era. The supply of commodities decreased drastically in the early 1990ies.

#### Price Liberalization

The second step, liberalization of prices, was aimed at giving incentive to divert production towards the domestic and increase the supply of commodities. However, the effect was a further weakening of the informal network that had grown between the various industries because new prices meant the renegotiation of trade relations. With regard to these uncertainties the company directors did not react by re-organizing their companies and make them more efficient but instead cut production and increased prices.

The shrinking supply together with the increased prices led to a high inflation which was unhealthy for economic growth. The high-inflation reduced the savings of the Russian population and the development of a functioning private capital market was hindered because of the lack of assets from savings. Even though in the early 1990ies the number of banks increased, many banks were undercapitalized and could not function as intermediaries between private savings and credit-takers in the corporate sector. Only those banks connected to export-oriented industries and their high revenues could generate enough capital but mostly served as means to conduct financial transactions (or for organizing capital flight to avoid the devaluation of profits from exports because of the galloping inflation).

#### Insider Privatization (I)

The third step was to privatize state-companies. There are three forms of privatization: auctioning on the private capital market, distribution of vouchers among the population, and distribution of shares among employees and other insiders. For fear of foreign ownership of strategic industries and because of the lack of a private capital market the first option was not used. The second option was partially attempted but often failed because of the lack of public trust in these vouchers. The only method achievable by the government (and obstructed by the company directors of the large industries) was to privatize the industries by allowing ownership of employees or directors.

This, however, only enforced the trend of privatization used by the Gorbachev government in the Soviet Union. Gorbachev gave the directors of the Soviet state-companies more control and flexibility. Production exceeding the plan could be sold to other companies and employees could lend the production facilities during off-peak hours for their own production. However, because of rigid price controls, the measures did not have the desired effects. Those companies that sold products at prices below costs could not economically extend their production while those companies that sold products at prices above the costs decreased their official production and earned privately. The main result of the Gorbachev reforms was to provide the company-directors with knowledge about the true assets and costs of their companies.

When the Russian government wanted to increase the privatization in order to enhance the efficiency of the Russian economy, the insider knowledge allowed preventing a form of privatization that would weaken the influence of the insiders. Normally a private capital market would assess a company's value and gather funds from savings and foreign investors to buy shares of the privatized companies. Yet, as already indicated, because of inflation no domestic capital market existed and foreign capital was not allowed ownership. The foreign capital accumulated by the Soviet economy (and resting in foreign accounts of the former Soviet Banks) did not counterbalance the insider-knowledge of the company directors. In fact, the knowledge of the whereabouts of the large assets only strengthened their position via the government.

#### Public Deficits

Insider privatization led to a shift of economic power towards the new owners of the industrial sectors, the so-called oligarchs. Of course these oligarchs had no incentives to use their revenues to increase the efficiency in the Russian industry. Against the background of inflation, high incentives were given for stripping what remained of Russian industrial assets and diverting them to foreign accounts, which shrunk the tax base of the public budgets.

Together with barter instead of market transactions, decreasing income through employment

and an increasing black market for labor, tax revenues were already decreasing. Servicing the extensive Soviet debts bound large parts of the budget. Public spending could only be partially decreased because the industrial sector relied on the public spending for its survival and threatened to cut providing social welfare to the workers. Therefore, budget deficits were unavoidable.

To overcome public deficits, a government normally has a variety of options that are fairly neutral to economic growth. Loans from the private capital market (even though crowding out private investment) are the standard option used by governments in Western Europe; but since the private domestic capital market was not functioning in the early 1990ies the Russian government could not utilize that option.

The foreign private capital market did provide credits but only on high interest rates (because of the bad rating given by international rating agencies to the Russian economy). The interest rates only yielded higher deficits and postponed the problem of budget deficits only for a short time.

Loans from international institutions were a means to close the gap in the public budgets but, on the other hand, were often tied to economic conditions that the Russian government was neither willing, nor able, to fulfill.

Therefore, the only feasible possibility was credits from the Russian Central Bank which simply extended money supply by consuming the little foreign reserves held by the Central Bank. In most economies the Central Bank has some sort of institutional independence from the presidential administration. Another flaw was the quasi-dependence of the Russian Central Bank on the presidential administration. In Russia, the president can directly appoint the head of the Central Bank and therefore the Russian Central Bank is not an independent institution. The monetary policy of the Russian federation was largely determined by the political calculus of the presidential administration. The Russian Central Bank, being not only the supplier of money towards other commercial banks but, at the same time, being a competitor to these banks, could increase money supply and burden the costs of these policies through increased inflation on the consumers and savers. However, the inflation put further pressure on the devaluation of the ruble resulting in more capital flight.

**Insider Privatization (II)**

Inefficient industries, public deficits, inflation, and decreasing domestic income caused the GDP to continually decrease in the first half of the 1990ies. Because international loans often only provided a temporary relief, the Yeltsin government in 1996 introduced a second method of privatization to support the public budgets: the so-called loans for share scheme. The idea was to raise government revenues by selling shares of industries in which the state still owned a considerable fraction. The shares were auctioned by banks and the revenue from these auctions would go to the public budgets. However, by 1996 the banks already had formed large conglomerates with the companies from the industry and, especially with those companies in the highly profitable export sectors, and a second sort of insider-privatization occurred – not too the insiders within the industry but to the insiders within the financial-industrial conglomerates. Because of weak public bank control credits given from the banks to the industries often defaulted and tied the banks further to the industries. So it was not surprising that often the banks responsible for the auctioning of the shares were related to the companies ending up buying the privatized companies. Sometimes even simple methods, like organizing the auction in a remote area and close the airport in a remote area on the day of the auctioning, were used to keep outsiders from participating in the auction.

Because of the insider-trade the ownership structure tilted even more towards industrial-financial conglomerates highly active in the export sector. The auctions unsurprisingly did not yield the desired revenues for the public budgets. Thus, the public budgets were forced even more to look for funds at the foreign capital market (and pay high interest rates) or extend the monetary supply (which then causes inflation and depreciation pressure for the ruble).

**Income Distortions**

All of these developments resulted in a change of income distribution from the bottom to the top. Holders of insider-knowledge could accumulate enormous wealth through asset stripping

and capital flight. The consumers and savers, due to inflation, the employees in the non-industrial sectors, due to the loss of income, and the pensioners, due to the loss of pension payments all paid for the income distribution towards the top.

Why did such income redistribution meet little resistance and political crises? In fact, it did – as said before, the support for Yeltsin's government and his approval rates were very low. However, in presidential elections he could align the oligarchs in his election campaign and, thus, ensure his victory over his domestic opponents.

For the oligarchs and the Yeltsin administration a mutual partnership developed. The Yeltsin administration would ensure that the oligarchs could secure their wealth without too much political intervention. The oligarchs, on the other hand, ensured that revenues from export (even though temporarily withdrawn from the Russian economy) would return in foreign investments from countries like Cyprus (where most of the capital flight went because of Cyprus' cultural affinity to Russia). The oligarchs never decreased their payments to the public budget enough to seriously endanger the Russian state – they only weakened the state. Government revenues heavily depended on the sectors in which income was generated (and shifted towards the top). Those sectors were mostly the export-oriented industries.

**Investment Distortions**

The dependence on the export in the 1990ies is nothing new. As mentioned before, already the Soviet economy was dominated by export-oriented sectors. Yet, now with the introduction of market economy institutions, the dominance became increasingly malicious to restructuring the economy.

High investment costs in these sectors made it almost impossible for small firms to enter the market, thus, only a few vertically integrated companies dominate the sectors. Economies of scale and high sector-specific revenues allowed these companies to acquire other profitable companies in other sectors (like air-transportation and communication). Therefore, they became not only vertically integrated but also horizontally integrated. It also allowed them to create banks and other financial institutions from these revenues.

For small and medium-sized enterprises such circumstances were difficult. They had little access to profitable markets and private capital. In a market economy with functioning private capital markets, venture capital would be assigned to highly effective and innovative companies. The experience has shown that start-ups with little bureaucracy can often react faster to market developments and are more innovative. In Russia, most of the investments are drawn into the sector where monopolies, state-influence, and high export revenues yield high returns of invested capital.

In a normal open economy foreign investment would close the gap between distorted domestic investment allocations and investment needs in non-export sectors. Although the demand for investment stemming from repairing and reconstructing the industrial equipment were very high overall investment shrunk. Russia's political and legal system forced foreign investors to strongly cooperate with Russian companies and made it difficult to return investment revenues back to its foreign source (without using illegal methods). Consequently, foreign investors during the 1990ies were cautious of getting involved in the Russian economy.<sup>37</sup>

**Dependence on Export Sector**

The focus on the export-oriented industries artificially overrated the currency. To avoid capital flight, the government imposed exporters to make parts of their transactions in Rubles. At the same time it kept the currency pegged to the dollar so that the servicing of foreign debts would function and give some stability to the financial markets. However, price levels and inflation would have yielded a currency rate considerably lower than the one existing before 1998.

The artificially high currency, together with the investment distortions and the increased capital costs for the other sectors, made the overall economy less productive – which again pushed more private and public money towards the export sector because it could maintain a relative productivity. This 'Russian disease' of channeling capitals towards export-oriented sectors was

<sup>37</sup> Höhmann (1998), p. 12

due to the intertwined banking and export sectors supported by the government's dependence on revenues from this sector.<sup>38</sup>

The interdependency of the Russian government with the dominant sectors resulted in the desire for the political leadership to keep political control over the dominant sectors. The leadership within these sectors had to be close allies of the government or a political crisis would sooner or later emerge. If the company leaders are effective in managing the industry then no harm is done but, if the company leaders are effective only with the governments support and a private control mechanism (that would lead to a replacement of unsuccessful management) is missing, then the whole economy suffers from these distortions.

#### Protectionism

Since banks and state are dependent on one sector, this sector has no incentive to be efficient or to cut costs. The textbook answer would have been structural reforms – strengthening the tax base, floating the currency, supporting small and medium sized enterprise, strengthening non-export sectors by investments in infrastructure, and breaking up the financial-industrial conglomerates.

An efficient mechanism for enforcing these reforms would have been integration into the World Trade Regime. Tariff regimes supporting inefficient sectors would have to be abolished. However, the Russian leadership did not speed up the entry into the World Trade Organization. Already the first transition shock in 1991 had weakened agricultural industry and the machine-producing sector. The Russian leadership feared that these sectors once again would have been damaged by the entry to the WTO.

They also knew that not increased exports and imports as such would lead to growth but only trade relations that helped to improve efficiency through economies of scale. Since this was only to be expected in the sectors exporting natural gas and oil, all effort of the Russian economy was aimed at stabilizing these sectors.

Other obstacles in the WTO accession were the existence of state companies (Gazprom de facto is a state company) or low domestic prices for energy. However, under Article XVII of the 1947 GATT agreement, exceptions for state companies can be negotiated. Therefore, the existence of de facto state companies would not have been a serious political obstacle if the political will to integrate the WTO in the world economy would have existed. More crucial were the low domestic prices for energy – which helped to stabilize those industries that were very energy-intensive. The strategy of the Russian leadership was simply to wait with WTO accession until after these sectors could be stabilized as well. Only when the gains from WTO accession were greater than the costs through increasing domestic energy prices, Russia was ready to remove this obstacle.<sup>39</sup>

#### Crash and Resurrection

Up until 1998 the incoherent reforms did not address the structural problems of the Russian economy: the inefficiency of the Russian industries, the reliance on the export sectors, and the public deficits financed through inflation and expensive foreign capital credits.

The overrated ruble, the high inflation, the dominance of the export sector, and the increasing public budget deficits made the Russian economy very volatile to currency fluctuations on the world market. The crisis in Asia only reinforced the weaknesses of the Russian economy. The 1998 currency crisis caused a rapid devaluation of the ruble, decreased growth, decreased income, and reinforced the institutional deficits of the Russian economy.<sup>40</sup>

While observers in 1998 and 1999 were very pessimistic about the prospect of the Russian economy they had to revise their assessments two years later. The economy was recovering and even growing. What had caused these unexpected changes?

Five effects were responsible: first, the devalued ruble urged decreased imports and increased consumption of domestic products especially in those sectors that could not compete with quality of the world market (for instance agriculture); second, inflation decreased and reinstalled

<sup>38</sup> Hóhmann (1998), p. 13 speaks of the danger of deindustrialization from the orientation on export of natural resources which works similar like the famous 'Dutch disease' and results in heavy investment distortions.

<sup>39</sup> For a discussion of the effects of WTO accession to the Russian economy see Hishov (2005), Naray (2001)

<sup>40</sup> For a discussion of the 1998 currency crisis see Hóhmann (1998), Braithwaite (2000), Raketic (2004), p. 17

stability on the financial markets; third, public debts were partially rescheduled or even cancelled and therefore gave the government the possibility to pay wages and pensions; fourth, increasing prices for oil and gas continued to support the export-sector; fifth, the strengthened central power of Prime-Minister (and later President) Putin allowed to introduce coherent reforms.<sup>41</sup>

Since then, Russia's transition seems to have been partially successful: the supply of goods on the domestic market is exceeding Soviet levels of supply and the overall income is rising. The GDP is almost back to its level of 1990, the public budgets enjoy surpluses, and the foreign reserves of the Russian Central Bank are constantly increasing. The reformers managed to privatize many key industries introducing reforms in tax and tariff legislation, allowing ownership by foreigners, and successfully attracting foreign investments.<sup>42</sup>

On the other hand, disparities in the distribution of wealth, unemployment, and poverty are increasing as well. State control over the key industries is still strong and Russian industry still remains partially inefficient. Environmental problems, increasing crime rates, tax evasion, corruption, and bribery show that the institutions controlling the markets are not working well. Transition is not complete and it is unclear whether Russia will turn into the market economy it promised to be.

## 4. G8 and Russia's Transition

How did the G8 help to promote Russia's transition? The G7 from the early 1990ies supported Russia with various instruments: direct help (such as aid and technical assistance), loans and credits through the IMF and World Bank system, indirect help (such as canceling legislation prohibiting trade with Russia or providing government securities for foreign investments), and rescheduling of Russian debts.<sup>43</sup>

Direct aid and technical assistance was most important in the first phase of transition. It helped to overcome shortages in commodities. However, the instrument had its negative effects as well. Since the aid or technical assistance was connected with the condition of importing commodities from the country giving the aid, or employing agencies from the donor country, it slightly distorted the economic structure by decreasing the demand for domestic goods. Yet, during the first transition period, such help stabilized the economy and, therefore, can be seen as a success.<sup>44</sup>

Loans and credits through the IMF system also had diverging effects. IMF loans are normally given on strict conditions; such as a coherent macro-economic policy, combating inflation, decreasing public budget deficits, and introducing market institutions. Such measures – although unpopular – in the long term stabilize the economy. The loans helped the government to commit itself to international politics and economics. Even though in the public debate the Russian governments complained about the intervention into transition politics, it knew that the IMF strategies were in the long-run worthwhile to pursue. The IMF loans to Russia helped to overcome public budgets shortages and indirectly stabilized the Russian government.<sup>45</sup>

However, often the conditionality was weakened due to political arrangements within the G8 system which decreased also the incentives for the Russian government to commit itself to international strategies. Thus, its macro-economy strategy was vulnerable to be exploited by interest groups. The IMF loans sometimes were sometimes used to strengthen the market values of certain industries in order to attract foreign capital; thus, they partially distorted the economic structure of Russia (even though this was not intended). Furthermore, it appears that the IMF loans were often used for providing a bail-out to the failure of the private capital market. In fact, for various credit lines by the IMF, the government announced reforms but did not have

<sup>41</sup> Braithwaite (2000), Raketic (2004)

<sup>42</sup> The recovery of Russia's economy since 1998 can be seen in all economic indicators: economic growth measured between 4 and 10 percent, inflation reduced to about ten percent, real disposable income rose continuously, trade and revenue surpluses and increasing reserves of the central (2003: 64 billion USD). Rumer (2003), Bush (2003), Hóhmann (1998), pp. 8n

<sup>43</sup> For a description of instruments see Fischer (1990), Christopher (1998), p. 57

<sup>44</sup> Cox (1994), p. 647 describes how almost half of 1.6 billion USD aid of the US to Russia in 1993 was tied to the purchase of American grain. See also Strobe (2002), p. 70 for discussion of aid given to Russia in the early 1990ies. Smith (2002), p. 238 speaks of 400 million ECU of food aid in 1999.

<sup>45</sup> See for instance Gould Davies (1999)

success in implementing the reforms. At various times the IMF threatened to halt or cancel the disbursement of loans and only the intervention of the G7 state ensured that IMF loans were paid for.<sup>46</sup>

What prompted the G7's indulgence towards Russia? Through the strong cooperation between Russia and the G7 (despite Russia's economic problems), Russia's membership in almost all other important financial and economic structures, such as the G20, the G22, the Financial Committee of the IMF, the G33, the Paris club, the IMF, and World Bank made it easier for Russia to pursue its interest via the countries outside of the G8. Even if the official statistics in the middle of 1990ies were very pessimistic concerning the Russian economy, Russia was in fact throughout the 1990ies and especially after 2000 an influential economic player.<sup>47</sup>

During the 1990ies the groundwork was laid for the energy relations of the next 20 years between Western Europe and Russia. As I will describe in detail in Chapter G, Western Europe already depended on gas imports from Russia. To make energy relations reliable, Russia, despite its economic flaws, had to be involved in the major economic and financial institutions of the world.

From the point of view of the export-sector these economic flaws were in fact advantages. Russia and the G7 knew in the early 1990ies that due to the Soviet lack of investments in oil and gas production facilities it was evident that the sector needed clear property rights to ensure investment incentives. This made the introduction of oligarchs and all their bad side effects absolutely necessary. However, most side effects are, on a closer look, less malicious than they seem. For instance, most capital that went out of the country in the early 1990ies came back in the middle of 1990ies.

Of course officially the G7 tried to counter the structural deficiencies of the Russian economy. The IMF (or the EBRD) loans were tied to conditions such as the funding of small and medium sized enterprises and the World Bank developed programs to support those companies. However, all macro-economic developments worked against this effort. The need for a stable export industry was more important than combating the negative effects of the dominant raw materials sector.

The G7 behavior towards the Russian foreign debts, especially those inherited from the Soviet Union, can also be explained by their energy relations. It strikes odd that the G7 did not cancel all debts (at least to the Paris Club) in the early 1990ies to make transition easier. The G7 helped the Russian government through rescheduling the debt and partial cancellation but only reluctant and minor rescheduling took place. Only during the 1998 currency crisis, when political and economical instability also threatened the export sector, the G7 leaders agreed on measures that substantially changed the debt situation (even against the advice of the G7 meetings of financial ministers). Everybody knew that as soon as export prices for oil and gas would increase Russia would be able to service its debts and nobody wanted to give a free gift to the Russian government.<sup>48</sup>

How could one summarize the G7's impact on the Russian economy? They helped sustain the transition path. However, the path chosen aimed for energy security, not necessarily market economy.

<sup>46</sup> See also Talbott (2002) on American support for Russia in the framework of the G7 and Freytag (2001), p. 25n on coordination of macro-economic policies within the G8.

<sup>47</sup> Freytag (2001), Russia's involvement in the other international institutions see for Kirton (2001), pp. 143n, For a description of the Russian economy at the time of Russia's G8 admission see for instance Höhmann (1998), p. 12 or Bayne (2005), p. 6

<sup>48</sup> See for instance Kirton (2001b), pp. 143n on the disputes between G7 finance ministers and G7 head of states on debt rescheduling.

## F - The Security Dimension

### Russia was admitted to the G7 because of NATO expansion and other security issues.

In the literature, sometimes the G7 membership of Russia is explained by Russia's resistance towards NATO's expansion.<sup>49</sup> Russian President Yeltsin has hinted in his autobiography that his strong opposition has made it necessary to incorporate Russia in the G7 framework:

*"In Denver, 1997, Russia gained for the first time the status of a full member [in the G8]. From that time, our delegation was present in almost all sessions. I think our strong position on the expansion of NATO eastwards, which I laid out a few months before at the Russian-American summit in Helsinki, had an impact on this decision. Back then I had declared that the expansion is a mistake and would lead to a new East-West confrontation. I did not err in this assessment."<sup>50</sup>*

But a few pages later in the book he asserts:

*"When in 1997 NATO expansion was considered and we had to reach a decision with our Western partners on that issue [...], suddenly Japan objected to Russia's membership in the G8. They pointed to the different economic potentials and financial systems. For me it was clear that the objection was caused by our political relationships between Japan and Russia and especially the issue of the Southern Kuril Islands. Japan believed that our admission to G8 was bought with our position towards NATO expansion and wanted to gain advantage from that position. But membership in G8 is something else than the political settlement. A bargain on this issue was not possible."<sup>51</sup>*

Yeltsin's statements seem paradoxical: on the one hand, he claims that his resistance to NATO expansion strengthened his influence in the G7/G8, on the other hand he refuses any speculations on a possible trade-off between NATO expansion and G7/G8 membership.

In the scholarly literature on the G7/G8 the importance of the security dimension for the G7/G8 summits is often emphasized. On the agenda of the G7/G8 summit were the Start I and Start II agreements on arms reduction, the Non-Proliferation treaties, NATO's Partnership for Peace Program, and the military conflicts in Kosovo, Chechnya, Afghanistan, and Iraq.<sup>52</sup>

Did NATO expansion play a prominent role among these other security topics to give enough substance for a trade-off with Russia? Or were there other security-related reasons for incorporating Russia in the framework of the G7/G8?

### 1. NATO Expansion and Western Security Interest

While the confrontation of the two blocks was the most dominant security issue before the 1990ies, the military conflict ceased within a few months after the disintegration of the Soviet Union. The early 1990ies revealed that the state of Russia's military capabilities is far less threatening than the perceived military threat by the Soviet Union. The size of the military arsenal, the technology and equipment, the training of military personnel, and the stationing of military units does not meet Western standards. Some scholars even argue that the US has reached nuclear primacy because the US can now preemptively strike against any country (even with nuclear weapons) without fear that another country retaliates against such a strike.

Despite the US military power, new issues emerged that could not be solved by the Western countries alone: what would happen with the nuclear arsenal of the Soviet Union? How could the mass proliferation of weapons into conflict regions around the world be prevented? How to prevent the proliferation of technology to build weapons of mass destructions? How to erect a global security regime that would allow answering the challenge of conflicts centering on ethnicities, religion, or natural resources?<sup>53</sup>

<sup>49</sup> Hajnal (1999), pp. 19, 28n, Talbott (2002), p. 237

<sup>50</sup> Yeltsin (2000), p. 129

<sup>51</sup> Yeltsin (2000), p. 139

<sup>52</sup> See for instance Christopher (1998), p. 238 and p. 248; Cox (1994); Körber (2001); Baker (2002)

<sup>53</sup> See Christopher (1998), Hunter (1999), Talbott (2002) on perceptions of security in the early 1990ies.

The instrument of choice to answer these questions was NATO. Before the end of cold war the main aim of NATO was to protect Western Europe against aggression from the Warsaw Pact and ensure the military presence of the USA in Western Europe. Without the Soviet Union as a main aggressor and with security threats that could not be answered by a large military deployment in Europe, the cause for NATO had gone.

However, the military coordination and the erecting of a complex military structure set the Western leaders on a path that they could not leave without considerable political costs. The costs spent on NATO during Cold War can be understood as 'sunk costs' – costs that already have occurred and which are non-retrievable. However, what other options were available? The NATO coordination had proved successful, so why not continue the institutional arrangement? For the members of NATO to assign new tasks to an existing structure saved the costs of negotiating a new security design.

After the disintegration of the Warsaw pact the former Soviet republics such as Lithuania and Central European states like Poland, the Czech Republic, and Hungary had applied for NATO membership. Their main motives were the rule out the possibility of Russia having territorial aspirations towards their homelands and filling the security vacuum in Central and Eastern Europe. At the same time they wanted to strengthen their military relationships with the West.<sup>54</sup>

For the security dimension of NATO, the expansion did not provide considerable advantages. None of the new countries provided a strategic position for the emerging conflict zones. In the Middle East the NATO member Turkey already provided a strategic platform and for the Balkan area Italy provided the main strategic support. What was the reason then for NATO expansion?<sup>55</sup>

A first possible explanation is coalition building within NATO. Although decision-making is unanimous, the process leading to decision-making is nevertheless open to influence by various coalitions. The discussion leading up to the military involvement in the Iraq War in 2003 showed that there are three basic groups within NATO now: the Americans plus the British, the Western Europeans with most dominantly the Germans, and the Eastern European with most dominantly the Polish. From the point of view of the Americans, NATO expansion towards the Eastern European countries would reduce the dependence on the Western European countries (and for the same reason the Western European countries were at first reluctant to promote NATO expansion).

A second and more probably explanation is that NATO expansion was part of an overall strategy to expand the sphere of influence of NATO towards Central Asia. Why Central Asia? Often one hears about the ethnic conflicts in the region and the perceived threat from Muslim authoritarianism. However, I have come to the conclusion that again energy security is the key to understand the security issues involved. Nevertheless, before going in detail about this explanation, I want to discuss some arguments concerning Russia's objection to NATO expansion.

## 2. Russian Security Issues

Various sources claim that the original position of Russia towards NATO expansion was not negative in the early 1990ies. In fact, Russian president Yeltsin had supported the Polish and Czech leadership in their aspirations towards NATO. What prompted President Yeltsin to reverse his course? Some analysts argue that in 1995 and 1996 President Yeltsin faced domestic opposition because his economic reforms did not work and the conflict in Chechnya showed the weakness of Russian military. He was accused by his domestic opponents of having damaged the superpower status of Russia. Especially opposition within the military was increasing. NATO enlargement was perceived as a direct threat to Russia and Yeltsin's resistance to NATO expansion was an attempt to regain domestic ground by appealing to this threat.

There is no doubt that the military always played a strong role in Russia's domestic policies. At the time of the Tsars rule, the political elite of Russia often went into the military service – which meant that the political ruling elite recruited itself from the military hierarchies. In Soviet times the Communist party introduced new ways into the ruling elite through the circles of the nomenclature. Yet, since the Red Army was essential in stabilizing Soviet rule (for instance in

<sup>54</sup> For the motives of the CEE countries towards joining the NATO see Donaldson (1998), p. 214

<sup>55</sup> See Talbot (2002), p. 98 for a description of the NATO strategy.

the Civil War after the October Revolution, or in the Second World War) it held a great degree of prestige with the Russian population and had considerable influence on domestic and foreign policy.

With the beginning of Perestroika, the Russian military lost its role. Gorbachev started with down-sizing military expenditure. Yeltsin continued the withdrawal of Russian forces from the former Warsaw pact states and spent less money on the military. Often the military was deeply divided of opposing or supporting the Russian leadership. In the coup against Gorbachev in 1991 and the conflict between the parliament and the president in 1993, the military stayed mostly on the side of the president. Yet, when it came to reorganize the Russian military or to defend security interests in the former Soviet republics, Russian leadership had a hard time exerting leadership over the military.<sup>56</sup>

However, resistance to NATO decreased soon after the first step towards enlargement was made. The NATO membership of the Baltic States was less controversial than NATO membership of Poland, Czech Republic, and Hungary. President Putin seems to have adopted a more pragmatic approach towards NATO. He has increased Russia's cooperation within the Partnership for Peace program and supported NATO in their missions in Afghanistan.<sup>57</sup>

It seems that the enlargement of NATO towards the Central and Eastern European Union countries was not the real controversial issue in the security relations between Russia and West. Again, I want to argue that the controversial question was Central Asia – which was quietly solved between the West and Russia in the framework of the G8 while the whole world discussed a potential East-West confrontation.

## 3. Natural Resources and Security

NATO expansion gave Russia, Western Europe, and the USA a possibility to guarantee a security framework for the so-called Near Abroad Countries. Why was this security framework necessary and what were the vital interests of the G8 powers in that region?<sup>58</sup>

The countries of Central Asia - especially the former Soviet republics Kyrgyzstan, Uzbekistan, Tajikistan, Turkmenistan, and Kazakhstan - are situated in an area of enormous geopolitical importance because of raw materials; especially natural gas and oil in and around the Caspian Sea. But also the resources of natural gas in Iran contribute to the region's strategic importance. Because of rising demand for natural gas in Western Europe, in Eastern Asia, and in the United States the demand for natural gas will increase in the future. Russia's gas reserves in Northern Siberia and the Ural are already shrinking and it is generally expected that Gazprom, the Russian gas company, will more and more substitute Central Asian natural gas to supply Europe. At the moment, the majority of pipelines go from the Caspian Sea through the territory of Russia to Western Europe giving Russia the chance to keep the Central Asian countries dependent and accessible to Russian influence.<sup>59</sup>

For the United States of America access to natural gas from the Caspian Sea is not as easy. Not only are pipelines from the Caspian Sea to the Indian Ocean needed but infrastructure to cool down and liquefy natural gas also needs to be constructed. A necessary condition is some degree of political stability in the countries in Central Asia – maybe one reason why the US is strongly involved in Afghanistan and Pakistan and why political disputes towards Iran have not yet turned into military conflicts.

For both the US and Russia, it was important to ensure political stability in Central Asia – for the Russians since they wanted to keep a steady producer-distributor relationship, for the US because they wanted to establish one. However, the economic prospects in Central Asia after

<sup>56</sup> Although Yeltsin claimed that he alone made all the decisions concerning Chechnya, between the lines one can read in his memoirs how much Yeltsin was influenced by his security advisors on these issues. Yeltsin (2000), p. 58

<sup>57</sup> Speech by Sergei Yasthrhembki, Assistant to the President of Russia in Körber (2001)

<sup>58</sup> See Russett (1998), Croft (2000), Lynch (2004), Lieber (2006), Sushko (2004), Orlov (2005), Hunter (2000), Odom (1998), Seward (2005).

<sup>59</sup> Donaldson (1998), pp. 170n for a description of Russia's interest in the Near Abroad. Mandelbaum (1991), p. 12 describes how political tensions broke out immediately after the disintegration of the Soviet Union (for instance between Armenia and Azerbaijan) and led to a disturbance in the trade relations. Cox (1994), p. 645 describes how Russian involvement in Central Asia could stop the Islamic Fundamentalism. See also Kortunov (1996) for a description of the Russian geo-strategic approach towards Central Asia and its perception as an Asian superpower.

1991 were not very promising. Weak economic growth after the economic collapse in 1991 increased the possibility of 'weak state spillovers' – in other words, the fear of political instability caused by political and economic problems and transcending the borders of the Central Asian countries.<sup>60</sup>

What would be the best possibility to ensure political stability in Central Asia? It seems that the strategies of Russia and the US are relatively similar: provide long-term trade relations, support incumbent governments, integrate the countries in regional and global economic institutions (such as CIS or WTO), and station military forces in these countries.<sup>61</sup>

Since the ownership of some of the gas sites in the Caspian Sea is still disputed, only an institutional framework that involves all major players (the G8 and the Central Asian countries) can solve the ownership question and provide a stable background for the exploitation of the natural gas. With NATO expansion into Central Asia, such a background could be provided; thus, the expansion of NATO towards Central Europe was only the first step of NATO expansion.

Even though Russian leadership first resented NATO expansion precisely for that reason, the economic interdependencies eventually convinced Russian leadership that political control over Central Asia would be possible with having Russian and NATO (primarily American control) over Central Asia. The global security regime evolved together with the gas-interdependencies between Europe and Russia. Russia's incorporation into the global security regime is only confirmed by the G8 admission. The next step then is the admission of Russia to NATO. This could help also to improve training, equipment, and the overall condition of the Russian military. The third step would be NATO expansion to Central Asia.<sup>62</sup>

The Russian resistance in the middle of 1990ies and the indifference in the late 1990ies towards NATO expansion can be understood by the fact that, through cooperation in the Kosovo conflict in 1999 and in Afghanistan in 2002, Russia gained a perspective of being a vital component in the Western security design and a guaranteed influence in Central Asia. So, in fact, Russia's G8 admission was not a trade-off for NATO expansion but only served to strengthen the relation between NATO and Russia.

<sup>60</sup> MacFarlane (2004), pp. 119 on EU strategy to Central Asia.

<sup>61</sup> Talbott (2002), p. 240 explains how Clinton avoids making concessions to Yeltsin on halting NATO expansion and not including the Central Asian countries. See also Mandelbaum (1996) for a discussion of Russia's security interest in Central Asia.

<sup>62</sup> See for a description of the current development in Siberian and Caspian Oil and Gas fields Preuss (2005), pp. 21-57

## G - The Energy Dimension

### Russia was admitted to the G7 to ensure a steady supply of natural gas to Western Europe.

The previous chapters indicated that an explanation for Russia's G8 admission needs to incorporate historical, institutional, political, economic, and security-related aspects. The energy dimension described in this chapter incorporates all these aspects.<sup>63</sup>

## 1. The World Oil and Gas Market

### Availability

Oil and gas are the main resources for producing energy but they are also needed in various chemical processes to construct synthetic materials for endless industrial applications (fibers to textiles to pharmaceuticals).

In the industrial countries since early industrialization up to the 19<sup>th</sup> century energy was mainly produced using coal and wood – which, to a great extent, was locally produced and consumed. At the turn of the century increasing global trade also increased the global trade of energy raw materials. Industrial innovations, like the internal combustion engine and chemical innovations like oil refinery techniques, made oil and gas more efficient than coal and wood. Transportation for civil, economic, and military purposes, chemical processes, and the provision of energy and heat soon became dependent on these two materials.<sup>64</sup>

In theory, oil and gas are local resources just like coal and wood. The initial global distribution would have allowed all major industrial countries to use their own resources for their economic purposes – at least for a while. But in practice the costs of retrieving the natural resources determined the exploration sites and trade flows.

Oil and gas are often exploited together (because oil and gas are both created by applying pressure to decayed organic products). They, nevertheless, have very different economic characteristics. If oil is found, gas is often found as well since gas gathers at the top of an oil site. Gas on the other hand is not necessarily found together with oil. Therefore, oil producers are often also gas producers, while gas producers are not necessarily oil producers.

Like any raw-material market (but unlike most markets), the theoretic trade volume of oil and gas has an upper limit because of limited worldwide deposits, so in theory as reserves shrink and demand stays constant, prices should go up. However, the world prices for oil and gas are not so much determined by the available world reserves but by the current costs for retrieving and refining oil and gas. The limits of oil and gas production are set by the production methods, not by the natural resources. Higher prices result in making expensive retrieval costs more feasible – which in turn increases supply and decreases the prices.

The long-term price of oil is determined by supply and demand but the short-term price is often set by other considerations; such as speculation, political insecurities, or actions of the OPEC cartel. To some extent this is true for the price of gas as well because the gas price is partially linked to the oil price. But since there is no gas cartel, at the moment, political considerations have less influence on short-term prices. Nevertheless, as seen in the dispute over gas prices between the Ukraine and Russia at the beginning of this year, political considerations do play a role in determining trade relations. The difference is due to the different means of transportation.

### Trade

Oil is easier to transport because it has a higher density than gas. Oil can simply be filled into oil tankers; gas needs to be cooled down to be made into liquid (so called LNG) and then can be transported via tankers. An easier and less costly method is to use a pipeline in which the gas pressure is artificially increased. The high pressure makes the gas molecules move many kilometers so long distances can be bridged at relatively little costs. Yet, the initial costs of estab-

<sup>63</sup> For an comprehensive and detailed historical analysis about the relevance of energy and especially oil in International Relations see Yergin (1993)

<sup>64</sup> I have drawn most of the information in this chapter from various sources Maull (1980), Maull (1981), OECD/IEA (1986), pp.9n, OECD/IEA (1991), Yergin (1993), Mussa (2000), IEA (2002) Finon (2004), Preuss (2005), Dronnikov (2005)

lishing pipelines are very high and bind producers and consumers for a number of years.

For oil producers the production volume and the transportation costs are correlated; therefore, increases and decreases of oil production can be adjusted to the markets. Gas producers on the other hand have to bear the maintenance costs of the pipelines regardless of their production volume. Therefore, the incentives to decrease or increase gas production are given by long-term expectations of demand – not so much by the short-term considerations of the market price.

Because of these differences the oil market is a very liquid market while the gas market is very rigid. For markets to exist, prices have to be allowed to form in response to demand and supply. Free prices can only exist if consumers and producers can (threaten to) leave the market and competing consumers and producers can (threaten to) enter the market either increasing demand or supply.

Within the gas markets both threats are not very likely because the long-term considerations for production are also effective for the trade relations between the gas producers and consumers. Consumers in the oil market can switch to another producer quite easily and producers in the oil market can send their supply to other consumers quite easily – both just have to reroute the lines of transportation. In the gas market the pipeline establishes a binding trade relation from which the consumer cannot deviate.

Since infrastructure investments are very high and the most feasible transport is through pipelines, long-term trade relationships, usually having a range of 20 to 30 years, have developed. Both producers and consumers of gas can be considered as oligopolies since changing a market partner is often not possible (even in the long-term).

The oil market on the other hand has a real diverse market structure. In some parts of the production process (shipping, refining) the market is very split up; in consumption and production the market has the same monopolies as the gas market. The oil market prices are formed by the arbitration of supply and demand – although increasingly other aspects (political turmoil, rumors, behavior of the spot market) influence the price as well.

Since most oil-producing countries have joined OPEC and since most oil consuming countries have drafted emergency measures in the framework of the IEA in case of oil shortages, the price can at least partially be influenced by the governments. Trade relations on the gas market are more amenable to the influence of governments; therefore, prices are less volatile.

## 2. An Alternative Story of the G7

Energy as  
Motivation  
for the G7

In the third chapter, I have sketched the G7 as the industrialized countries' response to global transformations. In fact, the developments on the energy markets provide a good explanation for the emergence of the G7. Until the 1970ies, the interdependence between the industrial countries in the West and the Arabian oil-producing countries posed no problems. While the Arabian countries produced the crude oil, the industrial countries had the technical expertise to refine the oil and produce the end products. This resulted in stable prices, stable investments, and stable consumption. Due to political and economic reasons in the early 1970ies the oil-producing countries reduced their production, which, in turn, increased prices and caused inflation in the industrial countries. Political leaders in the West had to find emergency strategies, coordinate their macro-economic policies, and diversify their energy sources.

To diversify their needs the industrialized countries increasingly relied on natural gas. For the Western European countries this meant to use natural gas from the Soviet Union as one of their main sources. However, the shift from Arabian oil to Soviet gas was difficult for ideological, political, and economic reasons. The global trade market had to be adjusted and a more flexible global capital market had to be established to finance the increasing investments needed for retrieving gas.

This was the driving force behind creating the G7 in the middle of the 1970ies. Only in the informal framework of the head of states the Western countries could they quietly but effectively develop a new energy strategy. Unsurprisingly energy was on the agenda of almost each G7/G8 summit since 1975.

The issues related to energy security discussed in the 30 years of the G7/G8 summits can be separated into four areas: first, the supply and price of energy sources (oil, natural gas, coal and nuclear power); second, the demand for energy, energy efficiency, energy conservation, and the availability of renewable energy sources; third, nuclear safety, especially the transfer and use of nuclear material and the safety of nuclear power plants; fourth, energy trade such as Soviet gas trade with Europe and Japan and, recently, Russia's energy pricing as a point of dispute in Russia's WTO accession.<sup>65</sup>

The issue of energy supply was the most important one in the first phase of the G7 summits. The G7 allowed the leaders to overcome a classic prisoner's dilemma on the world energy market. Each country wanted to decrease oil consumption in order to get a lower world price for oil. However, to curb oil imports would also yield in reduced productivity for each country individually. If all oil consumers reduced their oil inputs, the relative productivity of each country's industry would not decline. However, if one country would have defected by omitting to reduce oil imports it could have free-ridden on the actions of the others and enjoy economic growth and low import prices.

Before the G7 summits were established, other instruments such as International Energy Agency and Emergency mechanisms for oil shortages were developed but were not very successful. The G7 as an institution was more successful because macro-economic, financial, and energy issues could be linked in the discussions. The connection of cross-topics agreements reduced the incentives for defection for all participants.<sup>66</sup>

### Informal or Institutional?

The development of the G7 in the second half of the 1970ies mirrored the search for the right institutional setting for discouraging defection. The G7 summits underwent the institutional metamorphosis from an informal summit to an administrated institution.

The informal summits from 1975-1978 were a response to the aftermaths of the first oil crisis in 1973: public debts were used for investments and aimed at combating the effects of the starting recession. The first four summits showed that the G7 could successfully work together through the informal process. By 1978 the G7 countries had recovered from the first oil shock and imbalances of external trade and deficits were corrected. The informal mode worked on very precarious issues even though the G7 members had conflicting short-term goals but converging long-term goals.

Yet, the most disputed issue (decreasing the oil consumption) could not be solved in the informal setting of the G7. Only after the 1979 oil crises and the increasing institutionalization of the G7 some agreements on oil consumption could be reached.

The second oil-crisis was spurred when the fall of the Shah in Iran interrupted oil exports once again and led to high oil prices. The supply reduction was no more than five percent of the IEA countries supplies (about 2.5 million barrels per day) but did not trigger the emergency measures agreed before - the IEA countries had only agreed to initiate the oil-sharing mechanism if the supply would fall by seven percent. Also, low oil prices before 1978 had caused an investment gap in the oil infrastructure. The market's uncertainty on supply security showed in high spot prices. Neither the low-price-regime of the OPEC system nor the informal G7 summitry could prevent the markets' reaction to the political and economic developments.<sup>vii</sup>

The summits from 1979 slowly managed to commit themselves to reducing oil imports. Only after the G7 leaders agreed to use monetary coordination instead of the fiscal policies to combat the starting recession and through low-inflation policies could they substantially reduce the high oil prices - but at the expense of economic growth and a longer recovery period. Nevertheless, the summits in the early 1980ies showed that with the increased institutionalization the

<sup>65</sup> For a comprehensive list of treatment of the energy question see Laura Sunderland's compilation in Kirton (2005) or the review of Panova (2006). The problem is that the Communiqués in the middle of the 1980ies and early 1990ies only partially reflect what was discussed at the summits by the head of states due to an increasing tendency to draft considerable parts of the Final Communiqué weeks ahead of the summit.

<sup>66</sup> The political leaders tried to coordinate their energy strategies between 1973 and 1975 but often failed to agree because of diverging macro-economic interests. They only agreed upon the establishment of the International Energy Agency (IEA) as a counter-mechanism for OPEC. Only when financial, macro-economic, and energy issues were discussed in the same framework then agreements could be reached. Garavoglia (1984), pp. 4-6; Kirton (2001b)

economic problems of high oil-prices could be tackled.<sup>67</sup>

#### Trade Disputes

However, the only method of reducing oil imports permanently was the substitution of oil through other energy carriers. Even though the G7 countries had developed alternative energy sources in the 1960ies, the oil crises in the 1970ies urged the Western countries to look for new energy sources. In all G7 countries the answer was natural gas. For instance, the US developed its own gas infrastructure with a pipeline to Alaska. Western Europe and Japan relied on gas imports from the Soviet Union.

Notwithstanding the beneficial aspects of increased gas trade (and less dependency on the oil price), the increasing gas trade with the Soviet Union had political and security aspects. For the Americans it endangered their strategy of containing the Soviet Union, for Western Europe such containment could not be upheld with the increasing reliance on Soviet gas. The G7 heavily disputed the question of gas trade and could only find consensus at the G7 summit in Williamsburg 1983 by agreeing on import quotas for Soviet products.

Even though the Soviet gas trade increased as much as was possible with these quotas, at the same time the oil price dropped considerably because of the effects from the recessions in the 1980ies and the G7's efforts to curb oil imports. This decreased the revenue of the Soviet Union from exporting oil. The Soviet economy, heavily dependent on both oil and gas exports, was not able to pay their foreign debts and finally collapsed in the late 1980ies.<sup>68</sup>

The collapse of the Soviet Economy put energy back on the agenda in the late 1980ies/early 1990ies. Gas supply dropped and threatened to worsen the global stagnation in which the world economy of the early 1990ies had moved. Efforts were made to strengthen the Russian economy. The G7 in particular thought about how to improve trade relations with Russia and to stabilize gas consumption in Europe.

#### Interdependency

The G7 feared that without ensuring the continuing consumption of Russian Natural Gas, the reform efforts of Russian leadership would have been in vain.

To facilitate the Russian supply, the Russian leadership, on the other hand, had to refrain from any economic reforms that would threaten the stability of the gas sector in Russia – especially it would have to prevent that privatization of the gas sector would lead to outside control of the gas supply.<sup>viii</sup>

This meant that the gas sector became the dominant sector in the Russian economy – which then tied the hands of the Russian political leadership. Even more, Russia's political maneuvering space from then on depended on the world price of gas. In other words: Russian reforms could only be achieved by a strong central power in Russia that was depended on the gas price.<sup>69</sup>

Given Russia's historic need for a strong central power, these systematic weaknesses could only be overcome by admitting Russia to the G7. Only here the development of the Russian economy, the world gas market, and the global economic situation could be tailored accordingly to ensure the ongoing supply of Western Europe with Russian gas. Since political stability in Russia was crucial to the stability of the gas sector in Russia, the G7 leaders did everything they could to ensure political stability – even if it meant to temporarily delay the development of a democratic society or a market economy in Russia.

<sup>67</sup> For a description of the early summits see Merlini (1984), Putnam (1987), Hajnal (1999)

<sup>68</sup> Putnam (1987), p. 140, 178; Mandelbaum (1991), pp. 9n describes how Soviet growth in the 1960ies still averaged about 8 percent in the 1960ies, but dropped to 3 percent less at the beginning of the 1980ies due to the decreasing oil price at that time.

<sup>69</sup> Aslund (2005) writes that if the oil price exceeds 27 USD then ninety percent of the revenue goes into the state budget which then enlarges the government's ability to fund its programs. Rumer (2003): Besides being the largest producer of Natural Gas and facing an increasing demand, many former Soviet republics in Central Asia have to use the Russian pipeline-system to transport their oil and gas to Europe. Countries like Ukraine and Belarus rely on the fees for the transit of the gas. Thus, Russia's decision on how the pipeline-system is used has large effects on its neighbors.

## H - Conclusion

In the last few chapters I have tried to explain the peculiarity of Russia's political and economic institutions and how they have interacted with global institutions, in particular with the G8. Although many of the raised issues need further elaboration and more research, I have tried to highlight some of the possible explanations for Russia's admission to the G8.

We have seen that Russia is a superpower – but not necessarily a Western superpower. In fact Russia differs in many categories from the other G8 members – economically, politically, and culturally. On the surface this can be seen as an obstacle to further integration into the Western institutions. In reality, the fact that Russia's similarity to a centralized company, using its competitive advantage of vast energy resources to strengthen its position in the world, has often helped its integration into the Western institutions.

The West, dependent on Russia, but more happily depending on Russian gas than on Arabian oil, have let Russia join their game – they have allowed a one-sided and distorted economy and the emergence of an authoritarian and only partial democratic state in expectation of political and economic stability. My analysis showed that Russia's admission to the G7 did not have the aims of introducing democratic and market institutions. Russia's admission helped to further the security-related and energy-related interests of the Western European countries.

The G8, despite its public statements, is not on the verge of becoming a forum of global governance. Its ambitions and influences are not developed enough to issue coherent global governance. The G8 summit in St. Petersburg will underline this tendency. Despite public attention generated through forums with civil society, the most precarious issues will be discussed and shaped by the (egoistic) interests of the countries.

Is that necessarily a negative development? So far, the G8 countries have been able through inserting their own interests in the negotiation process to create some collective goods from which also other countries and the global economy are profiting. The positive spillovers from the G8 policy coordination are beneficial for other developed countries, for the emerging countries, and, to some extent, also for developing countries.

However, in the long run, this method might be exhausted. The issue of energy security will play a vital role in determining whether the G8 will be successful in negotiating energy security. There are lots of points for common interest, such as a stable supply and demand of Russian gas. However, there are also lots of points of disagreement – for instance, the flow of profits generated from the gas trade. The liberalized European gas market will increase the tensions – since competition reduces prices and revenues but also allows companies like Gazprom to horizontally integrate itself in the European Gas Market.

Such increasing monopolistic powers, already seen in the gas price dispute between Ukraine and Russia at the beginning of the year, have to be harnessed. The G8 might provide the right institutional setting for harnessing the company but only if Russia allows the Gazprom to become an asset of strategic importance for *all* G8 members – not just the strategic asset for Russia. But this can only be done if Gazprom is allowed itself to become a true multinational corporation. However, this challenge has to be faced by the Russian society – it has to become a society in which the world is not seen as a zero-sum game between the superpowers.

At the moment it seems that the political climate in Russia encourages this kind of zero-sum thinking. Also the world markets are giving signs towards such zero-sum thinking, especially when it comes to developing alternative sources of energy in which, at the moment, Russia does not play a large role. Here the Russian leadership could show its strength by explaining and promoting international interdependence. However, as of right now, the increasing strength of the Russian presidency discourages exactly those people that might promote the benefits of international interdependence.

Therefore, the challenge for the G8 summit's next cycle and for each member country (in particular Russia) is to strengthen domestic support for international interdependencies.

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## 2. Articles

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**Financial Times** (2006:01:04). Gas pressure: why Putin is squandering world prestige in his squabble with Kiev. Authors: Neil Buckley, Thomas Catan. London (UK): January 4<sup>th</sup> 2006. p. 15.

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**Financial Times** (2006:05:17). Russia's G8 energy hopes. Author: Neil Buckley. London (UK): May 17<sup>th</sup> 2006. p. 6

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## 3. Internet Resources

All websites were accessed on June 11<sup>th</sup> 2006

### a. G8 Research Group

Russia: Objectives for the Summit (1997 Denver Summit)<sup>70</sup>  
<http://www.g8.utoronto.ca/evaluations/1997denver/russia/object.htm>

Final Communiqué Denver 1997  
<http://www.g8.utoronto.ca/summit/1997denver/g8final.htm>

<sup>70</sup> All accessed on June 12<sup>th</sup> 2006

Final Communiqué Birmingham 1998  
<http://www.g8.utoronto.ca/summit/1998birmingham/finalcom.htm>

## b. Wikipedia

London Club  
[http://en.wikipedia.org/wiki/London\\_Club](http://en.wikipedia.org/wiki/London_Club)

Mikhail Khodorkovsky  
[http://en.wikipedia.org/wiki/Mikhail\\_Khodorkovsky](http://en.wikipedia.org/wiki/Mikhail_Khodorkovsky)

Natural Gas Prices  
[http://en.wikipedia.org/wiki/Natural\\_gas\\_prices](http://en.wikipedia.org/wiki/Natural_gas_prices)

Natural Gas  
<http://www.energy.ca.gov/naturalgas/index.html>

OECD  
[http://en.wikipedia.org/wiki/Organisation\\_for\\_Economic\\_Co-operation\\_and\\_Development](http://en.wikipedia.org/wiki/Organisation_for_Economic_Co-operation_and_Development)

Old Believers (Altgläubige)  
[http://en.wikipedia.org/wiki/Old\\_Believers](http://en.wikipedia.org/wiki/Old_Believers)

Paris Club  
[http://en.wikipedia.org/wiki/Paris\\_Club](http://en.wikipedia.org/wiki/Paris_Club)

Russia  
<http://en.wikipedia.org/wiki/Russia>

Russian Economy  
[http://en.wikipedia.org/wiki/Economy\\_of\\_Russia](http://en.wikipedia.org/wiki/Economy_of_Russia)

Russian Rivers  
[http://en.wikipedia.org/wiki/Rivers\\_of\\_Russia](http://en.wikipedia.org/wiki/Rivers_of_Russia)

Russian serfdom  
[http://en.wikipedia.org/wiki/Russian\\_serfdom](http://en.wikipedia.org/wiki/Russian_serfdom)

Russian Transportation  
[http://en.wikipedia.org/wiki/Transportation\\_in\\_Russia](http://en.wikipedia.org/wiki/Transportation_in_Russia)

Sunk Costs  
[http://en.wikipedia.org/wiki/Sunk\\_cost](http://en.wikipedia.org/wiki/Sunk_cost)

There is no such thing as a free lunch (TANSTAAFL)  
<http://en.wikipedia.org/wiki/TANSTAAFL>

## c. IMF

Russian Federation: Transactions with the Fund from May 01, 1984 to April 30, 2006  
[http://www.imf.org/external/np/tre/tad/extrans1.cfm?memberKey1=819&endDate=2006%2D06%2D20&finposition\\_flag=YES](http://www.imf.org/external/np/tre/tad/extrans1.cfm?memberKey1=819&endDate=2006%2D06%2D20&finposition_flag=YES)

## d. World Bank

Russian Federation: Country Brief 2006  
<http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/RUSSIANFEDERATIONEXTN/0,contentMDK:20565202-menuPK:517666-pagePK:1497618-piPK:217854-theSitePK:305600,00.html#4>

## e. OECD

The G8 and OECD work  
<http://www.oecd.org/g8>

OECD and Russia  
[http://www.oecd.org/departement/0,2688,en\\_2649\\_34681\\_1\\_1\\_1\\_1\\_00.html](http://www.oecd.org/departement/0,2688,en_2649_34681_1_1_1_1_00.html)  
<http://www.oecd.org/ccnm/russia>

## f. Paris Club

Agreements with Russian Federation as a Participating Creditor Country  
[http://www.clubdeparis.org/en/countries/countries.php?INDICE\\_DET=31](http://www.clubdeparis.org/en/countries/countries.php?INDICE_DET=31)

Russian Federation list of the debt treatments  
[http://www.clubdeparis.org/en/countries/countries.php?CONTINENT\\_ID=europe\\_asie\\_en&PAY\\_ISO\\_ID=RU](http://www.clubdeparis.org/en/countries/countries.php?CONTINENT_ID=europe_asie_en&PAY_ISO_ID=RU)

Members of the Paris Club  
<http://www.clubdeparis.org/en/presentation/presentation.php?BATCH=B04WP02#1>

Description of the Paris Club  
<http://www.clubdeparis.org/en/presentation/presentation.php?BATCH=B01WP01>

News: Russia wants to pay debts advance of their time  
[http://www.clubdeparis.org/en/news/page\\_detail\\_news.php?FICHIER=com11473449330](http://www.clubdeparis.org/en/news/page_detail_news.php?FICHIER=com11473449330)

### g. Other Sites

International Energy Agency – Energy Statistics  
<http://www.iea.org/statist/index.htm>

Debt Restructuring Clubs  
<http://www.iif.com/ipi/sovereign.quagga>

Debt Figures for Russia  
<http://pnwccs.pnl.gov/ProgramAreas/DFN/DebtFigs.htm>

## J - Appendix

### 1. General Data

Table 1: G7/G8 Summits<sup>71</sup>

Date	Venue	Topics	Hosting Rotation	Agenda	Institutional Development
1975	Rambouillet (France)	Monetary Issues, Oil Prices, GATT	First Cycle	Ambitious economic policies	Meeting of leaders and finance ministers
1976	San Juan, Puerto Rico (USA)	Balance-of-payment problems			
1977	London I (UK)	(Nuclear) Energy			
1978	Bonn I (Germany)	Growth, Energy			
1979	Tokyo I (Japan)	Energy			
1980	Venice I (Italy)	Energy	Second Cycle	Non-economic foreign policy issues	Regular Meetings of Foreign and Trade Ministers
1981	Ottawa (Canada)	Trade, Aid to developing countries, East-West-Trade			
1982	Versailles (France)	East-West Trade, Surveillance of monetary policies by IMF			
1983	Williamsburg (USA)	Debt crisis, Arms Control			
1984	London II (UK)	Debt crisis, terrorism			
1985	Bonn II (Germany)	Trade, Environment			
1986	Tokyo II (Japan)	Agriculture, Trade, Terrorism			
1987	Venice II (Italy)	Terrorism			
1988	Toronto (Canada)	Debt relief	Third Cycle	Transnational issues	Post-summit meeting with Russia, Meetings of Environment Ministers, Ad hoc Ministerial
1989	Paris (France) – Summit of the Arch	Debt relief, Human Rights			
1990	Houston (USA)	Soviet Economic Reforms, Proliferation of Weapons			
1991	London III (UK)	Help for USSR			
1992	Munich (Germany)	End of East-West conflict			
1993	Tokyo III (Japan)	Jobs and growth			
1994	Naples (Italy)	Involvement of Russia, WTO			
1995	Halifax (Canada)	Reform of IMF	Fourth Cycle	Reforming international institutions	Inclusion of international institutions
1996	Lyon (France)	Development			
1997	Denver (USA) – Summit of the Eight	Help for Africa			
1998	Birmingham (UK)	Employability			
1999	Cologne (Germany)	Debt Relief, Conflict Prevention	Development, Terrorism, Security		Leaders Only Summits
2000	Okinawa (Japan)	Information Technology (IT)			
2001	Genoa (Italy)	Poverty beyond debt relief			
2002	Kanaskakis (Canada)	Security, Africa	Sixth Cycle	Energy	
2003	Evians (France)	Security, Africa			
2004	Sea Island (US)	Security			
2005	Gleneagles (UK)	Development and Debt Relief			
2006	St. Petersburg (Russia)	Energy, Education			
2007	Helligendamm (Germany)	?			

<sup>71</sup> Hajnal (1999), pp. 19,57n, Bayne (1998), Garavoglia (1994), Maull (1994), Kirton (1995), Bergsten (1996)

Table 2: G7/G8 Voting Power in World Bank and IMF in 1999 (and 2006)<sup>72</sup>

Country	Percent of IMF Votes	Percent of World Bank Votes (IBRD)
United States of America	17.78 (17.08)	16.68 (16.39)
Japan	5.53 (6.13)	8.00 (7.86)
Germany	5.53 (5.99)	4.57 (4.49)
France	4.98 (4.95)	4.38 (4.30)
United Kingdom	4.98 (4.95)	4.38 (4.30)
Italy	4.02 (3.25)	3.47 (2.78)
Canada	3.72 (2.94)	3.91 (2.78)
Russia	2.90 (2.74)	2.83 (2.78)
<b>Total G7</b>	<b>46.54 (45.29)</b>	<b>45.39 (42.90)</b>
<b>Total G8</b>	<b>49.44 (48.03)</b>	<b>48.22 (45.68)</b>

As can be seen in Table 2, the admission of Russia to the G8 enhanced the voting power only by three percent. Italy, Canada, Russia, China, Brazil and India have around three percent voting rights in both international bodies.

## 2. Economic Data

### a. Macroeconomic data

Table 3: Macroeconomic data for Russia<sup>73</sup>

	2000	2001	2002	2003	2004
GDP – Change in percent	10.0	5.1	4.7	7.3	6.8
GDP per Head in billion USD	1786	2140	2410	3046	3862
Industrial production in percent	11.9	4.9	3.7	7.0	6.9
Unemployment in percent	9.9	8.7	9.0	8.7	7.4
Inflation in percent	20.2	18.6	15.1	12.0	11.6
Exports in billion USD	105.0	101.0	107.3	135.9	168.0
Imports in billion USD	44.9	53.8	61.0	75.4	66.6
Foreign Debt in billion US	143.4	133.1	123.5	119.7	117.9
Foreign Debt in percent	55.3	44.4	36.2	25.7	25.2
Currency reserves incl. gold in USD	28.0	36.6	47.8	76.9	100.1

Table 3 shows the macro-economic trends since 2000 and the recovery of Russian economy.

Table 4: Country shares of total G-20 output (in percentages)<sup>74</sup>

Country	1960	1980	2002	2025p <sup>75</sup>	2050p
United States	46	31	33	24	15
EU-4	26	30	25	16	7
Japan	15	21	20	11	4
Australia+Canada	2	4	4	3	2
<b>Industrial countries</b>	<b>89</b>	<b>86</b>	<b>82</b>	<b>54</b>	<b>28</b>
China	1.5	1	4	15	20
India	1.5	1	2	5	15
Korea	0.5	1	2.5	6	10
Brazil	2.5	3	3	4	5
Russia	-	3	3	4	3
Others in G-20 <sup>76</sup>	5	5	5	13	20
<b>Emerging markets</b>	<b>11</b>	<b>14</b>	<b>18</b>	<b>46</b>	<b>72</b>

Table 4 shows how world output has changed in the last 50 years, indicating that the G7 countries are losing their shares in the world output. Emerging economies will produce most of the output in 2050, however Russia will not be the most significant player among the emerging economies.

<sup>72</sup> Hajnal (1999), p. 53. Italy and Canada includes a small number of votes cast on behalf of other countries.

<sup>73</sup> Raketic (2005), p. 7 2004 only first ten month, Meier (2001), p. 191

<sup>74</sup> Bergstren (2000) quoting Goldman Sachs, Global Economic Paper No. 99, October 2003;

<sup>75</sup> Projected using growth rates of other G-20 emerging market economies.

<sup>76</sup> Argentina, Indonesia, Mexico, Saudi Arabia, South Africa, and Turkey;

Image 1: Russian GDP, fiscal revenues, the real exchange rate and oil prices<sup>77</sup>

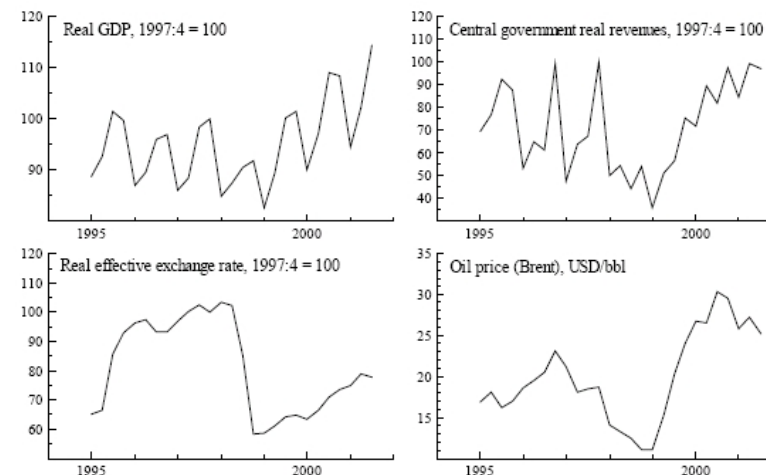


Image 1 shows the correlation between GDP and fiscal revenues and how the drop in the effective exchange rate together with an increase in the oil prices has resulted in the recovery of the economy after 2000.

### b. Trade

Table 5: Foreign trade of Soviet Union 1922/1950-1985)<sup>78</sup>

	1922	1940	1950	1960	1970	1975	1980	1985
<b>Export in Million Rubles</b>			1615	5007	11520	24034	49634	72463
% socialist countries outside COMECON			27.9	19.7	11.1	5.1	5.2	5.8
% socialist countries inside COMECON			55.7	56.0	54.3	55.6	49.0	55.3
% industrialized countries			14.6	18.2	18.7	25.5	31.9	25.6
% developing countries			1.8	6.1	15.9	13.8	13.8	13.2
% Machines	0.2	2.0	12.3	20.7	21.5	18.7	15.8	13.6
% Energy Materials	7.8	13.2	3.9	16.2	15.6	31.4	46.9	52.8
% Metals	4.4	4.1	10.8	20.2	19.6	14.3	8.8	10.2
% Chemicals	1.6	3.0	4.0	2.9	3.5	3.5	3.3	3.8
% Wood	16.2	6.4	3.1	5.5	6.5	3.5	4.1	3.0
% Textiles	20.2	18.1	11.2	6.2	3.4	5.7	1.9	1.9
% Agricultural Products	33.3	27.2	21.1	13.1	8.4	2.9	1.9	1.6
% Consumption Goods	1.2	7.8	4.9	2.9	2.7	3.1	2.5	2.1
% Others	15.1	18.2	28.7	12.3	18.8	15.6	14.8	11.0
<b>Imports in Million Rubles</b>			1310	5066	10558	26671	44463	69101
% socialist countries outside COMECON			18.7	20.6	8.1	4.1	5.0	6.6
% socialist countries inside COMECON			59.4	50.1	57.0	48.3	48.2	54.5
% industrialized countries			15.6	19.8	24.0	36.4	35.4	27.9
% developing countries			6.3	9.5	10.8	11.2	11.4	11.0
% Machines	21.4	32.4	22.4	31.1	35.6	33.9	33.9	37.2
% Energy Materials	3.8	6.5	11.8	4.2	2.0	3.9	3.0	5.3
% Metals	8.8	26.6	14.1	15.6	9.6	11.6	10.8	8.4
% Chemicals	14.8	4.3	6.9	6.0	5.7	4.7	5.3	5.0
% Wood	4.3	2.6	3.8	1.9	2.1	2.2	2.0	1.3
% Textiles	15.5	6.7	7.8	6.5	4.8	2.4	2.2	1.7
% Agricultural Products	14.5	14.9	19.7	13.1	15.8	23.0	24.2	21.2
% Consumption Goods	14.2	1.4	7.4	16.9	18.3	12.9	12.1	12.4
% Others	2.7	4.6	6.1	4.7	6.1	5.4	6.5	7.5

Table 5 shows the importance of raw material in the foreign trade and the increasing importance of trade with the Western European countries.

<sup>77</sup> Rautava (2002), p. 10

<sup>78</sup> Feiguine (2004) p. 50 quoting Gokomstat SSSR, 1986

### c. Investments

Table 6: Foreign direct investment in Russia 1990-1999 in billion USD<sup>79</sup>

Country	Cumulative FDI 1990-1999
USA	4.541
Cyprus	2.727
Germany	1.007
United Kingdom	0.763
Netherlands	0.603
Switzerland	0.309
France	0.172
Italy	0.160
Japan	0.152

Table 6 shows that besides re-investments from Russians (through Cyprus) the G7 were Russia's primary source of foreign direct investments.

### d. Foreign Debts

Russia has four types of external debt: 1) bilateral debt from other governments (represented in the Paris Club); 2) multilateral debt from multilateral financial lending institutions like IMF and World Bank 3) commercial/private debt from commercial banks, individuals, and investment firms (represented in the London Club) and 4) miscellaneous debt owed by official elements in Russia like regional governments, and debt not subject to Paris Club or London Club negotiations.

Table 7: Debt Structure in billion USD in 2000<sup>80</sup>

Lender	Amount	Inherited from FSU
Paris Club	41.2	32.9
Germany	18.1	15.6
Italy	5.8	5.4
France	2.9	2.9
USA	3.3	2.7
Other	11.2	6.4
Non-Paris Club	3.1	
London-Club	21.2	
Foreign Investment Firms	5.8	
Foreign Banks	4.2	
Foreign Hedge Funds	1.0	
Foreign Individuals	1.2	
Russian Entities <sup>81</sup>	11.2	
Non-London Club	36.9	
Multilateral	14.9	
COMECON	12.1	12.1
<b>Total</b>	<b>130.1</b>	

The total debt in 2000 still remained at 130.1 billion USD, but due to the budget surpluses much of the debt could be repaid. For instance the debt to the Paris Club shrunk to 22 billion USD by the end of 2005, the IMF loans were almost paid back in full. In the aftermath of the financial crisis the debt structure changed considerably because of cancellation and restructuring of debts.

<sup>79</sup> Feiguine (2004), p. 110, Meier (2000), p. 9

<sup>80</sup> Meier (2000), DIW (2000a)

<sup>81</sup> Government Organizations, Firms and Individuals

Table 8: Transactions with IMF and World Bank in Million USD<sup>82</sup>

Year	IMF Disbursements	IMF Repurchases	World Bank Disbursements	World Bank Commitments
1992	719			
1993	1078		303	1370
1994	1078		284	1520
1995	3594		142	1741
1996	2587	359	981	1816
1997	1467	359	2085	1715
1998	4600	673	2172	1628
1999	471	3101	657	1930
2000		2189	606	90
2001		2997	455	397
2002		1147	376	351
2003		1356	208	581
2004		1117	220	100
2005		2293	135	205
<b>Total</b>	<b>15594</b>	<b>15591</b>	<b>8624</b>	<b>13444</b>

## 3. Energy Data

Image 2: World Distribution of Oil and Gas<sup>83</sup>

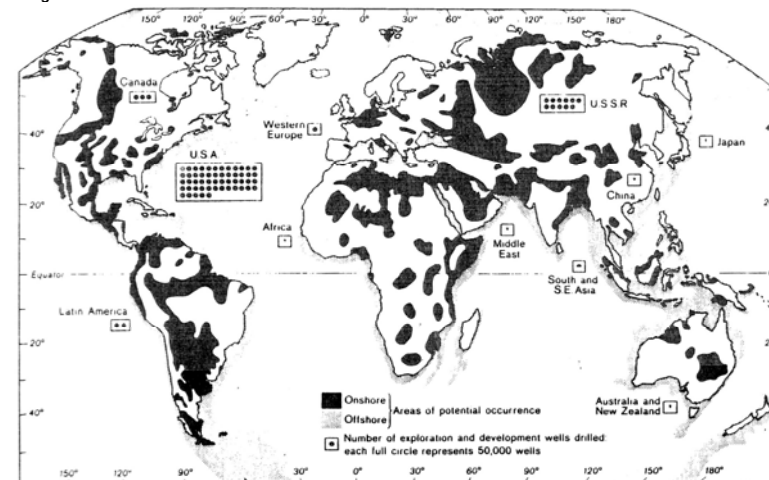
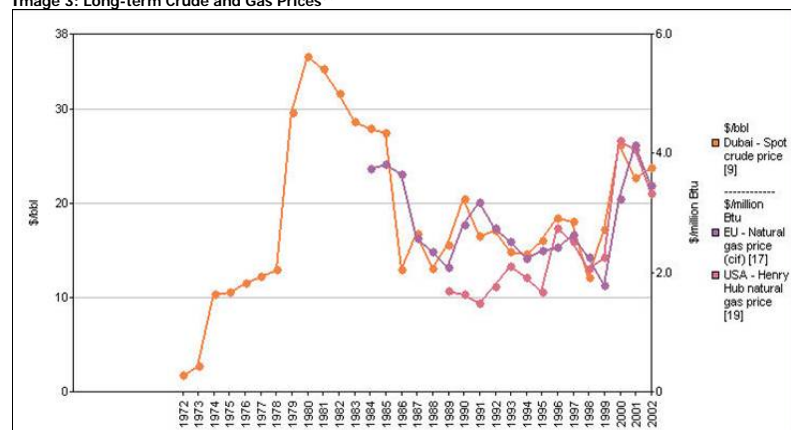


Image 2 shows that oil is available throughout the world and in fact a local resource, but due to differences in the costs of retrieving oil prices the global trade patterns on the oil markets emerged.

<sup>82</sup> IMF: Transactions with the Fund from May 01, 1984 to April 30, 2006

<sup>83</sup> IEA (1986)

Image 3: Long-term Crude and Gas Prices<sup>84</sup>



In Image 3 the correlation of world oil and gas price, the 1973 and 1979 oil crises and the steep drop of gas and oil prices in the 1980ies can be seen.

Table 9: World Primary Natural Gas Demand (bcm)<sup>85</sup>

	2000	2010	2020	2030	Average annual growth 2000-2030 (%)
OECD North America	788	992	1161	1305	1.7
OECD Europe	482	640	799	901	2.1
OECD Pacific	122	168	201	243	2.3
Transition economies	609	748	876	945	1.5
China	32	61	109	162	5.5
East Asia	83	139	200	248	3.7
South Asia	51	96	153	205	4.7
Latin America	105	167	251	373	4.3
Middle East	201	272	349	427	2.5
Africa	53	95	155	239	5.2
<b>World</b>	<b>2526</b>	<b>3378</b>	<b>4254</b>	<b>5048</b>	<b>2.4</b>

Table 10: Reserves, Producers and Consumers of World Natural Gas in 2002<sup>86</sup>

Reserves		Production		Consumption				
Bcm	% of world	bcm	% of world	Bcm	% of world			
Russia	47.570	30.5	Russia	554.9	22.0	USA	667.5	26.3
Iran	23.000	14.8	USA	547.7	21.7	Russia	388.4	15.3
Qatar	14.400	9.2	Canada	183.5	7.3	UK	94.5	3.7
Saudi-Arabia	6360	4.1	UK	103.1	4.1	Germany	82.6	3.3
UAE	6010	3.9	Algeria	80.4	3.2	Canada	80.7	3.2
USA	5190	3.3	Indonesia	70.6	2.8	Japan	77.4	3.1
Algeria	4520	2.9	Norway	65.4	2.6	Ukraine	69.8	2.8
Venezuela	4190	2.7	Iran	64.5	2.6	Iran	67.9	2.7
Nigeria	3510	2.3	Netherlands	59.9	2.4	Italy	63.6	2.5
Iraq	3110	2.0	Saudia-Arabia	56.4	2.2	Uzbekistan	52.4	2.1

<sup>84</sup> Victor (2003)

<sup>85</sup> IEA (2002), p. 110

<sup>86</sup> Zeitl, BP

Image 4: Net Inter-regional Natural Gas Trade Flows, 2000 (bcm)<sup>87</sup>

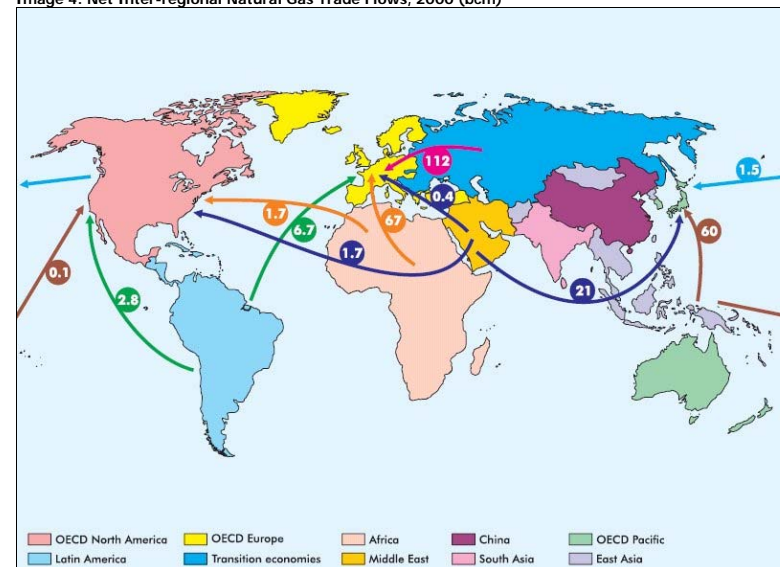
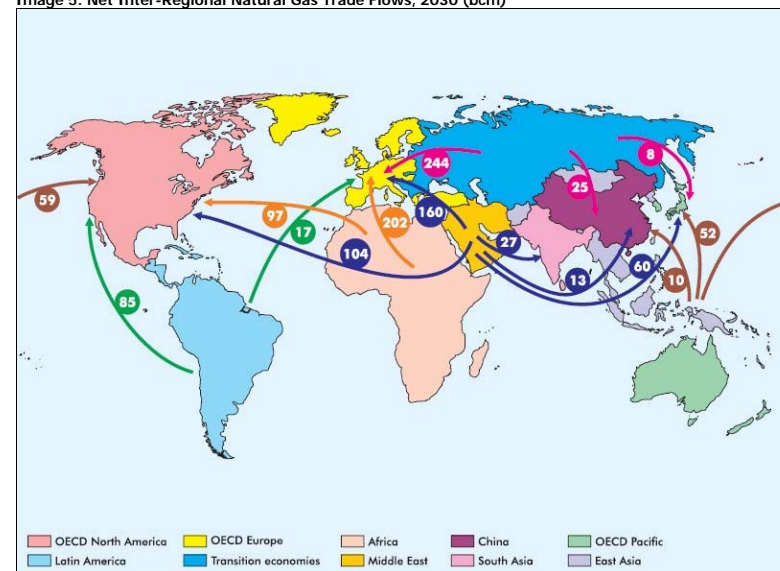


Image 5: Net Inter-Regional Natural Gas Trade Flows, 2030 (bcm)<sup>88</sup>



<sup>87</sup> EIA (2002), p. 119

<sup>88</sup> EIA (2002), p. 120

Image 6: Existing and Planned Gas Pipes from Russia to Europe<sup>89</sup>



Table 11: Major European Recipients of Russian Natural Gas Exports in 2004<sup>90</sup>

Rank	Country	Imports (bcf/year)	% of Domestic Consumption
1	Germany	1110	44 %
2	Italy	777	29 %
3	Turkey	473	65 %
4	France	470	26 %
5	Hungary	378	72 %
6	Finland	269	100 %
7	Slovakia	261	100 %
8	Poland	258	60 %
9	Czech Republic	240	82 %
10	Austria	201	63 %
11	Bulgaria	184	94 %
12	Romania	177	24 %
13	Former Yugoslavia	74	-
14	Greece	74	92 %
15	Switzerland	18	17 %

Table 12: Russian Natural Gas Balance 1992-2008<sup>91</sup>

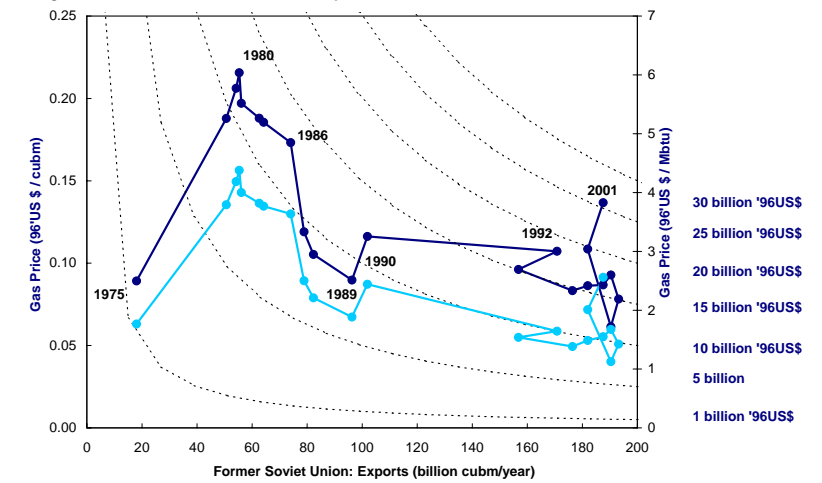
Tcf/y	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005e	2006e	2007e	2008e
Production	22.6	21.8	21.0	21.2	20.2	20.9	20.8	20.6	20.6	20.5	21.0	21.8	22.4	21.7	22.7	22.8	23.4
Consumption	16.5	16.2	15.2	14.5	14.5	13.4	14.0	14.0	14.1	14.4	14.6	15.3	15.3				
Export	6.1	5.6	5.8	6.7	5.7	7.5	6.8	6.6	6.5	6.1	6.4	6.5	7.1				

<sup>89</sup> Bera (2005)

<sup>90</sup> EIA, BP (2005)

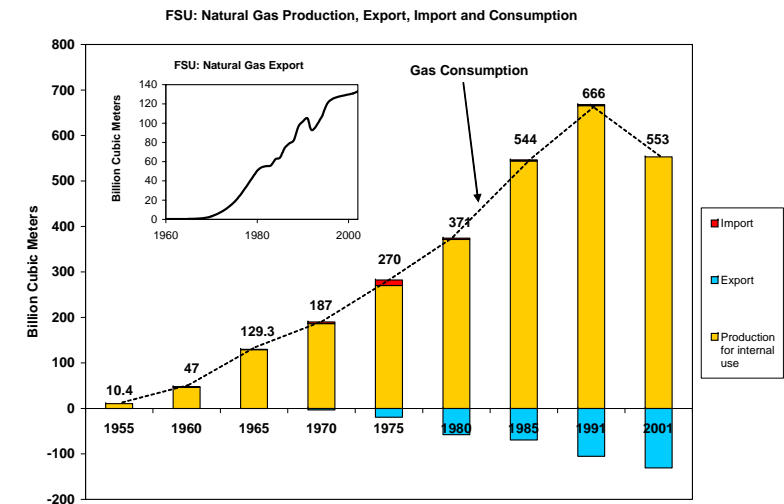
<sup>91</sup> EIA, BP (2005), Interfax, 2006-2008: Gazprom

Image 7: Value of Soviet & Russian Gas Exports<sup>92</sup>



Note: Prior to 1992 FSU export, excludes movements between FSU countries.  
Data source: BP(1975-1990), EIA (1992-2001)

Image 8: Natural Gas Production, Consumption and Exports 1955-2001<sup>93</sup>



<sup>92</sup> Victor (2003)

<sup>93</sup> Victor (2003)

Table 13: Division of Russian Gas Market in 2003, Actors<sup>94</sup>

Division	Volume	Actors	Percent
Reserves	47300 bcm	Gazprom	55 %
		Independent Producers	30 %
		National Reserves Funds	15 %
Exploitation	616 bcm	Gazprom	88 %
		Independent Producers	12 %
Import	2 bcm	Gazprom	100 %
Transport	674 bcm	Gazprom	100 %
Storage	61 bcm	Gazprom	100 %
Distribution	254 bcm	Gazprom	43 %
		Regional and local distributors	57 %
Delivery to end consumers	378 bcm	Gazprom	77 %
		Independent Producers	20 %
		Regional and local distributors	3 %
Export to Europe	129 bcm	Gazprom	100%
Export to CIS	54 bcm	Gazprom	78 %
		Independent Producers	22 %

<sup>94</sup> Dronnikov (2005), p. 98

## K - Notes

<sup>i</sup> I want to try in this paper to avoid **explaining developments in society through personal traits of political and economic leaders**. Such explanations overestimate the role of an individual in a complex network of institutions and decision-making. It also does not yield much clarity for policy recommendations. The growing semi-biographical literature of public figures portraying history as a personal struggle can yield only one interesting insight: whether leaders reflect upon their constraints or not. For examples of how political developments are explained by the personal background see for instance Cox (1994), p.641

<sup>ii</sup> In my attempt to incorporate 'irrationalities' in the decision-making calculus of the decision-maker, I follow Schumpeter's approach of the **political entrepreneur**. Schumpeter (1950) refers to four conditions necessary for a functioning democracy: a class of citizen educated to be political entrepreneurs, a class of responsible administrators, a separation between the sphere of the market and the sphere of the democracy, and mechanism of democratic self-control. How these four conditions apply to Russia I have written in an unpublished essay: Wenzlaff (2005)

<sup>iii</sup> Both the **global** and **local institutions** are characterized by enormous lock-ins – deviations can only be achieved at considerable costs. A lock-in has beneficial and detrimental effects: it reduces uncertainty but discourages institutional innovations. Indeed the global political institutions have relied for more than 300 years on the notion of the sovereign nation-state – since the Westphalia Peace Treaty international institutions are based on distinct geographic entities with a distinct population and a distinct political autonomy. The prevailing global economic institutions on the other hand were characterized by the principles of individual liberty, property rights and market mechanisms – which were the nation-state is less and less able to protect on the global scale. The advent of multi-national corporations, multi-national civic networks and supra-national institutions can be understood as attempts to leave the lock-in created by the reliance on national sovereignty.

<sup>iv</sup> **Soviet Attitudes to Economic activity** are best illustrated by this joke: An American sees his neighbor driving an expensive new car. He will start to work harder so he can also afford a new car. A citizen of the Soviet Union sees his neighbor driving an expensive new car. He will complain to his local party boss that the neighbor is getting above himself and demand that the car be confiscated. Mandelbaum (1991), p. 17

<sup>v</sup> The term **Globalization** refers to a wide range of different processes and descriptions, in most general words to the feeling that "the world has shrunk". It is used to describe economic processes (such as the opening of countries towards global markets, the development of trading blocks and a global capital market), political processes (such as the disintegration of the Warsaw Pact), technological processes (such as the advanced information and communication technology, the standardization of logistics), social processes (such as the emergence of a global culture) or environmental processes (such as global climate change). Globalization can also be described by referring to the presence of new actors (supra-national institutions vs. nation states, multinational corporations vs. national labor unions). Global problems can be protecting global public goods such as biodiversity or stable capital regimes, problems of controlling global interdependence such as capital flows, problems resulting from competition between countries such as competition for investments, taxes, or qualified labor, problems that can be solved through intergovernmental cooperation (like over-fishing of the North Sea), problems that appear globally but can be solved by nation states with the support of the international communities (such as the emergence of Mega-Cities). Globalization in its specific meaning of various contexts is therefore not always a global phenomenon; it is more a trans-national phenomenon, why it is sometimes also referred to as "glocalisation". Gstöhl (2003)

<sup>vi</sup> **Accountability and Responsibility**: It seems interesting that public opinion in general makes those accountable who seem to have the most control over a process – even though they maybe are not directly responsible for the results of certain politics. Critics of the G7 often don't contemplate about how the world would be without the G7, but how the world ought to be if the G7 leaders would only do what public opinion expects of them. Humans seem to evaluate somebody else not in the terms of "What if he had not done this..." but "What if he had only done something else...?" See for a comment on this Putnam (1987), p. 255

<sup>vii</sup> For a lack of space I would like to clarify how the **oil market functions**. Basically there are three types of markets: first, contracted oil markets in which long-term production and prices are agreed. OPEC and IEA countries have a large influence on these markets. Second, spot markets in which excess supply and excess demand could be traded for short-term purposes. The prices on this market reflect the volatile demand and supply and are only with difficulties to be influenced by national governments; only macro-economic strategies have a small impact on spot prices. Third, the derivatives market where speculations on the future oil price are traded. The derivatives market is largely influenced by uncertainties in the markets and gives consumers and industry the possibility to diversify their risks, but at the same time the increasing importance of the derivatives market makes oil prices for governments very difficult to control.

<sup>viii</sup> **Take-over scenario for Russian gas industry:** Although this is not a likely scenario for 2005 (because of the strong connections between Russian government, Russian financial institutions and the Russian gas industry in Russia), to privatize Russian gas industry would have allowed the possibility of hostile take-over from outside of Russia. In the Western economies even large industrial conglomerates of strategic importance to Western countries were taken over through the private capital market. I assume that it would be possible (at least in theory) to gather enough private capital and take over the Russian gas industry – and then threaten to reduce supplies and thus blackmail Western countries. Again: such a James-Bond-Evil-Villain-Scenario is not likely to develop, but given the crucial importance of the gas industry it needs to be understood why the Western countries do not dispute the heavy distortions caused by Russian gas industry.