Russia's economic relations with Europe including energy security
Chairman: Silvana Malle
Discussion Leaders: Andrei Illarionov and Philip Hanson

Silvana Malle: It is a great pleasure to chair this session, which features two distinguished economists, Phil Hanson and Andrei Illarionov. I do not really have to introduce them, but just a few things. We have known Phil for years, and the many books and articles he has written. For me, the more interesting works are "The Rise and Fall of the Soviet Economy" and "From Stagnation to Catastroika"[1]. An article you have in your folder, which I found extremely interesting, is "The Resistible Rise of State Control in the Russian Oil Industry"[2], and the idea that the managers are private, but maybe not so private. Let me also introduce Andrei Illarionov. I met Andrei twenty years ago at the Sopron Conference in Hungary, where reforms were being discussed at the time. Hungary seemed a more developed country, so they were gathering people from all over the region. The professional life of Andrei is extremely interesting because he has held a number of prestigious positions and from 2000 to 2005 he was Putin's chief economic adviser, but a certain point he decided to leave. He also served as the chief economic adviser to the Russian Prime Minister, Victor Chernomyrdin in the early 1990s. He is now a fellow of the CATO Institute. So, Andrei really knows a lot about Russia and also knows the political life of the country, but first let me give the floor to Phil.

Philip Hanson: I want to talk mainly about gas in the context of energy and security. Just a little bit of background about economic relations between Russia and Europe. Russia is stuck with Europe in the sense that because of the size of the European economy – not only the EU, but also Switzerland and Norway – and because of the location and distance Europe is a dominant partner in Russia's trade. Lately, about 52% of Russia's merchandize trade is with Europe. That compares with only 14% with other CIS countries and about 3% with the US. So for better or worse, these trade partners are stuck together for obvious reasons to do with location and economic size, as the gravity model of trade would predict. The looming large issue in Russia-EU economic relations is energy security. That is really very much to do with gas rather than oil or any other particular form of energy. Because oil is traded on competitive markets, if you have problems with one source of supply you can get oil from another source of supply fairly flexibly. And this is not the case with gas. And still today, despite the development of liquefied natural gas, most gas moves from one place to another by pipelines, characteristically around the world in general, and certainly in Russia's relations with Europe, under long-term supply contracts. You have a

[1] "From Stagnation to Catastroika. Commentaries on the Soviet Economy, 1983-1991, New York: Praegar/Center for Strategic and International Studies".

[2] "The Resistible Rise of State Control in the Russian Oil Industry" by Philip Hanson, *Eurasian Geography and Economics*, February 2009". This was a Reading for the Colloquium.

particular partner in one end, and you have a particular partner in the other end; of course in the Russian case it is always *Gazprom*. In fact, it has legally entrenched monopoly of trade in gas. It is sometimes said that the problem is not really so acute as is sometimes suggested because reportedly they need us; Russia needs Europe, as much as Europe needs Russia, in the sense that they need the money just as much as we need the energy. That is true as far as it goes, but I would caution very strongly against it for several reasons.

First of all, gas, which is the tricky component of the energy relationship. That particular fuel, gas, accounts for much less of Russia's export earnings than oil plus oil products. Whereas gas, oil and oil products have been in recent years 60-65% of export revenue in total Russian exports, gas alone accounts for less than 20%. Russia consumes oil, of course, but it is both a very large producer of gas and at the same time an exceptionally large consumer of gas. It actually consumes the great bulk of the gas it produces. So its financial dependence on export revenue from gas is nowhere near as large as its overall dependence on earnings from energy.

The second reason for being cautious about this mutual dependence is that short-term disruption of gas supplies to a recipient country can be a very considerable disruption to economic activity and, indeed, to things like heating for houses. The adjustment on the revenue side for the exporter is less sharp in its short-term effect. And that fact is, I think, in the back of many people's minds, when they are concerned with energy security, both in Europe and Russia. I think it is understood this is something that makes European customers of Russian gas cautious in their dealings with Russia: inclined at least to try to avoid offending Russia at the margins so to speak. This uneven mutual dependence can affect policy-making.

Third reason for worrying, I believe, about European energy and security as far as gas is concerned is to do with the companies that have major long-term contracts of gas supply from Russia: E.ON Ruhrgas, ENI of Italy and Gaz de France. They have quite considerable political leverage in their own countries. They influence what happens and what governments do. They are lobbyists of considerable power. And there is a word for one aspect of this: 'schroederisation'. So there is a sensitivity to Russian pressures which, I think, most analysts and most policy makers in Europe would like to see reduced. But how? What to do about it? Because, after all, European gas demand has been growing fast, and currently it is projected to resume its growth after the crisis. Countries like my own country, the UK, which currently are not using Russian gas, except very marginally, may well find themselves importing more gas from abroad as North Sea reserves dwindle, and this could quite possibly be from Russia.

So what should Europe, or, more to the point, European governments and European companies do? One solution, which is sometimes talked about is liberalization of gas markets: unbundling distribution from production, separating ownership of upstream and downstream activities, and moving towards creating a spot market in gas, moving towards something like a real market in gas, which for most purposes there is not at present. Although this is desirable, it is politically very difficult partly for the reasons I have suggested, influence of companies - but not only for that reason. There may be measures, developments short of that, which are potentially helpful, like more investment in gas storage and more interconnection of gas pipelines. There are at present considerable limits on how far gas can move freely around Europe. So you have these bilateral Russian relations with Germany, for example, conducted in isolation from German energy relations with the rest of Europe. But who is going to make this investment? It is not in the immediate interest of the major European companies to do this. They have cosy relations with *Gazprom*, and they have every reason from their own point of view to continue those relations. There is also, of course, as part of the problem in the background, there is the Russian role in (so far successfully) monopolizing the westward flow of gas from Central Asia. If the *Nabucco* pipeline is built it would take some Azeri gas, but not necessarily Central Asian gas. If there could also be more effective links with Central Asia, ideally a Trans-Caspian, pipeline taking Turkmen gas across to Baku and then down into the *Nabucco* pipeline, we would have a route by which Central Asian gas bypasses Russian pipelines. That has got an obvious attraction.

One of the most impressive analysts in this area, John Roberts from Platts Energy, reckons that *Nabucco* is a real possibility; it is not as unlikely as it seemed a while ago. But so far it is not clear how much gas would come through the *Nabucco* pipeline and it is not clear whether Central Asian gas will be a part of it.

Then, of course, we can cultivate other sources of supply, Algeria, Qatar, Nigeria, but note that the Russians are trying to get in there as well. The Russians actually have the ambition to have a stake in, if not control of, a Trans-Sahara pipeline from Nigeria, believe it or not. So these are all areas of concern. It is not quite clear how things are going to go, and it is not entirely clear who is going to take the relevant decision, which would, in my judgement, be helpful to European interests. One obvious worry is that the present set up is really quite robust as a commercial arrangement. Because of the ritual, actually, more than ritual – quite serious – spat with Ukraine in January and the knock-on effects on Russian gas deliveries through Ukraine to other European countries, *Gazprom* sales to Europe fell quite sharply in 2009. And, of course, because of the recession European demand has been lower, so that *Gazprom* went, I think in the first seven months of the year, 20 billion dollars down in gas revenue in dealings with Europe. But if you look at it month-by-month *Gazprom* had climbed back by July to the market share it had before − about 32% of European gas consumption. So that even with all the stresses of both the January conflicts and the recession, the arrangements are still sufficiently robust that Gazprom quickly gets back to where it was before in terms of market share.

One final observation: one requirement, I think, is more vigilance towards *Gazprom* activities in Central Europe. Professor Jeszensky mentioned it in the paper, which is in the conference material, and I think he is absolutely right. You have developments like *Gazprom*'s acquisitions of 51% of NIS – a Serbian company. Since Professor Jeszensky wrote his paper, there has been the acquisition by *Surgutneftegaz* of 21.2% of MOL, the Hungarian company. This was odd in certain ways. *Surgutneftegaz* is not officially a Russian government-controlled company, it is a private company. It had not previously invested abroad; it had been a company, which was very much devoted to domestic development in Russia. It had been unusual among most Russian, and only Russian but other oil and gas companies, in building up quite a big cash flow, quite a bit of liquidity. And finally, they paid twice the market rate for their stake in MOL. It would be naïve, I think, to see that *Surgutneftegaz* acquisition as purely commercial exercise. And it all is very important to the potential development of

South Stream, which would be the Russian alternative route to *Nabucco*. It is not impossible that both could be in place and could both operate. But *South Stream* would tie some of the Central European countries more tightly to Russian gas supplies. So that concludes what I wanted to say. I have simply pointed out what I think are the key features of the situation and some of the policy questions that arise.

Andrei Illarionov: Clearly there is some mistake that I have been invited to talk on this particular issue – from at least two points of view. First, we are discussing the issue of Russia; Russia's economic relations. But it seems that it is not so much Russia's economic relations but Russia's leadership policy – the authorities' policies and approach and so on. This is not something that can be explained from the position of Russia's national interest, commercial and economic interests. This is why it is difficult to associate these leadership policies with medium and long-term interests of the country. Since we have to look at the origins of this policy, of this approach, we are forced to leave the area of economics. We need to look at the political system of the country, which has nothing in common with a democratic state. Indeed, it is a harsh authoritarian state – although, not quite the totalitarian state of several decades ago. It is important to stress that even this so called political scientific analysis is not enough, because not every authoritarian state can be described, as Russia must be.

We need to look at the sociology of this political regime and identify the group actually in charge of most of the decisions taken on Russia's behalf. It is a very small group, consisting at most perhaps a dozen, with five or so taking the most important decisions. It should be noted that one person takes many of these decisions. That is why instead of analysing some kind of economic regularities and looking at their application, we are forced to analyse a particular narrow group's approach, or that of a particular personality. This is why these decisions, in many cases, are being taken not on an economic or commercial basis, but for another reason. It is something a psychologist should examine, not an economist. That is why we cannot understand the actual policies and we will not look at the reasoning of some particular people. But if we move there, we are leaving the basis of some kind of more or less objective analysis.

Look at the title of our session: "Russia's economic relations with Europe including energy and security". It is implied that energy and security are part of economic relations. That is certainly not true. Energy is not fully part of economic relations. The very fact that we are forced to discuss energy issues means that they, at least in many cases, are not a result of the free market, but of some political policies pursued by different actors. It is even much more true for security issues. That is why many people, trained in economics, opposed discussing these energy and security issues, as they are topics for security specialists. Nevertheless, the issues are on the table, and need to be discussed. I will probably skip description – many of you follow events – and move to explanation and forecast. Forecasting is a very risky business and I would not attempt it, but I would like to say something about explaining the system.

A few years ago it was just a big question mark – what does that mean? Why does Russia have a series of gas wars with Ukraine? What does the halting of the oil flow to the Mazeikiai oil refinery in Lithuania mean? Or why do they not allow Kazakhstan oil to go through the Russian pipeline system? Why Blue Stream, North Stream, South Stream pipelines and so on? It is not a consensus, but a general understanding of existing policies. It is very consistent policy that had been pursued since 2001/2002. The policy had an aim, and, initially, it was concerned with only Russian territory. Over the last four or five years it has definitely moved outside that territory to monopolizing energy resources, and other kind of resources, through different instruments. To monopolize resources it is not necessary to nationalize, as many people still believe. Boris Abramovich Berezovsky in the 1990s showed that if you just appoint the right person as manager to control cash flows, you can control the organization much more effectively than with so-called *de jure* property rights. The reality in some parts of the world, including Russia, is that you have other instruments to control organizations, firms, companies, and flows of financial and material resources. So it is a monopolizing of energy sources, transport routes for energy, and, as much as possible, of supply. To whom? Ideally, to everyone. Some people still think that at some point it will be possible. But in real life it is too much, even for this particular period of time, and nature and history have provided the policy’s first victim: Europe. That is why Phil Hanson is right to say that Russia is stuck with Europe. Due to historical, political, geographical reasons Europe was, is and for the foreseeable future will be, a consumer of a substantial amount of Russian energy. And Russia was, is and will be, again for the foreseeable future, a supplier of much of Europe’s energy.

If you look at the map of Europe, maybe with Western Asia, and at a map of pipelines, particularly, gas pipelines, the so-called energy hits against Europe, taking Europe in almost full monopoly with all possible resources. That is why this is a big battleground which has been evolving for several years. With South Stream or Blue Stream, it is just an attempt to cut other sources for Europe, and take control of all other sources and transportation routes to Europe. The trans-Saharan pipeline goes to the same group. If you look at perhaps hundreds of decisions taken over the last eight or nine years, in almost each one you would find traces of a grand plan of how to create this so-called new energy reality. We can certainly discuss whether this plan has been successful and until recently I would say it was quite successful. A number of acquisitions in European pipeline construction companies, with establishing control over different energy fields, striking deals with Central Asian regimes for sending energy, game with OPEC… all go in the same direction. So, the most important thing, is to understand this logic. It is up to Europe, or the European nations, to decide what to do in these circumstances. Phil Hanson has already made several reasonable suggestions.

Now, a few words about Georgia. It is not only the Russian-Georgian war *per se*, which is incredibly interesting and important for nowadays, but it is also only a small part of the big picture of energy policy, the grand plan of energy control. If you look at the map of Eurasia, you will see that the most important new energy resources are located in the Caspian basin in Central Asia. With Russia to the north, Afghanistan on the border, with almost permanent civil war and occupation by different forces, Iran to the South with bad relations with the United States and Europe, there is only one known channel to transport resources from this area. It is via Azerbaijan and Georgia to the Black Sea and the Mediterranean Sea via Turkey. We have very narrow bottleneck of energy resources, that is relatively untapped, and that is why it is natural for someone to try to unblock this bottleneck, and reroute all possible energy resources from the region, not via Afghanistan, but via Russia. The idea of creating problems on this route from the Caspian basin via Azerbaijan and Georgia to the

Mediterranean and the Black Sea was identified early on, at least in the late 1990's. But these policies were implemented as late as September 1999, when the new Russian prime minister initiated a consistent policy of undermining Georgian independence, provoking different movements in the enclaves of Abkhazia and South Ossetia, and it resulted in the Russian-Georgian war. I would stress once again that this campaign has lasted exactly ten years, from September 1999. Since then there has been an endless list of varying preparations, provocations, the amassing of military equipment and troops, sending Russian officers and secret police operators first into South Ossetia, then to Abkhazia, supplying armaments and so on. I would mention several facts. The first big supply of Russian tanks and heavy armaments to South Ossetia took place on February 2 2003. At that time officially and until late August 2008 Russia recognized Georgia's sovereignty and control of the Russian-Georgian border. Nevertheless, many T-55 tanks, was sent through the Roki tunnel[3] to Mr Eduard Kokoity, President of South Ossetia. They were detected by the Georgians and the Americans who sent angry protests, but in vain. The supply of military equipment to Abkhazia and South Ossetia that day was ten months before the so-called Rose Revolution that brought Mr Saakashvili to power. So regardless of the state of personal relations the leaders of Russia and Georgia after that, what is important is that a great deal of military equipment was moved when no one could have predicted that Mr Saakashvili would be the next President of Georgia.

Clearly this was a long-term policy of the Russian leadership and not linked to whoever was Georgian President. The reason was the geographical or, more properly, the geopolitical position of Georgia, the crucial country in this channel. The volume of this flow of armaments was immense, and by January 1 2008, just seven months before hostilities broke out, the number of tanks, armoured vehicles, artillery units, and all other rocket missiles in South Ossetia was the highest in the whole world's military ranking. For example, the number of tanks per 1,000 people in South Ossetia was ten times higher than in North Korea. Before 2003 that country was the champion in military preparations of all kinds. Since 2003, with Russian help, the first has been South Ossetia, Abkhazia second, with North Korea in third place. The number of armaments has been, in some cases, ten times higher than in North Korea on a per capita basis. But, per capita is per capita; it is also important how much, of course, is strategically situated. It is striking that by January 4 2008 the number of tanks, artillery units, armoured vehicles and other equipment happened to be in South Ossetia and Abkhazia, with the total population of 260,000 people. In Georgia, its 4.5 million people were outnumbered three to one. So Georgia, as a sovereign nation that spent a great deal to modernise the army, was two-three times weaker militarily than South Ossetia and Abkhazia. By December 1 2007 Russia withdrew its military base from Georgia, so that in the envisaged campaign, its army would not be surrounded and taken hostage, and equipment would not be captured by the Georgian army. Russia walked out of this treaty limiting military armament on the European flanges, and there was a Presidential decree stipulating two mountain brigades in the Caucasus by December 1 2007. There were reasons for this particular date. This date was initially given to Marti Ahtisaari to prepare a report on Kosovo independence, and it was obvious that some kind of agreement between Kosovans and Serbs would be impossible. In December, Kosovo's independence would be decided and by then the

[3] The Roki Tunnel was built by the Soviet authorities in the 1980s in the Caucus Mountains north of the village Upper Roka. This is the only route joining the North and South Ossetia.

military campaign in Abkhazia and South Ossetia against Georgia would be prepared. But as we know, it was postponed until February and Kosovo's independence was proclaimed on February 17 2008. Subsequently, they decided the summer was better for the campaign. I could go on, because there is a large body of evidence available on the campaign's preparation and how it was prosecuted. On September 30 the European Commission, headed by Heidi Tagliavini, a Swiss diplomat, will release a nine hundred page report on this war. [4]

With reference to the club Medium-term ballistic missiles SS21 and 26 (so-called *Tochka-U* and *Iskander*) against the Baku-Tbilisi-Ceyhan pipeline, they have deployed about two dozen missiles in attempts to destroy the pipeline. But because it is underground, it was undamaged, but nevertheless these intentions were clearly demonstrated. It is important to remember that only three days before hostilities broke out, the head of Abkhazia's security service publicly warned journalists that brave Abkhaz groups would destroy the Baku-Tbilisi-Ceyhan pipeline. And he was right – just 24 hours later there was a big fire in one of the gas installations on Turkish territory (Turkish Kurdistan), which temporarily cut off oil supplies from the pipeline. Fortunately, it was not a big fire and it was put out relatively easily. Twenty four hours later a new war started.

Silvana Malle: Both speakers have talked about the energy issue, but we could probably go outside this field and discuss what other structural changes have taken place in Russia.

Bernard Brscic: Firstly you seem to be sceptical and say that a psychiatrist should examine Russian policies, but then in confirmation of the above you seem to apply cost-analysis, and you give a completely irrational explanation of the policies pursued by the Putin administration and this is, on the level of state players' monopoly of the energy sector. Basically, it is completely rational, every rational monopolist tries to cut competitors out of the game and deploys all geostrategic weaponry in order to achieve this. Of course, it is questionable whether, as an economist, one can expect a level of analysis that goes beyond the individual actor, so the main player, instead of the individual, becomes the state. But if you accept applying rational choice at government level, it seems to me that Russia is behaving quite rationally in trying to extract monopoly rents from the energy sector.

Andrei Illarionov: Thank you very much; it seems I succeeded in attracting your attention to this particular issue. It is true and that is why I was trying to provide a different view on it. It is completely rational in the short-term, but irrational in the long-term, because if the Russian leader took a rational long-term view, he would pursue a different policy to produce much better results in the long-term. We could consider that he is trying to convert the country, maybe not to a state like North Korea, but in that direction. Even if in short term it looks as if he achieves so-called respect of this might or power, in reality he is destroying this power and those resources. The clear alternative has been offered by Mr. Khodorkovsky by his actions: privatization of resources and decentralization of decision-taking, decentralization of

[4] The final report, published on 30 September 2009, concluded that Georgia started the war, but both sides bore responsibility for escalating the conflict.

supply and of consumers, such as reaching the US and China. That alternative is much better than the shortsighted policies being pursued right now.

Miroslav Prokopijevic: You said that up to twelve people are decision-makers, if I understood you correctly. I would summarise my question by saying if there is a liberal market in Europe for gas, it is easier is to take Europe hostage for a supplier, is that correct? My next question is, assuming Europe discovers some new gas supplies, where are you going to send your gas?

Andrei Illarionov: Your first question is correct. In terms of the second one, in Russia we have a proverb, it is not the tsar's business, which means it is not the government's responsibility. The idea is to transform gas into normal commodities that can be traded, sold and bought by anyone who can profit by that and has an interest in it. It is not the authorities' business, to run around the world shocking journalists and the general public with details of the gas business, that actually not everyone in the gas industry is aware of, such as the diameter of a pipeline. It should be left to the industry's experts; it is not the government's responsibility. There are technical conditions for the development of the market and there are legal and institutional conditions for the market. As to the legal and institutional arrangements, Professor Hanson mentioned the liberalization of the market in Europe, that is actually a key element on the European side. On the Russian side in 2000 a group of people, including myself, proposed the reform in the gas industry in the liberalization of the market in Russia by dismantling Gazprom's monopoly, privatization of resources such as gas fields and pipelines and creating a real market for gas. There is also a technological aspect, the more supply on the world market, the better it will be for everyone, including suppliers and producers.

Phil Hanson: I would like to make another comment on that. In the medium term, there is no problem for Moscow if Europe diversifies its sources of supply. Russian gas production is practically static and going down slightly, and total European demand is growing. It will take them a long time, six or seven years, to develop Yamal and Shtokmann and going eastwards, which is also on their long-term plan. It would take even longer to develop east Siberia in order to develop the Asian market. So I think for the time being we have a more or less stagnant Russian supply with possibly variable additions from Central Asia, facing growing European demand, some of which may be met by other sources. But they would still be playing a role, although a less dominant one.

Bob Reilly: In the early 1980s the Reagan administration lobbied furiously in Europe against the Soviet gas pipeline at that time. The obvious reason, which Miro just confirmed, that it would leave Europe hostage to Soviet intentions, develop the Stockholm Syndrome in Europe and meet the Soviet geostrategic objective of separating Western Europe from the US. So it was clear to us in the Reagan administration what political purpose was being served through the promotion of the Soviet gas pipeline and why we needed to convince our European allies not to make themselves dependent upon it. Now it seems that Bernard suggests this may be a pursuit for the economic benefits that monopoly can provide, but I would like you to address what possible political strategy this evil dozen might pursue.

Andrei Illarionov: Let me say a little more about the twelve people who are taking decisions on a wide variety of issues, not all of them strategic. Most key decisions are taken by a maximum of five people, but mostly by only one.

As for this question, I think the answer depends on what gas is considered to be, whether gas is considered to be a special type of weapon, and even a book has been published "Gazprom: Russia's New Weapon"[5]. If it is a weapon, then the Reagan administration was right and it is not rational to put someone's weapon to your throat. If gas is considered to be a normal commodity, that is not a problem. The more of this commodity, the better for consumers and it is interesting that during Soviet times, the Soviet Union never used these gas pipelines as a weapon. It was not only a centrally planned economy, but also a real economy with Brezhnev's Doctrine and so on. But the communists of that time wanted to do real business: they wanted to supply gas. They needed hard currency to buy machine equipment or some kind of technology, but it was really business, nothing more. It is surprising that now Russia is considered to be a market economy with a business oriented administration and not once, but many times, these business-oriented leaders have used gas as a weapon as we have all witnessed. The answer to this would be to depoliticize or demilitarise gas. The suggestions of liberalizing gas are not completely right, it should be demilitarized. The success of these policies will only be achieved when we cease to discuss economic issues including energy, just as we do not discuss buying and selling clothes or tractors.

Bob Reilly: Would you not have to be monopolized to be demilitarized?

Andrei Illarionov: This is exactly what has been prepared. In the year 2000, we had to make a plan, when some people including myself entered the government administration. Frankly speaking, those people who came to the administration then had no idea that gas could be used in the way it is now and is planned for use in the future. So it was quite an effective system inherited from the past but we actually wanted to create a normal market.

Miroslav Prokopijevic: So when Brezhnev is back everything will be solved?

Andrei Illarionov: No. Once again, as I said, it was a gas monopoly under Brezhnev, but this monopoly was not the actual but the potential weapon; they never used it. So our view was to destroy even the potential weapon, although we did not think that it could be used at the time.

Philip Hanson: Just a comment on the 1980s pipeline campaign. I recall the arguments that were deployed on both sides. One of the things which was being said at the time in Europe, was that we had, as I understand, an informal understanding that no NATO membership country would permit more than 30% dependency on Soviet supplies of any major energy source. That appears to have just about been observed by Germany at that time. (Bear in mind, by the way, that German energy dependence is much smaller than gas dependence since very little German electricity is gas-generated). Of course, there was some straight commercial lobbying involved: you make large diameter pipes, so you are keen to do a gas-for-gas pipeline deal. That

[5] "Gazprom: Russia's New Weapon", Valery Panyushkin and Mikhail Zygar, Moscow 2008

was part of the story. However, there was also this belief that we should not hit the prescribed ceiling of usage of Soviet gas. Also, in purely commercial terms, no gas utility would be interested in a certain level of dependency on one source. I used to hear this argument many times in the 1980s.

Karl - Peter Schwarz: Does the use of liquefied natural gas (LNG) reduce the possibility to escape this trap?

Philip Hanson: At the moment the difference in prices within Europe in terms of dollars per million BTUs is about 4 dollars for the LNG and 7 dollars for the Russian gas. What is striking is how the established Russian customers are taking Russian gas even at this higher price. You have a long-term supply contract where the price is based on an agreed formula, setting the gas price, with a lag, the basis of prices of oil products. Because of LNG, however, you have a possibility of developing completely independent gas prices which is a gas market itself. So where are we now? Who has actually delivered the first LNG terminal for Russian Shell on Sakhalin? We have. More precisely, Shell, Mitsui and Mitsubishi have. In some ways, curiously reminiscent of Soviet times, we are back to the inability on Moscow's part to do certain things like developing LNG terminals and developing the Shtokmann Field. Yes, they do get some things done when they have the co-operation of Western companies. Moscow still has the old problem of weakness in applying advanced technologies and managing very large projects.

Geza Jeszensky: Let me introduce an historical analysis. One aspect is that gas is absolutely essential for our development, but even three decades ago this was not the case; coal use in households was much more common. Today we take it for granted that without electricity we would not be able to live. But again, how to produce electricity – it has become very fashionable and very cheap to produce electricity from gas. The world is facing the reality that in a given time, 30-50 years, natural oil resources will dry up and we have to be careful. I suppose the same applies to gas although probably this is not as essential. Nuclear energy is currently more essential than both oil and gas, although there was this attitude, particularly in Germany two years ago, that nuclear energy is to be dropped because it is dangerous. But now many countries are planning the building of new nuclear power stations. So is it not a possible solution to a very serious international problem: gas supply and its use or misuse as a weapon? The alternatives already exist and it is only the question of how much it will cost. Probably we will reach a point and return to a society using less gas than today.

Krassen Stanchev: Geza, I agree with your point about the alternatives, but there is a significant element of security related to the proliferation of the nuclear energy industry and it is very simple. When you have half of the nuclear energy industry you should have nuclear fuel suppliers, so nuclear fuel supply and recycling nuclear fuel requires proper plans, so part of the problem with Iran now is the enrichment facility for the nuclear fuel. Only China is planning to build 125 nuclear reactors, but they are not dangerous, as China is a part of the nuclear security system. But if you have more countries using more nuclear power, you will inevitably need to have more enrichment plans and then it would be a nightmare from a security point of view. Russia is part of the game as well. I am not sure whether I rightly understand you, Andrei, but you said that at the end of the 1990s there was a group which was trying to demilitarize the use of natural resources. Also that there was some good will not to use gas pipelines as a weapon during the Communist period, but at the same the current Russian authorities are handling the issue rather irrationally. But if you look at history, Russia had the tendency, from the beginning of the 19th century, to embark on different uses of weapons towards artificially or naturally defined areas of interest. How I understood Bob's question is, what is the timing of this militarization of energy issues and gas in particular and what is the way out of it? So, the fact that there was a good will at the beginning of this century does not necessarily mean that this good will would be bad, and does not give any information when it will prevail.

Andrei Illarionov: The answer is very simple but it does not necessarily relate to the energy issue. Almost anything in the modern world can be used as a weapon. For example, if you have a car you can kill someone with it, but generally people use a car for driving. Many other things can be used as weapons; civilization produces many things that can be used in different ways. This does not depend on the product, not on gas pipelines nor a car, but on who is using them. That is why we are moving towards the topic I suggested earlier, a more important one: the nature of the political regime in the country that tries to use everything as a weapon. That is why we have to shift our attention to this. If you suggest Russia was always like this and will be forever, it does not mean that any country will be in such a position. Before 1933 not many people suspected what would happen in Germany. Only over the last decades have people understood what it was about. That is why we need to analyse the appearance and evolution of political regimes and particular people; how they appear in each country and how they can use the whole nation as a weapon. If you like we can discuss this.

Bob Reilly: Thank you for that, I think the nature of the regime is precisely the key question in this discussion. If I choose to use my car as a weapon, I am killing that person as a means to achieve an objective in my strategy. That is what I am asking, if they are using gas as a weapon what political objective describes the end of their strategy?

Andrei Illarionov: It is very clear, power, which in itself is a great goal. It is hard to imagine anything more important than power.

Bob Reilly: But that is an obvious statement.

Andrei Illarionov: Does it surprise you? I do not think it is anything new; it is just a fact of life. First of all power which can be used for different purposes: more power, more money, control of people and control of nations who happen to be neighbours, for which we have a wonderful term 'areas of privileged interest', not specified as any country or any place.

Bob Reilly: So there is no ideology of the power or guiding the power?

Andrei Illarionov: That is important, that is evolution, because at some point it was rather hard to detect anything like ideology, because nobody stayed in the same place, so it is evolution, a development. Now we have more information about this ideology, because part of it is being created, recreated and restored. For example, even a few years ago it was hard to imagine that it would be artificially recreating nationalism and imperialism versus the neighbours, Europe, the US or some group of people. Only three years ago it was hard to imagine that there would be ethnic cleansing of the Georgian ethnic minority, as in October 2006. It was a purely fascist action, when schools received orders from the Minister of the Interior to produce lists of pupils with Georgian names and then expel them on any kind of excuse. For me it was impossible to imagine, that a country that claimed as a main part of its ideology was the fight against Fascism in the Second World War, would continue such policies. I am not talking about what is happening on the streets of many Russian cities. So it is evolution.

For example, just a few months ago no one would have predicted that the authorities would restore Stalin as a hero, building statues, using Stalin's sayings, hymns and, recently, fully justifying the Molotov-Ribbentrop Pact and the Soviet Union's invasion of Poland in September 1939. There are publications, supported by the authorities, declaring it was the right move, and now these arguments will be extended to the Ukraine, the hotspot in the coming months. The presidential elections take place soon and Russia has decided to solve the 'Ukrainian question'[6]. Last night the newspaper *Izvestia*, some time ago considered a symbol of liberalism in Russia, published a detailed explanation of why the Ukraine has no right to exist. It is a kind of Ukrainian doomsday exactly like Poland's in September 1939. It was on the website yesterday; the style of seventy years ago is back. If you ask could we have expected this, I would have said no. But this is an evolution of ideology, which is ideology for public consumption, whether it is nationalism, imperialism or anti-Ukrainianism. The intent is solely to keep power and extend power. The best way to do this is to find a common enemy and say that we are a besieged fortress. What is inside us? Traitors, oligarchs, liberals or democrats, this is the best way to control society. This is absolute power.

Karl-Peter Schwarz: Is this Putinism, or would it actually work without him?

Andrei Illarionov: I have been arguing in a number of papers that, in my point of view, it is wrong to associate everything with one particular person, even though many decisions are taken by him. A more accurate description of this political system, as an insider is that the political power of the country has been taken over by a 'gang' of secret police officers. And the ideology of this group, not one particular person, Putin, could be much more advanced, more radical than many others, but he is not alone in defining our strategy. This is an ideology and a policy of an organisation that you could classify as mafia. But mafia essentially does not differ from secret organisations, whether it is government or non-government; it depends on whether it has full power. If you analyse it, it is not that different from the classical definition of state.

Bob Reilly: A monopoly of power.

Bernard Brscic: My view of monopolizing the fuel sector is that it is completely rational. I understand that we Europeans are much against monopoly, but from the perspective of the Kremlin it is completely rational. If I were the chief executive of Gazprom, I would also want to monopolize supply and force gas prices to jump and then naturally the monopoly rent would be increased. It is in the interest of the EU to have fuel and gas prices as low as possible but, in a way for monopolists, like Adam Smith, who said that it is natural for monopolies to merge and conspire and the end result is the monopoly. You cannot say the process of de-monopolization that you advocate is an improvement. Certainly not for the oligarchs and businesses involved.

Andrei Illarionov: If you like to use the term 'rational choice', you can actually describe any human act as a rational act. If somebody kills someone, it is a rational act because the enemy must be killed, so it is a rational decision. When Leszek Balcerowicz's government in Poland was privatizing and de-monopolizing the Polish economy, was this an irrational decision? No, it was quite rational. They decided that a monopoly of assets in government hands is bad and that is why they did it, as did others around the world. They were rational actions, as any other action. But I use the term 'rational' in a different sense. In economics we say that 'rational' means the maximisation of output and by using this particular definition of rational approach we would like to increase the well-being of society, that is why liberalization and de-monopolization would be a much more rational decision, rather than the opposite.

Bernard Brscic: It is not the fact that the main goal of economics starts off with maximising the welfare of society, which I agree with, but the question is whose welfare are we maximising.

Andrei Illarionov: Let us look at the statistics; I mentioned Leszek Balcerowicz and we can look at this data, but Poland was outside the Soviet Union. Estonia was inside the Soviet Union, and it did not and still does not have oil, gas, metals and other resources, but what they have done is approach the economy rationally. They would engage all possible intellectual and physical resources of the population. The result is that Estonian GDP per capital is more than twice as high than in 1991. Russian GDP per capita only exceeded the level of 1989 for one year and has now contracted by 10%. So that is the answer to the question: whose well-being is being improved, as a result of these particular policies. It is the welfare of the population. Certainly different people increased their living standards at different rates. Some succeeded more, some less, but on average the quality of life is much higher for Estonian society, while in Russia it contracted.

Bob Reilly: I wonder if what you said about the ideology is not only what you said, but also taking people's attention from many other problems in Russia; the declining life expectancy, declining population, health and all the rest.

Andrei Illarionov: You are absolutely right, the ideology in totalitarian societies is a way of nationalization of contrasts. We are discussing a lot about the nationalization of assets and that is a very important element. But from my point of view nationalization of the personal conscience is much more important. When you deal with people from totalitarian societies, they are different; they are not like those who were raised in Western Europe or in the US. I do not know how many of you have travelled to North Korea. I have been there and the people are very different. They are not playing a double game like the citizens of the Soviet Union, who knew what to say to the party chiefs and what they think in reality. No, in North Korea, the second sort of people has either been killed or is serving time in the camps. It is the whole nation; 22 million people who know nothing about the outside world, only that North

Korea is the best country in the world and they are incredibly lucky to be born there. All other countries are suffering, especially South Korea, Japan and the US. By meeting these people with a nationalized conscience, you understand it is much more difficult to deal with them than with nationalized assets. I thought North Korea was unique, until last year I visited South Ossetia. As soon as I started talking to the people there, from ordinary citizens to security officials, I realised that I had heard it all before; not to such an extent, but otherwise exactly like in North Korea.

Jan Winiecki: If you look at the prospects for Russia, even to the lengths of using natural resources as political bargaining weapons, by acting in that way you are deterring foreign direct investment in the Russian oil business, which has been declining and will continue to decline for a number of years. Putin first encouraged foreign direct investment, but then the disregard for property rights discouraged Western investors. But this is only part of the story and I would say it is not a surprising part of the story, especially as Russian history does not demonstrate that the welfare of the people is a moving force of a particular policy. There we come to the basic issue of the Russian failed transition, if it comes from this short period in Russian history. You mentioned that you could expect Germany to do such things and after this there was a lot of talk how the Germans are. Then you look at the long-term history of Germany and the Nazi period is a kind of aberration. If you look at Russian history the transition period looks the same. I want to share a family story. When my grandfather was an engineer in the sugar processing business and building a factory in northern Ukraine − this was during the Russian Communist campaign − a workers' delegation came to him and said they had a question. They had been told by some Bolsheviks that from now on there would be soldiers, peasants and councils ruling, which would be good, but they did not say who would be the tsar!

So, if you say that now there is a group of twelve people ruling Russia, this is just a continuity of Russia's history from far back and it not only applies to the governing style, but also to property rights. Property rights have been the norm in Western Europe since Roman times, but in Russia Catherine the Great (who is not liked in Poland for obvious reasons) introduced property rights in the late 18th century, and did a lot of good for Russia. She introduced other reforms, bringing Russia closer to the West. If you look at this long history, the failed transition does not look like anything particular, because I think it may take fifty or a hundred years before Russia comes closer to the standards of Western civilization and history casts long shadows. Frankly I think that transition in Eastern Europe takes a very long time.

Philip Hanson: Just one observation, I very much agree with Jan, I think the difficulty we have is that somebody else's arrested development creates problems for us.

Andrei Illarionov: You mentioned a number of issues and I would like to comment on four points. First, we have actually drifted away from energy security, but that is not bad. In terms of failed transition in Russia, to answer the question whether it failed or not, we have to understand what kind of transition we are talking about. At least for many countries of Eastern and Central Europe there were two transitions: the transition from a centrally planned economy to a market economy and that from political authoritarianism to democracy. There is one more element in Russia, but also for Yugoslavia and Czechoslovakia, the transition from an imperial state to a national state. If we take this definition of transition in Russia, was there a transition from a centrally planned economy? Yes, there was. We can claim it was not to such an extent as in Estonia, but it is a market economy. As for the transition of the political system, that was uneven. For example between 1991 and 1993 there was real political democracy in Russia. According to indicators like Freedom House, Russia met all the criteria of a political democracy, with one exception: Russia did not have free elections that would put the opposition into power. However, it is not a political democracy right now. This is an interesting question, why this particular country went back to authoritarianism, even if the same relates to Francis Fukuyama’s *The End of History and the Last Man* actually insisted that with economic growth, high GDP per capita and Russia today has much higher GDP per capita than at the beginning of transition. Why, even with more wealth and a more liberal economy and society than during Communism, there was a movement in the opposite direction of political democracy. That actually, not only Russia, which is against what is considered to be the mainstream of political science of the West. This is an interesting question, why 90% of countries more or less move in the same direction, but 10% move in the opposite direction. Does this mean the theory is incorrect?

As for national transition, the Soviet Union fell apart and we have fifteen independent countries, so now we have attempts of revenge and revisionist policies, but why are some countries are coming back and some not? We did not have a war as Yugoslavia did. And those who would say Russia has always been a dictatorship – then why did Russia not advise bloodshed in 1991-1992 in the former Soviet Union with nuclear weapons against Ukraine? You would not explain this with the wonderful theory that you are citing, that of institutional heritage. What happened in the past would lead us that way forever: Roman heritage and property rights, for example. Tell me please, what kind of Roman heritage was there in Hong Kong, which has greater property rights than in most European countries? Then, Belarus, with a third of Catholics in its population and, according to this theory, should be more developed than Eastern countries; definitely more, than, for example, Kyrgyzstan. However, Kyrgyzstan is politically freer than Belarus. There is no way we can explain this by its institutional heritage. Why is Mongolia freer than Moldova these past 15 years? With all due respect to institutions, it does not work always and everywhere. There are exceptions and we need to understand why these particular cases represent a substantial deviation from the rule.

Many people agree with Richard Pipes' vision of Russia. Richard Pipes is a very good person, very knowledgeable, but there is a little problem. Before the mid-17th century, Russia was a very free country, judging by social development and political institutions. Unfortunately, Professor Pipes does not want to recognize this. In almost all Russian cities there were free elections of the equivalent of the today’s mayor (*pasadnik*). All of them were freely elected. From the 8th century to the mid-17th century. If you look at how the country was leading in development, check the story of 1611, when the Russians invited a Polish Catholic prince to be their Tsar. The Polish king sent his son to Moscow to rule the country. Although Wladyslaw only ruled for ten months before there was an uprising led by the local mayor in Nizhny Novgorod, financed by the local oligarch. We have a number of historians with interesting ideas, but the reality is more complicated and cannot be fully explained by current theories.

Philip Hanson: I want to move away from the interesting, but perhaps insoluble, question of how these things came to be, but to pick up on Andrei's observation of Russia having become a market economy and gone backwards in recent years, as far as democracy is concerned. I entirely agree that Russia has become a market economy, but all the indicators show that it is a highly imperfect market economy. If you look at the OECD economic survey of Russia this year and the McKinsey Global Institute study of a number of Russian industries, one thing comes out very clearly in both of these studies. These are very big barriers to competition. I am talking just about market competition, barriers to entry etc. If you look at where Russia sits in terms of the World Bank's ease of doing business rankings, for the upper middle-income country that Russia is now it is extraordinarily weak. It is not very different from China, but then it has something like three to four times China's GDP per capita. So there is a problem with the absence of competition in Russia and if we look at how this might change in the future, those liberals in Russia who talk about the need for reform, saying that what is needed is both economic and political change, and stress that more competition is needed. Now there are certainly cases of well functioning economies in authoritarian systems. But in Russia as it is now, the two reforms have to go together. Basically the political class controls the resources and unless they can be dislodged, the lack of competition in the economy will remain. So I think the two go together.

Andrei Illarionov: I agree with Phil and that is the point several people in Russia have been making over the last three or four years. We thought that we could change the economy. The changes in the political system, the courts and the media and preserving civil freedoms and political rights, are in my opinion much more important than economic rights. Economic rights are only an outcome of the civil rights. That is not easy to understand. Russia grew remarkably over the last ten years, its GDP doubled. It was growing much faster than most countries in the world. The traditional way in which we measured success in transition was not just GDP per capita and similar indicators, because according to those Russia is doing very well. But we found this is not enough. If you look at Hong Kong and Singapore, or other former British colonies, what kind of Roman colonies have been established in Scandinavia? It is not Christianity. Why did Christianity not produce similar results in Latin America, Macedonia or Russia? My point at is there is no silver bullet to explain everything. Is it Christianity, Roman heritage or Protestantism? Institutions are very important, but there are many exceptions.

We can also become a victim of nationalization of conscience, even if we consider we are completely free people, living in a free economy with a free flow of information. I will mention one element to show how we are not self-critical: the so-called Kyoto Protocol, which is complete nonsense, as is the Copenhagen Summit. But is it coming from Minsk, Tehran, Havana or Moscow? No, it is coming from Brussels, Tokyo, from Scandinavian countries. My plea would be not to blame one country. Britain, a cradle of democracy, is spreading all this nonsense. Let us try to be more careful and not to be unfairly critical to some of our older brothers.

Silvana Malle: We have run out of time; the discussions were very warm; I loved it.