

Russia's Interest in Trading with the "Axis of Evil"

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The Russian Economy and its National Interests

The puzzle is why a Russia that has improved its relations with the United States and Western Europe, that has supported the United States in the fight against the Taliban and Al Qaeda in Central Asia, and that seeks membership in the World Trade Organization (WTO) and to attract foreign investment would maintain and even deepen trade with North Korea, Iran, and Iraq—countries with regimes that reject market economics and democracy. Furthermore, Russian trade with Iran and Iraq, in particular, appears to support those regimes in their pursuit of what the United States believes to be policies to acquire weapons of mass destruction and the means for their use. This apparent contradiction suggests that Russia does not hold as a priority economic transformation, international integration, and fundamental cooperation with the United States and its Western allies. It suggests, some have argued, that Russia's true purpose is a new round of competition with the United States, determined by great power ambitions rather than Soviet ideology.

In fact, there is not much of a puzzle at all. The same conditions and objectives that led Russian president Putin to first improve relations with Europe and then with the United States are driving Russian efforts to join the WTO, and have led Putin to deem that Russian military bases in Central Asia and military assistance to Georgia are behind Russian relations with these three countries.

The most important condition is that Russia has no future if it remains the country we know today without significant economic growth, which requires working with the few strengths of what was inherited from the Soviet economy while building new capabilities that fit the modern global economy. The Soviet economy did not leave Russian many assets; the few are energy, metals, and other exportable commodities, a space and satellite industry, a nuclear industry, and conventional arms. In the past few years with a better environment created by significant reforms implemented by the Putin government, new sectors of the domestic economy have become successful, including certain consumer goods, a developing information technology industry, and services.

Although these new success stories are genuine, the main factors behind Russian economic growth rates of 9 percent in 2000, 5 percent in 2001, and probably 4 percent in 2002 are Russia's energy exports and high global energy prices. That is, although economic reform and some increase in investment and productivity have helped, Russian economic growth is due to its ability to sell oil and natural gas abroad and charge high prices for those commodities. The

beneficial effects of Russia's devaluation in 1998 are now gone; future growth will come only from increases in productivity and from selling abroad what is in demand at good prices. Although productivity may well improve, investment is still far below what is needed simply to replace obsolete Soviet stock. Economic growth in the short to medium term depends on oil and gas. Analysts estimate that for each \$1 change in the price of a barrel of oil, Russian GDP rises or falls 0.35 percent (Troika Dialogue, *Russia Market Daily*, April 15, 2002).

These facts have made Europe and the United States important for Russia. First, both are important foreign markets for Russian energy exports. Second, American and European corporations and financial institutions will have to be major investors if Russian productivity in a variety of new sectors is to improve. The Putin government seeks to join the WTO so Russian business can compete in international markets, so Russian business will have incentives to reach western standards, and so Russia will become an attractive investment environment.

These realities are the true reasons why Russian policy on NATO became accommodating and why Russia agreed to a new offensive nuclear arms treaty even after the United States withdrew from the Anti-Ballistic Missile (ABM) Treaty.

Russian policy is driven by military and political weakness as well. Putin welcomed U.S. military bases in Central Asia and similarly tolerated U.S. military training programs in Georgia largely because there was little he could do to stop them. Acceptance of U.S. missile-defense plans was in part a calculation based on the importance of the United States for Russia's economic future, but it was also a realistic acceptance of the fact that there was little Russia could do to prevent a decision allowed by the ABM Treaty.

Russia and the "Axis of Evil"

The very same package of objectives and weaknesses are behind Russia's trade and relationships with Iran and Iraq. Russia's long-term objectives are modernization, investment, and new sectors of development at the high end of production and technology. But in the short to medium term, Russia needs to sell what is in demand abroad. This means primarily the Soviet legacy of fossil and nuclear energy. Selling nuclear reactors and conventional arms to Iran, investing in Iraq's oil industry, and selling manufactured goods to Iraq is unfortunately part of the same policy, driven largely by the same factors, as selling natural gas to Germany or sending oil tankers to U.S. ports. It is to keep the Russia economy growing while it is weak so that it can be restructured to support a strong Russia in the future.

So, in addition to the \$12 billion or so in debt it is owed by Iraq that Russia seeks to recover from a post-sanctions Iraq (whether ruled by Saddam Hussein or not), Russia has a stake in the development of the future Iraqi oil industry. Russian oil companies stand to earn hundreds of millions and perhaps billions of dollars if they can realize promised commitments to develop Iraqi oil and natural gas fields. Several Russian companies are discussing building oil and natural gas pipelines in a post-sanctions Iraq, with contracts commonly worth \$50 million or more.

But Russia's stake is broader than oil. Russian exports to Iraq were nearly \$187 million in 2001, and over \$61 million in the first quarter of 2002. Commodities sold include, for example, Volga cars and grain harvesters, and therefore extend the benefits of trade with Iraq beyond Russia's oil production and transport companies.

It is worth noting, however, that even so, Russia's main trading partners are not North Korea, Iran, and Iraq. Over half of Russia's trade is with the European Union (EU) and EU-aspirant countries. Russia may have exported \$187 million in goods to Iraq in 2001, but that is a small slice of its total exports of \$101.6 billion. More significant than the amount is the concentration: Iraq buys manufactured goods and energy sector services that Russia for the most part cannot sell anywhere else. Iraq as an export market is part of a package of economic relationships that enables the Putin government to sustain a level of growth and stability while it buys time in modernizing and diversifying the economy.

Russia has another, less intuitive, but vital stake in Iraq's future oil industry. Although Russian oil companies stand to gain from Iraqi oil production, they also stand to be severely harmed by too much success. To understand this, remember that Russia's healthy looking 4 percent growth in GDP for 2002 is essentially due to its foreign energy sales. In addition, remember that each \$1 fluctuation in the price of a barrel of oil means a 0.35 percent change in Russian GDP.

This means it would only take a \$6 per barrel fall in the price of oil to halve Russia's GDP growth for the remainder of 2002. Such a price drop is not beyond the expectations of industry analysts. While war in Iraq should lead to an increase in oil prices, the subsequent peace would likely bring substantial Western investment in oil production and a significant opening of Iraq's vast reserves, possibly resulting in a decrease in prices.

That is, in addition to being concerned that a successful U.S. war will mean they will be squeezed out of future development in Iraq, Russian energy companies are also worried that U.S. companies will so successfully and thoroughly develop Iraqi energy resources, global energy prices will fall. Mikhail Khodorkovsky, CEO of Yukos, recently expressed this concern to a British journalist in terms of its affect on the profitability of Russian oil companies themselves. If global oil prices fall to \$11–13 per barrel, Russia's oil companies will fall below profitability. But in addition to eroding and possibly eliminating individual company profits, an American-led Iraqi oil boom could eliminate the only source of GDP growth in the Russian economy for the foreseeable future.

Russia's close relationship with Iraq, therefore, is rooted in the peculiarities of its distorted, essentially weak economy. Russia's energy wealth, in the absence of any other dynamic and productive economic sectors, makes it vulnerable to a fall in global energy prices, which is one reason the government opposes a U.S. war that would lead to U.S. occupation of Iraq. On the other hand, the energy sector is one of the very few successful sectors of the Russian economy, so the logic of pursuing that advantage creates incentives to maintain and even improve relations with Iraq, even as the United States prepares for war. Russia's relations with Iraq conflict with U.S. interests, but they are not based on a Russian conflict of interests with the United States. They are, quite ironically, based on the same objectives of economic modernization and internationalization that have been at the root of the overall improvement in U.S.-Russian relations.

The Russian Economy and the Government's Interests

In addition to Russia's national interests, we need to understand that global oil prices also affect the government's fortunes. Russia will hold Duma elections in December 2003 and presidential elections in the spring of 2004. Studies of Russian public opinion and voting behavior show that

the Putin government's popularity and support come from a more stable and successful economy as well as the belief that the current government has improved the security and predictability of Russian life.

That is, much of the government's support comes from relatively low inflation, balanced government budgets, prompt payments, and improving living standards made possible by an economy that has grown at rates between 4 percent and 9 percent for the past four years. With two very important elections coming up in just over a year, the government has a big stake in the performance of the economy. Since global energy prices have such a large and direct impact on Russian growth, the Putin leadership's political fortunes are affected rather significantly by the global price of oil and Russia's involvement in a post-war Iraq.

Because the Russian economy is so dependent on global energy prices, so is the Russian government budget. One of the main reasons Russia's budget has been in surplus (enabling it to meet its obligations without budget deficits) has been the revenue it has received from taxes and energy export duties. So dependent is the Russian government on oil prices for fiscal health and creating the economic stability Russian voters now value so dearly, its budget planning includes assumptions about global oil prices on which it bases projections of government revenues. If global oil prices fall more than a few dollars per barrel, the Russian government budget goes from a healthy surplus to deficit.

Russia is not only an energy economy—its government has to watch global oil prices in much the way Western politicians watch poll numbers.

Therefore, Russia's stake in Iraq and its energy sector is not merely a matter of national interests and a strategic for economic modernization that affects foreign policy, it is a matter of the direct political interest of its leadership. As long as elections have a place in Russia's political future, political leaders have to be directly interested in economic performance. That means a long-term strategy of western orientation and integration. But it also means, in the short run, a stake in Iraq and its future.

The Russian Economy and Narrow Interests

The Russian-Iraqi relationship, which is counter to U.S. policy, is rooted in a set of Russian strategic economic priorities that the United States has otherwise welcomed. The priorities lead Russia to Iraq because of the realities of Russia's energy dependent economy, and the weakness of its manufacturing sectors, which find an eager (indeed, nearly captive) market in Iraq.

The economic calculations that led Russia to Iran are similar, but they are more narrow than national and primarily opportunistic rather than strategic.

In one sense, Russia's economic relations with Iran are driven by the same factors of weakness in the legacy of a distorted Soviet economy that produces only a limited set of exportable goods. The Soviet Union invested heavily in its nuclear industry and attracted its best scientific minds. Similarly, its conventional military industries produced goods that were, and still are, in demand by foreign markets. Revenues for arms sales varied between \$2 and \$4 billion annually from the mid-1990s to the present, and for nuclear materials and technology between \$2 and \$2.5 billion annually in the mid to late 1990s. Although not a huge proportion of Russia's yearly exports, they are very significant because in both cases there is virtually no domestic demand for either of these industries. Russian energy use fell with the decline of its

economy in the 1990s, so the Ministry of Atomic Energy (Minatom) has not been selling on the domestic market. Similarly, the Russian military has not spent any significant amounts on procurements, so Russian defense plants have either been idle or have produced for foreign customers.

Foreign sales, therefore, are a significant asset for keeping these two industries alive. In the case of arms, it is clear why the Russian state would have an interest in sustaining a defense production capacity for a time in the future when it will be ready to buy arms for its own military. Customers like China, Iran, and India play a role in preserving Russia's defense industrial capacity until the Russian military becomes a customer again.

Minatom and Russian nuclear sales to Iran is a much more murky and problematic case. On the one hand, the \$800 million that Iran will pay for Russian completion of the Bushehr power plant (and the potential for a 10-year agreement to build 5 more power plants for \$6 billion) is obviously welcome to an industry with little new domestic demand and not many foreign markets.

However, the consensus among experts is that these commercial relations serve little in the way of strategic economic objectives in support of modernization and integration. The amounts of money are welcome, but do not have a larger impact on Russia's fiscal health or adaptation to a more competitive economic future. The contracts arguably keep some Russian nuclear scientists employed, which is valuable to prevent them from becoming a proliferation risk. But because there is evidence that scientists affiliated with the project have contributed to Iran's nuclear fuel-cycle knowledge, it is at best a weak claim.

Instead, Minatom appears to have privatized Russian foreign policy toward Iran, at least in the nuclear technology realm. There is no effective government oversight of Minatom programs and no evidence that contract revenues make their way to government revenue accounts. Increasingly, there are reports of corruption, disappeared funds, and scientists providing knowledge beyond the contracted and monitored work at Bushehr. Although technically legal under the Nuclear Non-Proliferation Treaty (NPT) and buttressed by a Russian-Iranian agreement that spent fuel from the plant will be returned to Russia, Bushehr poses a proliferation risk by contributing to Iran's knowledge for developing an independent fuel cycle for producing weapons-grade fuel.

There is no evidence that Russia seeks to provide Iran with this capability for strategic or political reasons. Russia sees some advantage in good relations with an important country in the difficult Caucasus and Central Asia regions. But to a greater degree, Russian and Iranian interests are substantially competitive. Russia has clashed with Iran over the division of the Caspian Sea. It competes with Iran in provision of natural gas to Turkey. Russia's natural gas prospects and export interests would be negatively affected if Iran were able to export more successfully in regional and global natural gas markets. Russia and Iran are in many respects natural competitors as energy providers. Many Russian analysts point out that Iran's policies on Islam are a potential problem for Russia's relations with its neighbors in Central Asia and the Caucasus, and within the Russian Federation itself.

Instead, the best explanation for Russia's nuclear relationship with Iran is the capture of this foreign policy relationship by a very large player, with very narrow and specific interests. The Russian government allows capture and privatization of its policy by Minatom because it brings contracts and resources to a noncompetitive sector of the economy that is too big and powerful to

be relegated to irrelevance. It also helps that the Minatom projects with Iran are technically legal under the NPT, meaning Russian officials can dismiss U.S. complaints as unfounded and demands to end the construction as illegal.

Russian Foreign Policy and U.S. Interests

Russia does not share substantial interests with any of the three countries grouped together as the “axis of evil.” Russia has no interest in an isolated, pariah North Korea. In the last months, Putin has played a constructive role in encouraging Kim Jong-il to mend relations with Japan, resulting in North Korea’s admission that it kidnapped Japanese citizens, many of whom have since died in captivity. Russia’s economic stake in North Korea is twofold. The first factor is its future emergence from isolation, whether that come in the form of partnership, confederation, or union with South Korea. The second is development of a transportation infrastructure that links Russia’s Far East with sensible land and sea facilities in both Asia and Europe. Neither is a threat to U.S. interests.

Certainly, many in Russia take some pleasure in defying the United States when it demands that Russia cut off economic ties with Iraq and Iran, and in asserting an autonomous Russian foreign policy. But there is no evidence for and no logic in believing that Russian relations with these countries are rooted in a policy of challenging or undermining the United States, or aiming to recreate Cold War zero-sum competition.

On many of the issues truly important to the United States in its relationship with Russia in the past year—NATO enlargement, national missile defense, a new offensive arms-control treaty, U.S. bases in Central Asia and military presence in the Caucasus, a new energy strategy—Russia has largely accommodated U.S. policies and priorities. If Russia sought to counter the United States, it could have done so on issues far more important than oil contracts with Iraq or far less self-defeating than turning a blind eye to Iranian nuclear ambitions.

The key to U.S. policy in dealing with Russia in terms of its relations with these countries should be to leverage Russia’s long-term strategic economic objectives. Where Russia’s policies with these countries threaten to harm U.S. interests, it is always because Russia is grasping for short-term benefits. It is in U.S. interests to help Russia’s political and economic leadership focus on its long-term objectives because these offer greater benefits. A single contract with Iran that benefits Minatom is not worth as much as joint development of new oil fields and pipelines (Russia is suffering from an excess of oil and limited ways to get it to markets) that has beneficial effects not only for oil companies, but also the Russian economy and government budget. Loss of lucrative nuclear contracts might be acceptable if Russian steel producers had the opportunity to compete in Western markets or if Russia’s higher value information technology industries benefited from integration and competition in the context of Russian accession to the WTO.

Most of all, U.S. policy would benefit from not putting Russia’s relations with these three countries in the rubric of the axis of evil. All three countries pose problems for U.S. interests, and Russia’s relationships with them exacerbate those problems. However, although there is a common thread in Russian relations with them, it lies within Russia’s economic ambitions, which are very different in each of these cases. We only burden our own ability to use our considerable assets in engaging Russian interests in Western investment and trade by using this

construct and will find it easier to tackle the challenge of eliciting constructive Russian engagement if we free ourselves of it.

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