

Russia: An Emerging Energy Superpower?

The year to mid-2006 saw the emergence of a more confident, more assertive and more powerful Russia – though over-dependent on oil and gas exports and facing domestic social challenges as well as continuing insecurity in the North Caucasus.

Russia was as stable, prosperous and independent as it had ever been in the post-Soviet era, and even in several decades preceding the collapse of the Soviet Union. No major terrorist attacks on the scale of the 2002 Moscow theatre siege and 2004 Beslan hostage crisis took place in the year to mid-2006. Driven by the rise in world energy prices, Russia's economy has continued to grow, bringing an increasing sense of wealth and power to the Russian political elite. This new domestic stability, combined with Moscow's presidency of the G8 and its role in addressing Iran's nuclear programme, have enhanced Russia's role in international affairs. Russia engaged in active global diplomacy, seeking to restore ties to Middle Eastern states, including Syria and Egypt, and to develop closer ties with China, India and Southeast Asia. Russian business interests, often used in support of its foreign-policy agenda, are increasingly visible in world markets, with companies such as Gazprom, Russia's main natural gas producer, acquiring assets in Europe and declaring their intention to expand their European presence.

However, Russia's growing dependence on revenue from oil and gas exports risks stalling growth of other sectors of the economy: plans to diversify the economy have run into the sand. There is insufficient investment in the exploitation of the country's very large oil and gas reserves, indicating that production

will tend to fall in the near future. In addition, there is growing political uncertainty leading up to the 2008 presidential elections, when President Vladimir Putin is barred by the constitution from seeking a third term. Although Putin's approval rating remained high in 2005–06, there was growing dissatisfaction with endemic corruption, an increasing gap between rich and poor, and lack of investment in social reforms, in modernisation of aged infrastructure and in resolution of demographic challenges. Domestic security problems continued in the North Caucasus, where instability was spreading from the decade-long conflict in Chechnya to engulf the entire region. Other domestic security challenges included proliferation of radical nationalist and neo-fascist groups, which carried out regular attacks against ethnic minorities and foreign migrants throughout Russia, particularly in Moscow and St Petersburg.

A perception that Russia was moving away from democratic reforms led to a further deterioration in relations with the United States and Europe. These relationships could no longer be cast as strategic partnerships, and were increasingly characterised by mutual mistrust, divergent interests and a limited agenda for practical cooperation. In 2005 Eurasia emerged as an important source of tension between Russia and Europe, as well as between Russia and the United States. Russian and Western interests clashed over elections in Ukraine and Belarus, over approaches to the resolution of conflicts in Georgia and Moldova, over routes for transport of Central Asian and Caspian oil and gas resources, over the stationing of US and coalition troops in Central Asia, and over prospects for NATO membership for Ukraine and Georgia.

The poorly conceived and badly executed decision temporarily to stop natural gas supplies to Ukraine in January 2006 over a price dispute undermined confidence in Russia as Europe's key strategic energy supplier and cast a shadow on preparations for the G8 summit in St Petersburg in July 2006. It prompted the European Union to take steps to lessen long-term dependency on imports from Russia. Europe was seeking to increase imports of Caspian and Central Asian energy resources, bypassing Russian territory and triggering new geopolitical rivalries with Moscow.

The likelihood that NATO would offer Ukraine and Georgia Membership Action Plans (MAPs) at the Riga Summit in November 2006 also generated tension. Expanding European and American engagement with the South Caucasus and newly independent states such as Ukraine and Moldova also provoked suspicion and resentment in Moscow. The departure of German Chancellor Gerhard Schröder and Italian Prime Minister Silvio Berlusconi, who had both been close allies of Putin, had a significant impact on European policies towards Russia, making it difficult for Moscow to prevent convergence of European policies towards Russia – even if most EU states tend to pursue primarily national policies towards it.

Economic successes

When Putin came to power in 2000 he inherited a country in deep economic crisis, suffering from domestic insecurity and under threat of further disintegration. US President George W. Bush, who entered office months after Putin, asserted in his campaign that Russia should no longer be treated as a major power and that American interest lay in safeguarding Russian nuclear materials in the face of domestic chaos and insecurity. Putin's commitment to restore law and order and to project Russian power abroad sounded unrealistic. Yet in 2006 Russia is stable and prosperous at home and increasingly assertive in its foreign policy. Putin's supporters argue this is due to his policies; his personal approval ratings remain above 70%. Critics say most of the economic achievements came in spite of Putin's policies, which failed to develop and implement badly needed reforms.

Putin has indeed been lucky to enjoy a continuous increase in oil and natural gas prices, bringing Russia unprecedented revenues. Russia remains the biggest oil producer outside the Organisation of Petroleum Exporting Countries. In the first quarter of 2006 Russia extracted on average 9.04 million barrels of oil per day (b/d), about as much as Saudi Arabia's 9.39m b/d. Russia extracted around 116.3m tonnes of oil in the first quarter of 2006, 1.8% more than in the first quarter of 2005, of which 61m tonnes (52.5%) was exported. Oil constituted 49.9% of Russia's overall energy exports (including oil, natural gas and petroleum products). Russia's natural gas production rose 2.5% in the first five months of 2006 compared with the same period a year ago, reaching 283.9 billion cubic metres, of which state-controlled Gazprom produced 233.8bn cubic metres, or 88% of total Russian gas production.

According to the Russian Federal Statistics Service, Russia's trade surplus in 2005 rose 40% year-on-year to \$120bn, with exports increasing by 33.9% to \$245bn and imports rising 28.5% to \$125bn; over the same period the price of Urals crude increased by 50% and natural-gas prices increased by 26%. Europe remained the main market for Russian oil and gas. In January–April 2006 the EU accounted for 54.8% (\$68.23bn) of Russian trade, up from 53.2% in the same period in 2005, while energy exports increased from 64% to 71.4% of total exports outside the Commonwealth of Independent States (CIS).

The impact is obvious. In 2005 Russia experienced its seventh straight year of economic growth; over the whole period Russia's GDP increased by over 50%, with 6.4% growth in 2005 alone. Russian foreign exchange reserves, the fourth largest in the world, increased from \$12bn in 2000 to \$217bn in April 2006 – the increase in 2005 was 46%. Russia has paid off most of its foreign debt, which stood at \$154bn in 1998 and \$22bn in 2006, and has completed negotiations over early retirement of its remaining debt to the Paris Club. At the beginning of 2006 Russia's budget surplus stood at 7.5% of GDP, the seventh straight year in the

black. The stabilisation fund set up to harvest windfall oil revenues over \$27 per barrel exceeded \$66bn in April 2006. In the first quarter of 2006 Russia attracted over \$8.8bn in foreign investment, 46% more than the same period in 2005. By March 2006 total accumulated foreign investment in Russia reached \$113.8bn, 33% higher than a year before.

Living standards have risen. Average income and pensions are increasing and there is greater distribution of wealth across Russia, particularly in commodity-producing regions. Consumption is increasing, attracting foreign investment in the consumer sector. Russians continue to travel to Europe and worldwide, constituting the fastest-growing outbound travel market in Europe and the third fastest worldwide. The number of Russian tourists rose by a further 18.6% in 2005 after a 66.7% increase in 2004. Russia now enjoys its highest levels of prosperity and stability for several decades.

Economic success has transformed the Russian leadership's view of the country's role in world affairs. Moscow's new foreign-policy doctrine relies to a large extent on projecting Russia's role as an energy superpower upon which Europe and China are increasingly dependent. Revenue from energy exports provides Russia with new resources to support domestic and international policies. Moreover, Russia's economic independence, in stark contrast to the 1990s when it relied heavily on Western loans and advice, has transformed it into an increasingly assertive and unilateralist power with global ambitions. This has led to increasing problems in relations with Europe and the United States, which, according to Russian decision-makers, refuse to recognise and accept Moscow's new international role.

Energy wealth: sustainability in question

Russia's slide towards the model of a classic 'petroleum state' has implications which, if not addressed, could lead it towards a new crisis. Amidst Russia's economic boom, economists and policymakers increasingly question the sustainability of its commodity-induced economic growth. Not only does dependence on oil and gas exports have a deleterious effect on the rest of the economy, but it is doubtful whether Russia can maintain its present levels of output.

Russia's drift towards becoming a petroleum state has undermined incentives to pursue badly needed structural, administrative and other economic reforms that could increase industrial production and stimulate technological innovation. Russia is experiencing growing inflation as well as the 'Dutch disease', in which high resource revenues cause appreciation of the rouble, making the manufacturing sector less competitive. Instead of implementing structural reforms, the government is increasingly engaged in redistribution of oil and gas revenues. At the same time, the gap between rich and poor is nearing a factor of 15: in 2005 the richest 10% of the population received 29.8% of the income, whereas

the poorest 10% received only 2%. The World Trade Organisation views a factor of 14.2 as enough to create a real danger of social unrest in a country, a line that Russia crossed in 2003.

A further effect of dependence on oil and gas income is declining competitiveness. Russia is witnessing endemic and growing corruption, even at the highest level of government; increasing centralisation, declining efficiency and slow restructuring of state institutions; excessive state intervention in and control of energy companies; a continuing monopoly over transport infrastructure; limited scope for introducing private-sector management experience and technological innovation in the energy sector; and growing pressure to limit foreign (and private) ownership of major mineral resources. Russia has made little progress in enhancing the rule of law; reducing bureaucratic controls over the economy; improving corporate governance, particularly in the energy sector; establishing guarantees for private property rights; and encouraging domestic investment.

As a result, economic growth has been slowing, from 7.3% in 2003 to 7.2% in 2004 and 6.4% in 2005. This level of GDP growth, although high compared with the United States and Europe, puts Russia ninth among the 12 states of the former Soviet Union. The decline in growth is taking place in spite of record energy export earnings, and is likely to continue in the coming years in the absence of structural reforms and faster investment. Slowing growth will affect living standards and foreign investment, and will hamper development of the non-commodities sector, which displays signs of healthy market-driven transformation. It will present a major challenge to Putin's successor, who may have to implement economic reforms in a much less favourable economic environment. The economy is also vulnerable to external shocks such as a drop in oil prices.

The position becomes even more worrying when a flattening of oil and gas production and failure to invest sufficiently in unexploited reserves are taken into account. Experts predict that oil and gas production will decline gradually over the next decade. According to the European Bank for Reconstruction and Development (EBRD), 70% of the production of Gazprom comes from fields with declining output.

Although Russia still has large undeveloped oil and gas deposits, its companies lack sufficient funds to initiate and sustain exploration and production, particularly in eastern Siberia, where resources are increasingly costly to develop. The EBRD estimates that the Russian energy sector needs investment of around \$700bn over the next 20 years. However, new Russian policies impede foreign investment in the energy sector. The government has made clear that only those foreign investors who accept the new rules will be allowed significant stakes in new exploration projects. Favour is likely to be shown to those foreign companies that would help Gazprom, which controls the Russian gas pipeline system, gain access to European energy-distribution assets. In April 2006 the German company BASF became the

first beneficiary of the new rules. It signed a comprehensive deal with Gazprom under which its Wintershall unit would acquire 34.9% of Severneftegazprom, the company that owns the licence to develop the Yuzhno-Russkoye gas field in western Siberia. For its part Gazprom would increase its share in Wingas, a joint venture with BASF's Wintershall unit, from 35% to 49.9%, and Wingas would concentrate on selling and marketing natural gas in Germany. Gazprom and BASF would each take a 50% share in Wingas Europe, a joint venture that would concentrate on distributing gas outside Germany. In June 2006 President Putin and Italian Prime Minister Romano Prodi announced an agreement under which Italian companies will be allowed to bid for production contracts in exchange for Russian companies gaining access to Italian energy markets.

Such deals, even if signed, are still likely to run up against obstacles. A case in point is the giant Kovykta field, estimated to contain 2 trillion cubic metres of natural gas, where the BP–TNK joint venture holds a licence for exploration, but has so far been unable to develop deposits that could play a key role in expanding Russian gas exports to China. Another major project, the \$20bn development of the Shtokman gas field in the Barents Sea, estimated to contain 3.2 trillion cubic metres of gas and 31m tonnes of gas condensate, has attracted attention from foreign investors including ConocoPhillips and Chevron, as well as the Norwegian companies Statoil and Hydro and the French company Total. But Gazprom has postponed a decision on foreign participation in the project.

The exploration of eastern Siberian deposits is crucial for Russia to realise its ambition of becoming a key energy supplier to Asia as well as Europe. Russia needs significant foreign investment to support construction of a Pacific oil pipeline that could take Russian energy exports to the eastern port of Nakhodka and onwards to Japan, Asia and possibly North America. Investors are reluctant to commit significant funds while Moscow maintains a state monopoly over the ownership of transport infrastructure (through Transneft) and remains reluctant to offer a significant stake in exploration and production projects to foreign investors. Russia has therefore given priority, at least in the short term, to the construction of a gas pipeline to China. During Putin's visit to China on 21–22 March 2006 a deal was agreed under which Russia would increase gas exports to China. Gazprom and China's state-controlled China National Petroleum Corporation (CNPC) signed an agreement on supply of Russian gas to China and construction of a new 3,000km pipeline, Altai, estimated to cost about \$10bn, which will connect Russia and China. According to Putin, Russia planned to supply up to 80bn cubic metres of gas per year starting in 2011. In addition, Russia's state-controlled Transneft and CNPC signed an agreement to conduct a feasibility study on the East Siberia–Pacific Ocean pipeline to China, and CNPC and Rosneft signed a joint-venture agreement that could allow the Chinese company to take part in exploration and extraction of oil in Russia.

Moscow's decision to expand its oil and gas exports to China came on the back of increasingly strained relations between Russia and Europe following the temporary cut-off of Russian gas deliveries to Ukraine in January 2006. This resulted from a price dispute: Gazprom was seeking to reduce the degree to which it subsidised gas supplies to Ukraine. The cut-off had the effect of reducing supplies to other European countries at the peak period of demand. Within four days, however, the two countries had resolved their price dispute by agreeing that Ukraine would purchase gas from Russia at \$230 per 1,000 cubic metres and from Turkmenistan at \$65, against a former price of \$50; Russian and Turkmen gas would be blended and supplied to Ukraine by the Russian-Ukrainian joint venture RosUkrEnergO at \$95. The parties also agreed to raise the transit tariff from \$1.09 to \$1.60 per 1,000 cubic metres per 100km for both transit of Russian gas to Europe and Turkmen gas through Russia to Ukraine. The deal was criticised in the West for a lack of transparency and for the alleged involvement of organised crime groups in RosUkrEnergO – which denies any such involvement. Gazprom also announced its intention to raise the price to Belarus from \$46.68 to \$200 per 1,000 cubic metres after the controversial re-election of President Alexander Lukashenko in March 2006. The price increases are hard for Ukraine and Belarus to handle, but they are unable to diversify their sources.

Europeans became concerned over Russia's potential use of gas exports as a political tool, fearing that it might resort to future supply cuts if relations deteriorated. Moscow retorted that concerns over its reliability as a supplier were unfounded because neither Russia nor the Soviet Union had ever cut off gas supplies to Europe, with the exception of Ukraine, which had refused to accept market prices. Alexei Miller, Gazprom chairman, warned European ambassadors that if Europe continued to criticise Russia, challenge its reliability and restrict Gazprom's investments and acquisitions on political grounds, Russia had the option to re-orient its energy exports from Europe to Asia. Russia, however, will be unable in the short to medium term to meet increasing demand for gas from Europe, which is expected to depend on imports for over 80% of its gas by 2030. And it will have little spare capacity to expand exports to China: in the absence of progress in exploration of eastern Siberian deposits, Russia has to rely on exports from western Siberia which are already committed to Europe, the CIS and domestic consumption.

Gazprom has compensated for declining production by importing cheap gas from Turkmenistan, using its virtual monopoly over pipeline options for Turkmenistan's exports northwards into both Russia and Ukraine. However, this monopoly will not last forever. In 2005 the United States renewed attempts to convince Turkmenistan to send gas via the Caspian Sea to join the Baku-Tbilisi-Erzurum pipeline, which opens in 2006. Although prospects for a trans-Caspian gas pipeline remain remote, it has not been ruled out. In April 2006 Turkmenistan

and China signed an agreement to construct a pipeline eastwards from Turkmenistan to China. The pipeline was expected to be constructed by 2009, and China agreed to buy 30bn cubic metres of gas annually from Turkmenistan. Judging from the pace of construction of the 998km Kazakhstan–China (Atasau–Alashankou) oil pipeline, built in a year and completed at the end of 2005, few financial and logistical obstacles stand in the way of the Turkmenistan–China pipeline. If any of these projects materialise – driven by increasing frustration in Turkmenistan about Russia’s use of its monopoly to pay low prices for Turkmen gas – Gazprom will have difficulty coping with export obligations and domestic commitments. This explains its push to raise prices for exports to the CIS, on the grounds that it can no longer afford to continue to subsidise exports and must either raise prices or redirect gas to customers who pay more. This has meant raising prices not only for Ukraine, Georgia and Moldova, all of which have had difficult relations with Moscow, but also for Armenia and Belarus, both close strategic partners for Moscow.

Stagnation of Russian oil and gas production is bound to have important implications for Russia’s domestic development and relations with its neighbours. It further reinforces concerns among importers of Russian oil and gas, who increasingly place energy security at the top of their policy agendas, about the reliability of Russia’s long-term supply commitments.

Domestic political prospects

The political succession remains a key source of concern and anxiety for Russia’s political elite and the international community. Recent Russian history suggests that in the absence of functioning democratic institutions – a real multi-party system, independent parliament and strong civil society – the personality of the leader plays a decisive role in defining the direction of domestic and foreign policy. The real leadership contest takes place behind closed doors in the Kremlin, balancing the interests of different power groups. As in the transition from Boris Yeltsin to Putin, a candidate will eventually be nominated by Putin and put forward for approval in the general election, likely to take place in March 2008, perhaps combined with parliamentary elections. The Kremlin candidate is unlikely to face any significant challenge, either from liberal parties on the right or communist parties on the left, since the opposition remains weak and lacks popular support. The pro-government United Russia Party is likely to shift towards nationalist sentiment as it struggles to maintain unity under pressure from two groups within the party, one supporting greater state control and intervention, the other emphasising globalisation and the market economy. Within the government, however, liberal reformers who constituted a significant power bloc in the first Putin administration have been virtually deprived of influence in strategic policy decisions, particularly after their reservations over

the Yukos affair in which the company's chairman, Mikhail Khodorkovsky, then the most powerful of Russia's business oligarchs, was detained in 2003 on tax evasion charges and sentenced in 2005 to nine years in prison.

Questions remain over the identity of Putin's successor and what role Putin will himself play after 2008. In 2005 two front runners for the succession emerged, who are likely to be selected either jointly – as a president–prime-minister combination – or separately. Dmitry Medvedev was the head of Putin's presidential administration and was promoted in November 2005 to first deputy prime minister. Sergei Ivanov, the minister of defence, was simultaneously appointed deputy prime minister. Neither enjoys popular support, with ratings ranging between 6 and 9%, yet Putin's backing, combined with the use of administrative and media resources controlled by the state, is likely to ensure victory for whoever is eventually selected. It is possible that another candidate might emerge before 2008 as a result of the continuous power struggle within the Kremlin. Leading up to 2008 the succession issue will dominate Russian politics, limiting prospects for domestic reforms and affecting relations with the outside world.

Russia asserts power

Russia has struggled to translate its status as an energy power into long-sought recognition of Great Power status. Russia's chairmanship of the Group of Eight (G8) industrialised countries, combined with its active diplomacy in Europe, Iran and the Middle East, presented opportunities for increasing its international profile. But assertive and threatening approaches towards some of its neighbours – including the cut-off of gas to Ukraine – combined with increasingly anti-Western political rhetoric at home, has led to a gradual deterioration in Russian–Western relations. In spite of Moscow's protestations to the contrary, pressure on Ukraine over gas supplies was perceived by the outside world as political. Europe and the United States agree that developments in Russia – both domestic and in regard to its policies in Eurasia – are a source of concern. However, dependence on Russian energy and the need to keep Russia on board in addressing the Iranian nuclear issue meant that they have mostly exercised caution in criticising Putin's policies. Russian–Western relations have shifted from strategic partnership towards a partnership of convenience.

An exception to the West's caution was criticism of Russia's policies towards its neighbours by US Vice-President Dick Cheney in a speech in Vilnius, Lithuania on 4 May 2006. He said: 'No legitimate interest is served when oil and gas become tools of intimidation or blackmail ... and no one can justify actions that undermine the territorial integrity of a neighbour or interfere with democratic movements.' Russia's response was angry but restrained, dismissing the remarks as geopolitically motivated, inherently anti-Russian and a sign of Cold-War era thinking. Anti-Western rhetoric increased among mainstream Russian policymak-

ers and analysts, who assert that Western policies in Eurasia are directed against Russian interests and seek to push Russia out of its traditional sphere of influence. Russia's policies, combining increased investment and economic assistance with support for existing regimes, have increased its influence in many parts of Eurasia, particularly Central Asia, where fear of Western-supported revolutions and unmet expectations about Western investment compel regional leaders to seek renewed strategic partnership with Moscow.

Russia has developed a more independent and assertive foreign policy relying on three principles. First, it seeks to promote its economic interests as part of its foreign-policy agenda (for example in relations with Germany, China, India and Eurasian states) or to use economic power in support of foreign-policy objectives. Secondly, it seeks to exploit weaknesses and mistakes of Western policy. It has positioned itself as a mediator in relations between the West and the Muslim world by developing closer ties with, for example, Syria, the Hamas-controlled Palestinian Authority, and Egypt. While the image of the United States and Europe is declining in Muslim communities, Russia's has been rising, following several years of anti-Russian sentiment stemming from its war in Chechnya. Russia has also attempted to play a mediating role in relations between Iran and the West, and is expanding military ties with Venezuela, China and Iran. The third principle is the restoration of its presence in Eurasia, particularly in Central Asia, where Russian influence has increased dramatically over the past year because of growing concerns among regional authoritarian leaders over the spread of Western-supported uprisings such as occurred with Ukraine's 'Orange Revolution'. At the same time, America's regional role and influence declined as it failed to meet expectations of economic benefits and political support in regional states in exchange for their cooperation in the Afghanistan war and the US 'war on terror'.

In contrast to the 1990s and Putin's first term, Russia no longer intends to follow the Western policy line, nor does it seek closer integration with Western institutions.

This shift is a result of annoyance in Moscow over growing Western criticism of Russia's domestic affairs, including what the West sees as Russia's drift away from the path of democratic development. Russian officials and analysts say Moscow is frustrated with what it sees as Western unwillingness to acknowledge and reciprocate Russia's goodwill gestures or concessions towards the West during Putin's first term, particularly after the 11 September attacks. Many in Moscow are also frustrated by a Western policy of democracy promotion and regime change in Eurasia: they see a Western conspiracy to initiate and finance the wave of democratic movements in Ukraine, Georgia and Kyrgyzstan.

Europe and the United States, on the other hand, criticise Russia for intervening in the domestic affairs of its neighbours and supporting undemocratic

rulers such as President Lukashenko of Belarus. The West refused to recognise the 2006 elections in Belarus, alleging fraud and intimidation, while Putin was quick to congratulate his ally with 'winning in a free and fair election'. As the G8 Summit in St Petersburg approached while this chapter of *Strategic Survey* was being written, it was difficult to envision what could prompt a new rapprochement between Russia and the West. It seemed more likely that relations would continue to deteriorate under the weight of mutual mistrust and disagreement over respective approaches to Eurasia.

New regional groupings exclude Russia

As Russia becomes more assertive both within and beyond its immediate vicinity, Ukraine, Georgia and Moldova are seeking to develop new post-Soviet identities and closer ties with Europe – particularly the new EU and NATO members in Central Europe who share their fears and concerns over Russian policy. Democracy promotion, prospects for diversification of energy transportation routes, and principles for resolution of conflict are the main areas of disagreement between Russia and the Western-oriented states of Eurasia.

The new pro-Western states in Eurasia have sought to build new groupings and institutions to bring them closer to the West. In August 2005 Georgia and Ukraine initiated the Community of Democratic Choice, including countries ready to embrace and support democratic reforms, with the support of the United States and many European states. The first meeting on 2 December 2005 in Kiev was attended by the presidents of Ukraine, Georgia, Lithuania, Latvia, Estonia, Romania, Moldova, Slovenia and Macedonia. The Community established links between countries in the Baltic and Black Sea regions seeking to distance themselves from Russian domination, share experiences in domestic reforms and come closer to Europe.

In May 2006 another loose grouping of states – GUAM, after its members Georgia, Ukraine, Azerbaijan and Moldova – was formalised into the GUAM Organisation for Democracy and Economic Development. The aim was to develop closer ties among Eurasian states wanting to reduce their dependence on Russia and pursue closer integration with the West. Among the key priorities of the new organisation were free trade and economic integration, particularly in regard to energy transportation, and plans for joint peacekeeping forces to address regional conflicts.

Russia views these bodies with suspicion as having inherently anti-Russian agenda to create an alternative to Russo-centric regional groupings such as the CIS. Statements from Georgia and Ukraine that they intend to review their CIS membership have reinforced the prospects for further fragmentation of Eurasia and the emergence of parallel regional alliances pursuing either the Russian or the Western policy agenda.

Ukraine: Tensions with Russia

Following the 2004 'Orange Revolution' (see *Strategic Survey 2004/5*, pp. 156–7) President Victor Yushchenko saw his domestic popularity decline, his political coalition all but fall apart, and Ukraine's economy decline. Ukraine continued to enjoy support from NATO and the EU – including its Central European neighbours – but relations with Russia remained tense, triggering a number of crises, most importantly over gas prices.

The crisis over Russian gas supplies and divisions between members of the Orange coalition, particularly the president and former prime minister Yulia Tymoshenko, led to poor results in the 26 March 2006 parliamentary elections for the presidential Our Ukraine party, which received only 13.95% of the vote. Yushchenko's rival and pro-Moscow candidate Victor Yanukovich and his Regions party won the highest number of votes at 32.14%. Tymoshenko's bloc finished with 22.29% and the Socialist Party, also part of the 2004 Orange Coalition, won 5.69%. Following the elections, the three parties of the former Orange Coalition tried to form a new coalition in parliament, and reached agreement on 22 June: Tymoshenko's faction received the post of prime minister and several key ministerial posts; Yushchenko's Our Ukraine party received the post of speaker of the parliament. Yushchenko had appointed Petro Poroshenko, one of Ukraine's leading oligarchs, to this post. Given the history of open confrontation between Tymoshenko and Poroshenko, the new coalition government might not last.

Yushchenko identified membership of the EU as one of his key priorities, but has so far not received a clear signal from the EU about its prospects. Relations are guided by the EU–Ukraine European Neighbourhood Policy (ENP) Action Plan, adopted by the European Council and Ukrainian parliament in February 2005. ENP offers some elements of integration, but no clear commitment to membership. The EU is unlikely to consider Ukrainian membership until it has absorbed the ten newest members and prospective members Bulgaria and Romania, as well as developing greater consensus regarding Turkey's accession and resolving the deadlock over internal reform following the failure of the constitutional treaty. Ukrainian membership of the EU is therefore unlikely for many years. However, membership of NATO is still under active discussion.

Ukraine's NATO prospects

In April 2005 Ukraine and NATO launched an intensified dialogue. Kiev could be offered a Membership Action Plan at the NATO summit in Riga on 28–29 November 2006, possibly leading to full membership as early as 2008. The majority of NATO member states strongly support Ukrainian membership. From Washington's perspective, it would be an important legacy for President George W. Bush. For Europeans, Ukraine's armed forces, experienced in multinational operations in the

Balkans and Iraq, could make an important contribution to an alliance that is short of deployable troops for commitments in Afghanistan and elsewhere.

However, NATO membership is a complicated issue for Ukraine and a source of new tension with Russia. While the Ukrainian leadership strongly supports NATO membership, opinion polls show the public is much more sceptical, with less than 50% in favour: it would be difficult for the government to win a referendum. In Crimea and eastern parts of the country, many people strongly oppose NATO membership. In June 2006 small but vocal protests in Crimea, combined with parliament's refusal to authorise the temporary presence of foreign troops on Ukrainian soil, led to the postponement of the annual Ukraine–NATO *Sea Breeze* exercises in the Black Sea. Ukrainian officials blamed Russia for masterminding the demonstrations and banned entry to several nationalist Russian MPs.

Russian concerns over potential Ukrainian NATO membership run deep and are unlikely to be alleviated in the near future. Russian Foreign Minister Sergei Lavrov stated that NATO enlargement to embrace Ukraine and Georgia would be a 'colossal geo-political shift', and that Russia was 'trying to foresee the consequences of this move, primarily from the viewpoint of Russia's national security and economic interests and relations with these countries'.

Moscow's concerns are based on a number of factors. First, in spite of expanding cooperation in the framework of the NATO–Russia Council, many in Russia continue to view NATO with suspicion as an 'anti-Russian organisation' and a potential threat. A US announcement about potential deployment of a missile defence system in Central Europe provoked a sharp negative reaction from Moscow, which saw it as directed primarily at Russia's nuclear deterrent and threatened to withdraw from the 1999 Adapted Conventional Forces in Europe Treaty.

A second factor relates to the extensive defence-industrial ties between Russia and Ukraine. Russian officials made clear that these ties would be suspended if Ukraine joined NATO. This could be costly for both countries. According to Russian Defence Minister Sergei Ivanov, co-production arrangements and easy-terms arms trade involved 1,330 Russian and Ukrainian enterprises in 2005. Russian–Ukrainian defence-related trade involves up to 8,000 items. Russia accounted for 22.8% of Ukrainian defence imports in 2005, and 50–60% of Ukrainian exports went to Russia. Some 95% of Russian helicopters are fitted with engines from Ukraine's Motor-Sich Factory in Zaporozhye, which also turns out engines for the Beriyev Be-200 Amphibious Multi-Role Twinjet Aircraft and the Yak-130 *Mitten* combat trainer. Ukraine produces warship and hovercraft propulsion units for Russia. Ukraine's Kremenchug automotive factory produces KRAZ trucks for S-300 surface-to-air missile systems, a Novokramatorsk plant makes S-300 radars, and a Lvov factory produces electronic units. Kiev has delivered avionics and weapons for Russian Sukhoi Su-30-MKI and Su-30-MKK *Super Flanker* fighters, exported

to India and China, but its participation in these projects has been reduced in recent years. In June 2006 Ivanov declared that Russia would pull out of the joint Ukrainian–Russian Antonov AN-70 transport aircraft project.

A third issue is the stationing of the Russian Black Sea Fleet at Sevastopol in Crimea. In 1997 Kiev and Moscow reached an agreement under which Russia had the right to station its fleet at Sevastopol, under lease, until 2017. The agreement, however, left points unresolved. Ukraine and Russia continue to disagree over ownership of the navigation and hydrographic infrastructure serving the Crimean coast. After the break-up of the Soviet Union Russia assumed control of this infrastructure, but Ukraine, which now has a fleet of its own, and military ties with other Black Sea and NATO states, wants to take it over. When Russia raised the price of gas exports to Ukraine, Kiev reciprocated by demanding an increase in the \$97m annual rent that Russia pays for basing its fleet. While Ukraine has indicated it is unlikely to agree to extend the lease beyond 2017, Russia intends to re-open negotiations on the terms of the 1997 agreement. There is little prospect of amicable resolution of tensions mounting between the Russian and Ukrainian fleets.

Russia has few options for relocating the fleet. Its short Black Sea coastline includes Novorossiysk, Russia's largest commercial port, built for shipping large quantities of oil. But it would require very large investment to house the naval fleet. Some NATO officials have suggested that Ukrainian membership of NATO would be incompatible with fulfilment of its 1997 agreement with Russia, since Ukraine would become the first NATO member with a non-NATO state's base on its territory. Russian concerns go beyond the basing issue: it objects to the prospect of greater NATO involvement in the Black Sea.

A further outstanding issue is a long-standing border dispute over the status of the Sea of Azov, which has busy shipping routes, rich fishing grounds and prospective oil fields. Russia wants to keep the sea as a common-use area between the two states, while Ukraine wants to demarcate a border. The argument escalated in 2003 when Russia started building a dike from the Russian mainland toward Ukraine's Tuzla Island in the Kerch Strait, which connects the Sea of Azov with the Black Sea. Ukraine sent troops to the island, and Russia stopped construction after tense high-level talks. Following perhaps the most dangerous crisis in post-Soviet Russian–Ukrainian relations, the two sides agreed to share the Sea of Azov as common property and to determine the countries' border in the Kerch Strait. In 2006, Ukrainian Deputy Foreign Minister Anton Buteiko said Kiev wanted to revise the agreement to change the status of the sea, but Russia refused to negotiate. It is unlikely that the two sides can reach a compromise on the matter given Ukraine's prospective NATO membership.

The issue of Ukraine's NATO membership comes on top of two other recent crises between Ukraine and Russia: the Orange Revolution and Russia's decision in January 2006 to stop gas supplies to Ukraine in the pricing dispute referred

to above. For Ukraine the agreement that ended the dispute meant that it had to accept higher gas prices at a time when its economy was experiencing a severe decline. The new price was not guaranteed, and is likely to increase when Turkmenistan increases its prices. In addition, Yushchenko, who initially hailed the deal, agreed under international pressure to conduct investigations into RosUkrEnergo. He has not signed an agreement cementing the January terms, but has stopped short of re-opening negotiations.

The South Caucasus: Conflicts Cloud Prospects

The South Caucasus – Armenia, Azerbaijan and Georgia – has seen growing interest and engagement from both the West and Russia. The region's importance has increased following EU enlargement and with the growing strategic importance of the Black Sea. In 2005 the EU began to consider the deployment of peacekeeping forces should Armenia and Azerbaijan reach agreement over the Nagorno-Karabakh conflict. The EU has been negotiating ENP Action Plans, expected to be finalised during 2006, with all three states. In February 2006 the EU appointed a new special representative, Peter Semneby, whose mandate was expanded to support resolution of regional conflicts. The United States has also been expanding high-level contacts and military and economic ties in the South Caucasus. Since 2005 the United States has actively promoted the resolution of frozen conflicts in the region.

These conflicts – Georgia–Abkhazia, Georgia–South Ossetia and Nagorno-Karabakh – are the main reason for increased European and US engagement in the South Caucasus. The second half of 2005 and the first half of 2006 brought new hopes – so far frustrated – for conflict resolution in Nagorno-Karabakh, the only major inter-state conflict in Eurasia, unresolved since the end of violence in 1994. Armenia occupies Nagorno-Karabakh and seven adjacent territories recognised by the international community as parts of Azerbaijan. However, the Nagorno-Karabakh Republic now exists as a *de facto* entity, populated by ethnic Armenians who claim it as their historic land. The prospects of Nagorno-Karabakh returning to Azerbaijan appear slim, although the territory's status must eventually be resolved by a referendum. The conflict has been frozen for over ten years without foreign peacekeeping forces, but Armenia and Azerbaijan remain in a state of war and are engaged in an arms race. While Armenia continues to receive assistance from Russia, which has military bases on its territory, Azerbaijan is able to redirect its rapidly increasing revenues from oil exports into defence spending. The growing number of clashes between Azerbaijani and Armenian forces, as well as concerns about future instability in Iran, which

borders both states, reinforced concerns about future escalation, which would have devastating consequences for both states. Negotiators saw 2006, a year in which elections were due in both nations, as offering potential for a breakthrough, but this has not yet occurred.

International mediators represented by the Minsk Group, which has Russian, US and French co-chairmen, sought to create conditions for beginning the settlement process by encouraging Armenia to return to Azerbaijan all or part of the occupied territories around Nagorno-Karabakh, to allow refugees to return and to agree on a timetable for holding a referendum on the status the territory. The proposed plan envisaged deployment of international peacekeepers, most likely by the EU. The Russian defence minister expressed readiness to deploy peacekeepers to the conflict zone should an agreement be reached, although both sides were reluctant to endorse this. Components of the plan were discussed during the so-called Prague process meetings between the Armenian and Azerbaijani foreign ministers throughout 2005. The two presidents met on 10–11 February 2006 at Rambouillet in France for direct talks, but these yielded no results. Follow-up talks in Washington in March 2006 and in Romania in June similarly ended without a breakthrough.

No significant progress has been achieved in resolving two other frozen conflicts, involving Abkhazia and South Ossetia, which seek independence from Georgia following bloody conflicts in the early 1990s. Although no escalation took place in 2005–06, the environment for bringing about political resolution of these conflicts became more complex. The success of the referendum in Montenegro (see pp. 150–152) and expectations of independence for Kosovo raised hopes that the two entities could also gain recognition. Both counted on Russia for support. Speaking against the background of deteriorating Georgian–Russian relations, President Putin called for application of universal criteria to the future of Kosovo, Abkhazia and South Ossetia. The Russian Foreign Ministry questioned Georgia’s territorial integrity, calling it virtual and aspirational rather than real. During a June 2006 summit between the Russian and Georgian presidents, Putin softened his tone, saying Russia did not intend to take over any Georgian lands; however, he reiterated the need for a referendum to determine the future status of Abkhazia and South Ossetia.

Moscow’s statements angered Georgia, which has long accused Russia of wanting to take over the two territories. Russia extended citizenship to the majority of residents in Abkhazia and South Ossetia and provided extensive economic assistance and political support to the *de facto* authorities, some of them former Russian civilian and security officials. Georgia claimed that Russia now constituted not an impartial mediator but a party to both conflicts, and the Georgian parliament demanded the withdrawal of Russian peacekeepers from South Ossetia and Abkhazia, to be replaced by international forces. Georgia has so far

been unable to find replacement forces, with both the UN and the Organisation for Security and Cooperation in Europe unable to provide sufficient troops. Moreover, the de facto regimes that control the two regions view Russia as their security guarantor and refuse to admit external peacekeeping forces. Progress appeared to depend on the state of Georgian–Russian relations, which remained perhaps the most tense among all post-Soviet states. Although on 31 March 2006 Georgia and Russia signed a final agreement on the timetable for withdrawal of Russian military bases from Georgia by 2008, Russia followed by increasing support for the de facto states, introducing an embargo on imports of Georgian wine and mineral water, and raising concerns over potential Georgian membership of NATO.

Following its 2003 Rose Revolution, Georgia enjoys widespread support in the West. It wants to obtain a NATO Membership Action Plan at the Riga summit in November 2006 and hopes to win membership of NATO in the near future. This aspiration is supported by the United States, but is opposed by some important Western European countries. Georgia's case is more complicated than Ukraine's. On the positive side is the remarkable success of its defence reforms. It has implemented an Individual Partnership Action Plan agreed in 2004 and has increased its defence budget from \$20m in 2002 to \$31m in 2003 and \$90m in 2004. Georgia has troops in Iraq, the Balkans and Afghanistan: its 850 troops in Iraq represent the largest per capita deployment of any member of the coalition. On the negative side, Georgia still has the unresolved Abkhazia and South Ossetia conflicts, which involve a stand-off with Russia. Concerns remain that Georgia has not excluded the use of force to resolve these conflicts. It refused to sign an agreement not to resume hostilities, and over the past year there have been instances when the conflict in South Ossetia threatened to escalate. NATO therefore risks being dragged into Georgia's internal conflicts, which might include confrontation with Russia.

The South Caucasus is also of note because it borders Iran. Any prospective military action against Iran would have to use facilities in the South Caucasus, just as Central Asian facilities were used during operations in Afghanistan. The United States has been developing close military cooperation with both Azerbaijan and Georgia. Washington and Baku have reportedly discussed potential US use of military facilities in Azerbaijan, including airfields. Azerbaijani airfields have been used by US aircraft operating in Afghanistan. In 2005 the United States signed an agreement on operating two radars in Azerbaijan which are likely to be used for monitoring Iran. In April 2006 Azerbaijani President Ilkham Aliev visited the United States, where he was given a very warm reception despite reservations about the conduct of the November 2005 elections in Azerbaijan, when international observers recorded election fraud and intimidation of the opposition. The new relationship is underpinned by US concerns over Iran's nuclear programme. For Azerbaijan, however, the issue is sensitive: there

are three times more Azeris in northern Iran than in Azerbaijan itself. Baku traditionally has close relations with Tehran and any destabilisation in Iran is likely to have severe effects within Azerbaijan. Days after returning from Washington, Aliiev hosted a visit by the Iranian president.

Central Asia: Developing Relationships Eastwards

Central Asia has seen a decline in US and European influence and growing engagement from Russia, China, India and other Asian neighbours, which are interested in the region because of its energy resources, geographic proximity and the threat of Islamic radicalisation. For land-locked and energy-rich Central Asian states, cooperation with Asian neighbours is essential to develop transport routes.

Most states, though they hold elections and have opposition parties, retain authoritarian governments. The only pluralist society is Kyrgyzstan, where the March 2005 'Tulip Revolution' attempted to repeat the examples of Georgia and Ukraine by removing the corrupt President Askar Akaiev through peaceful, popular discontent. A year later, Kyrgyzstan remained pluralist and pro-Western, hosting a large US and coalition military base at Manas, but was also economically undeveloped, criminalised, unstable and dominated by traditional and regional clans at the expense of its 'revolutionary' leaders. Little progress had been made towards real democracy.

The United States has sought to promote its own vision for Central Asia. During her trip to the region in October 2005, US Secretary of State Condoleezza Rice proposed a new concept of 'Greater Central Asia' as a framework for long-term integration as well as stabilisation in Afghanistan. However, this vision has not been supported by Central Asian states, which seek to distance themselves from what they view as increasing instability and the growing influence of radical Islamic groups in Afghanistan.

The establishment of US and coalition military bases for the 2001 invasion of Afghanistan failed to deliver expected economic benefits. Uzbekistan offered the most extensive and immediate cooperation with the United States, but later found its regime threatened by the prospect of popular revolution coupled with a rise of radical Islamist sentiment. Violence in Andijan in May 2005, when security and police forces clashed with Islamic militants and civilian demonstrators, resulting in the reported deaths of hundreds of people, provoked a crisis in Uzbekistan's relations with the US and EU. Washington and Brussels requested an independent international inquiry, but were refused. Uzbekistan notified the United States that the agreement on basing rights would not be renewed, forcing

the US to close its bases by the end of 2005. The EU imposed sanctions, leading to an almost complete freeze in diplomatic relations and a loss of European leverage. The majority of European- and US-funded NGOs have been closed. Uzbekistan moved towards rapprochement with Russia, agreeing mutual security guarantees, conducting bilateral military exercises and joining the Eurasian Economic Community. It also developed closer cooperation with East and South Asian neighbours and improved relations with Kazakhstan and Tajikistan.

Kazakhstan, the most oil-rich state in Central Asia, has developed close strategic relations with Russia, the United States and China. Previously dependent on Russia for transit of its oil to world markets, it completed in 2005 a 1,000km oil pipeline to China and signed an agreement with Azerbaijan to ship its oil westward through the Baku–Tbilisi–Ceyhan pipeline, also completed in 2005. These steps were taken without undermining relations with Russia. Kazakhstan has emerged as a regional leader, playing an important role in regional organisations such as the Eurasian Economic Community, the Collective Security Treaty Organisation and the Shanghai Cooperation Organisation (SCO), while at the same time becoming the first Central Asian state to conclude an Individual Partnership Action Plan with NATO and pursuing close military ties with the United States.

The SCO has become the most influential organisation in Central Asia, with a growing role in the wider Asian region. It was established in 2001 following more than five years of an informal confidence-building process known as the ‘Shanghai Five’, involving multilateral consultations over the demarcation of China’s border with Tajikistan, Kyrgyzstan and Kazakhstan. Founding members were China, Russia, Tajikistan, Kazakhstan, Kyrgyzstan and Uzbekistan. In 2005, India, Pakistan, Iran and Mongolia were admitted as observers: all have expressed interest in full membership. On 14–15 June 2006 the fifth anniversary summit of the SCO in Shanghai was attended by the heads of state of all SCO members and observers except India. Afghan President Hamid Karzai also took part. The SCO has established a regional anti-terrorist centre in Uzbekistan and has conducted joint exercises, which are expected to increase in scale and number. It is also an economic organisation, focusing on regional cooperation including infrastructure projects, and investment and credit for development schemes. Cooperation on energy issues is expected to become a major area of SCO activity, one particularly attractive to countries like India and China. However, the SCO is viewed with suspicion in the West, particularly in the United States, which portrays it as an anti-Western bloc dominated by Russia and China that seeks to exclude Washington from playing a role in Central Asia. It is also criticised as a ‘club of dictators’, given that the majority of members are not democracies, and that it does not seek to promote democratic or other political reforms in member states. This view may be alarmist: as an Asian organisation, rather like the Association

of Southeast Asian Nations, the SCO does not address domestic political issues of its members. A number of its members and observers maintain close relations with the United States.

However the future of the SCO remains uncertain, with two competing visions. One, favoured by Russia and some Central Asian states, sees it as a regional security organisation, with close cooperation between militaries and in fighting terrorism, separatism and extremism in Central Asia. This school of thought views the SCO as a geopolitical actor balancing the involvement of non-regional powers, keeping up pressure for the withdrawal of US and coalition bases from the region. Another view, supported primarily by China and India, would make the SCO primarily an economic organisation focusing on developing preferential ties in the energy field and introducing a free-trade area. The latter idea is opposed by Central Asian states and Russia, which fear they could not compete with China. Beijing, on the other hand, is adamant that the SCO will never become a NATO-type military bloc. Given these tensions, it is likely that the SCO will continue to combine security and economic dimensions. There could be room for dialogue and, at some point, cooperation with the United States, Europe and Japan.

Conclusion: Russia's Regional Power Curbed

In spite of its new economic clout and assertiveness, Russia is being forced to come to terms with the fact that its previously dominant regional power can no longer be taken for granted. It is having to accept greater pluralism, and growing presence and engagement of Europe, the United States, China and other Asian powers. Nevertheless, the region's future development and stability still depend to a large extent on Russia's future prospects, as well as its ability to find a pragmatic *modus vivendi* with newly influential states in Eurasia. Russia's new identity as an energy power, which increasingly underpins its foreign policy, particular in regard to neighbouring states, is likely to reinforce rather than mitigate geopolitical rivalries and to complicate the resolution of Eurasian challenges.

