

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is centered in the narrow neck of the hourglass. The word "WikiLeaks" is written in white on a light blue rectangular background at the bottom of the graphic.

WikiLeaks Document Release

<http://wikileaks.org/wiki/CRS-RL34512>

February 2, 2009

Congressional Research Service

Report RL34512

*Russia's Economic Performance and Policies and Their
Implications for the United States*

William H. Cooper, Foreign Affairs, Defense, and Trade Division

November 5, 2008

Abstract. Although its influence has been greatly diminished since the Soviet period, Russia remains a formidable force on the global stage, and its influence seems to be growing. Russia's economy is large enough to influence global economic conditions. Many European countries and former Soviet states are highly dependent on Russian natural gas. Russia is a significant player on a number of issues critical to the United States, for example, nuclear proliferation by Iran and North Korea. Russia's perceived national interests do not always match those of the United States, creating an environment for disagreement if not conflict.

WikiLeaks

CRS Report for Congress

Russia's Economic Performance and Policies and Their Implications for the United States

Updated November 5, 2008

William H. Cooper
Specialist in International Trade and Finance
Foreign Affairs, Defense, and Trade Division

<http://wikileaks.org/wiki/CRS-RL34512>



Prepared for Members and
Committees of Congress

Russia's Economic Performance and Policies and Their Implications for the United States

Summary

The Russian economy has grown impressively since 1999 and, by some measures, has been one of the fastest growing economies in the world. The growth has brought an improvement in the standard of living of the average Russian citizen and has brought economic stability that Russia had not experienced in at least a decade. This strong performance is a major factor in the popular support that former President (now Prime Minister) Putin enjoys—some 70%-80% of the population view him favorably. The improvement in the Russian economy is also arguably a factor in the boldness with which the Putin leadership has reasserted Russia's status as a world power, challenging the United States, Europe, the other former Soviet states in economic and national security areas.

The Russian economy is highly dependent on the production and export of oil, gas, and other natural resources. Its success has largely been the result of record-breaking world energy prices, although prudent fiscal policies have also helped to promote economic stability. However, oil dependence could prove to be a double-edged sword. The Putin regime's failure to complete important economic reforms and its penchant for re-asserting government control over key economic sectors also loom among the possible roadblocks down the road. Russia's dependence on oil and other weak spots in the economy have been exposed by the 2008 credit crisis and other events.

Although its influence has been greatly diminished since the Soviet period, Russia remains a formidable force on the global stage, and its influence seems to be growing. Russia's economy is large enough to influence global economic conditions. Many European countries and former Soviet states are highly dependent on Russian natural gas. Russia is a significant player on a number of issues critical to the United States, for example, nuclear proliferation by Iran and North Korea. Russia's perceived national interests do not always match those of the United States, creating an environment for disagreement if not conflict.

While U.S. exports to Russia are still relatively small, for some producers, such as poultry, energy equipment, and technology, Russia is an important market. Russia is also an important supplier of a number of raw materials that are critical to U.S. manufacturers. These links have drawn the attention of some Members of Congress. Hearings have recently been held on Russian economic performance and policies. Congress may consider in the near future whether to extend permanent normal trade relations (PNTR) status to Russia as Russia pursues accession to the World Trade Organization (WTO). This report on Russian economic conditions and policies will be updated as events warrant.

Contents

The Immediate Post-Soviet Period	2
Recent Economic Trends	6
Internal Economic Conditions and Trends	6
Foreign Trade and Investment Trends	8
Russian Economic Policies	10
Rationalize Government Expenditures and Revenues	10
Implement Structural Economic Reforms	11
Integrate Russia with the Global Economy	13
Implement Other Reforms	14
Reassert State Control of “Strategic” Sectors	15
The Role of Oil and Other Natural Resources	17
Is Russia’s Economic Growth Sustainable?	20
Implications for the United States	24
Recent Developments: Russia and the World Credit Crisis	26

List of Figures

Figure 1. Growth of Real Russian GDP, 1992-2007	7
Figure 2. Russian Oil Production, 1989-2007 (millions of barrels/day)	17
Figure 3. Oil Prices, 1989-2008 (\$/barrel–Urals-32)	19
Figure 4. Net Russian Exports of Oil, 1992-2006 (millions of barrels/day)	20
Figure 5. Percentage Changes in Russian Annual Fixed Investment, 1998-2007	22

List of Tables

Table 1. The Russian Economy at a Comparative Glance	2
Table 2. Major Russian Internal Economic Indicators, 1999-2007	7
Table 3. Select External Economic Indicators, 1999-2007	9
Table 4. U.S. Merchandise Trade with Russia, 1992-2007	24

Russia's Economic Performance and Policies and Their Implications for the United States

The Russian economy has grown impressively since 1999 and, by some measures, is one of the fastest growing economies in the world. The growth has brought an improvement in the standard of living of the average Russian citizen and has brought economic stability that Russia had not experienced in at least a decade. This success is a major factor in the popular support that former President (now Prime Minister) Putin enjoys—some 70%-80% of the population view him favorably. The improvement in the Russian economy is also arguably a factor in the boldness with which the Putin leadership has reasserted Russia's status as a world power, challenging the United States, Europe, the other former Soviet states in economic and national security areas. Putin himself acknowledged the potency of Russia's enhanced economic power:

...Russia's growing economic and military potential does allow us to be firmer in standing up for our national interests, both political and economic. We will never seek confrontation, but we do think it is our right to defend our interests, just as our partners do, and, indeed, we can learn from them.¹

Some experts assert that the Russian economy will continue to strengthen and categorize Russia with Brazil, India, and China as among the fastest growing economies. Others argue that Russia's economic prospects face risks.

Russia has some of the world's largest reserves of oil, natural gas and other raw materials, many of which are critical to industrialized countries. Many European countries and former Soviet states are highly dependent on Russian natural gas. Russia is a significant player on a number of issues critical to the United States, such as, nuclear proliferation by Iran and North Korea. Russia's perceived national interests do not always match those of the United States, creating an environment for disagreement if not conflict.²

While U.S. exports to Russia are still relatively small, for some producers, such as poultry, energy equipment, and technology, Russia is an important market. Russia is also an important supplier of a number of raw materials that are critical to U.S. manufacturers. These links have drawn the attention of some Members of Congress.

¹ Putin, Vladimir. Transcript of annual press conference. February 18, 2008. [<http://www.kremlin.ru>].

² For more information on U.S.-Russian relations, see CRS Report RL33407, *Russian Political, Economic, and Security Issues and U.S. Interests*, by Stuart D. Goldman.

Hearings have been held on Russian economic performance and policies recently.³ Congress may consider in the near future whether to extend permanent normal trade relations (PNTR) status to Russia as Russia pursues accession to the World Trade Organization (WTO).⁴

Russian economic policies and performance raise important policy questions for the United States and the U.S.-Russian relationship which this report addresses, especially as a new president, Dmitriy Medvedev assumes power: Is Russia's current economic growth sustainable? Is an economically strong Russia a threat or benefit to the United States? Is Russia following economic strategies that promote a market economy that underlies the international trade system manifested in the WTO?

Table 1. The Russian Economy at a Comparative Glance
(Key Economic Indicators)

	Russia	China	United States
GDP (2007)			
-Nominal (billions of \$U.S.)	\$1,290	\$3,242	\$13,841
-PPP (billions of \$U.S.) ^a	2,087	7,238	13,841
Per Capita GDP (2007)			
-Nominal	\$9,060	\$2,450	\$45,820
-PPP (U.S. Dollars)	14,660	5,480	45,820
Real GDP Growth Rates (2007)	8.1%	11.9%	2.2%
Average Annual Real GDP Growth Rate (1997-2007)	5.3%	9.5%	3.1%

Source: CRS with data from the Economist Intelligence Unit.

a. PPP stands for purchasing-power parity. PPP measures the cost of a basket of goods in the local economy in dollars. A number of experts consider PPP to be a more accurate estimate than nominal measurements.

The Immediate Post-Soviet Period

The first years of Russia's transition from the Soviet central planned economy (1991-1998) were not easy. The seven years of the transition that coincided with most of the regime of President Boris Yeltsin were, by most accounts, a period of economic chaos, if not collapse and failure.

³ House of Representatives. Committee on Financial Services. Subcommittee on Domestic and International Monetary Policy, Trade, and Technology. Hearing. *U.S.-Russia Economic Relationship: Implications of the Yukos Affairs*. Serial No. 110-71. 2008. 65p.

⁴ For more details on PNTR for Russia see CRS Report RS21123, *Permanent Normal Trade Relations (PNTR) Status for Russia and U.S.-Russian Economic Ties*, by William H. Cooper.

During the period, Russia lost close to 30% of its real gross domestic product (GDP), a decline reminiscent of the Great Depression of the 1930s in the United States.⁵ Russia also suffered very high rates of inflation— over 2000% in 1992 and over 800% in 1993— before it declined to more tolerable, but still high, levels of around 20% by the end of the 1990s. The inflation robbed Russian citizens of their savings as the value of the ruble collapsed, eventually forcing the Russian government to issue new currency on January 1, 1998, with 1 new ruble equaling 1,000 old rubles. As a hedge against inflation, some residents, who were in a position to do so, invested in hard assets such as art works, foreign currencies, and real estate. But the greater portion of the population saw their savings evaporate. The disposable income (income available after taxes) of the average Russian declined 25% in real terms between 1993 and 1999.⁶

The quality of life of the average Russian deteriorated in other terms. In 1991, the life expectancy of the average Russian male was 64 years and for the average Russian woman it was 74 years. By 1999, the life expectancy had declined to 59 years for males and 72 for females.

Russia did not perform much better in the foreign sector. Foreign direct investments were meager given the size and needs of the Russian economy. Furthermore, Russia was incurring serious capital flight— some \$150 billion between 1992 and 1999 by one estimate.⁷ Russian foreign debt soared in part because Russia had taken on the foreign debts of the entire former Soviet Union in an arrangement made with the other former Soviet states. However, Russia had also incurred its own foreign obligations since the collapse of the Soviet Union.

The economic problems were in part a continuation of economic collapse that was a factor in the demise of the Soviet government. The problems were also in part the result of the rapid disintegration of an economic system in which the state, guided by the communist party, maintained complete control and market forces were an anathema. It was a system in which the government emphasized heavy industry production regardless of cost and to the detriment of other sectors including agriculture, services, and consumer industries. The central planned economy also operated huge production facilities that proved to be inefficient, not very adaptable to change, often producing products of poor quality, and not competitive in world markets.

However, the problems were also the product of poorly executed, if not poorly conceived, economic policies of the Yeltsin regime. The regime failed to rein in government spending as it tried to deal with the Soviet legacy of massive subsidies for industry and the population. During the period, the Russian government ran up

⁵ CRS calculations based on official Russian data collected by the Economist Intelligence Unit (EIU).

⁶ EIU.

⁷ Capital flight is an abnormal flow of funds whose holders seek safe havens from financial uncertainty and taxation or to launder proceeds from illegal activities. It is a sign of lack of confidence in the local economy and deprives the local economy of the use of the capital and decreases tax revenues.

large budget deficits that reached as high as 9.8% of GDP, forcing the government to finance debt at very high interest rates. The Yeltsin regime was also criticized for employing “shock therapy,” or radical macroeconomic measures, as part of its economic reform program, largely attributed to Prime Minister Yegor Gaidar. Critics claimed that the measures unnecessarily created inflation and destabilized the economy because market prices were introduced too early in the reform process.

The most controversial aspect of the early post-Soviet economic transition was the effort to privatize state-owned and operated production facilities, in particular, the so-called loans for shares program. In 1995, the government auctioned off to local banks shares in 29 of the most potentially lucrative firms, including major oil companies and mineral producers (Yukos, Lukoil, Sufgutneftegas, and Novolietzk Iron and Steel).⁸ The banks would hold the shares as collateral against which they issued loans to the government to finance its ballooning deficits. The auctions were controlled by individuals with close ties to the Yeltsin regime and whose banks won the bids. They obtained the shares at a fraction of their market value and were able to keep them when the government failed to pay back the loans. The government did not challenge their control of these assets because their owners, who became known as “oligarchs,” financed Yeltsin’s reelection as president in 1996. They used their new wealth to gain control over other interests such as the media. The privatization program also resulted in small and medium-sized firms owned by those who managed them during the Soviet period—the “red directors.”⁹

Russia’s economic problems came to a head in the financial crisis of August 1998. The crisis proved to be a pivotal event in Russia’s transition to a market economy. It exposed many of the weaknesses of Russian economic policies and the need for economic reform.¹⁰

The crisis culminated in August 1998, when the government abandoned its defense of a strong ruble. It also defaulted on official domestic debt forcing its restructuring and imposed a 90-day moratorium on commercial external debt payments. The crisis led to the demise of many Russian banks, owned by “oligarchs,” which had held government debt.

Symptoms of the crisis developed months before August: Russian interest rates soared; prices on the Russian stock market plummeted; and the value of the Russian ruble sank— between the end of July 1998 and the end of September 1998, the ruble lost 60% of its (nominal) value in terms of the dollar.¹¹ In addition, foreign reserves

⁸ OECD. *The Investment Environment in the Russian Federation*. 2001. p.148.

⁹ Aslund, Anders. *Russia’s Capitalist Revolution: Why Market Reform Succeeded and Democracy Failed*. Peterson Institute for International Economics. Washington. October 2007. p. 161-164.

¹⁰ For a more detailed analysis of the financial crisis see (archived) CRS Report 98-578, *The Russian Financial Crisis: An Analysis of Trends, Causes, and Implications*, by William H. Cooper.

¹¹ Furthermore, the ruble continued to decline losing 71% of its value from April to the end (continued...)

declined sharply—between the end of July 1998 and August 1998. The reserves, including gold, dropped from \$18.4 billion to \$12.5 billion,¹² and real GDP declined 4.9% in 1998.¹³

The immediate cause of the crisis was the accumulation of Russian government short-term debt in the form of Treasury bills (the GKO) and bonds (OFZs), to finance burgeoning budget deficits. As long as the Russian government could service the debt, it managed to maintain large budget deficits without incurring inflation and was able to keep the ruble stable. But beginning in 1997 and into 1998, a number of forces came into play that placed Russia in a financially vulnerable position:

- World prices for oil and other commodities, on which Russia depends for much of its foreign currency earnings, plummeted, putting downward pressure on foreign currency reserves and making it more difficult to service the debt and defend the ruble.
- The Asian financial crisis made investors much more wary of holding risky short-term securities such as GKOs.

Foreign economic shocks that hit a financially vulnerable Russia largely explain the suddenness of the 1998 financial crisis. But Russia became vulnerable because of more fundamental problems associated with its economic policy and economic structure. These included the failure to institute tax reform, property rights, and bankruptcy laws and procedures.

Despite the setbacks, Russia made some strides toward economic reform during this period. It jettisoned the centrally planned economic system and introduced market prices for most goods and services, it made the Russian ruble convertible for trade transactions, and the economy was opened to foreign trade and investment. The downturn in the Russian economy was inevitable in a transition from an economy that was 100% controlled by the state at the direction of ubiquitous communist party officials. At the same time, the downturn was exacerbated by bad policies.

The turmoil of the economic crisis and Yeltsin's poor personal health and very low popular support led him to relinquish the Presidency to his Prime Minister, Vladimir Putin, whom Yeltsin had appointed in July 1999. Putin became acting

¹¹ (...continued)

of 1998. Measured on a real effective exchange rate basis (adjusted for inflation), the ruble depreciated 41% between April and December 1998. CRS calculations based on data in Central Bank of Russia data published in *Russian Economic Trends*. September 15, 2000. p. 29.

¹² Ibid.

¹³ Ibid. p.22.

President on December 31, 1999, which set him up to win election as president in his own right in March 2000.¹⁴

Recent Economic Trends

Since 2000 and roughly contemporaneous with the Putin regime, Russia's economic fortunes reversed on many accounts. The radical improvement is arguably a factor in the wide popularity that Putin enjoyed during his term. At the same time, improved economic conditions have brought a significant degree of economic stability to Russia.

The economic trends during the last nine years raise several important questions: Why has Russia achieved economic growth and is it sustainable? What have been the economic policies of the Putin regime and do they help or hinder Russia's long-term economic success?

Internal Economic Conditions and Trends

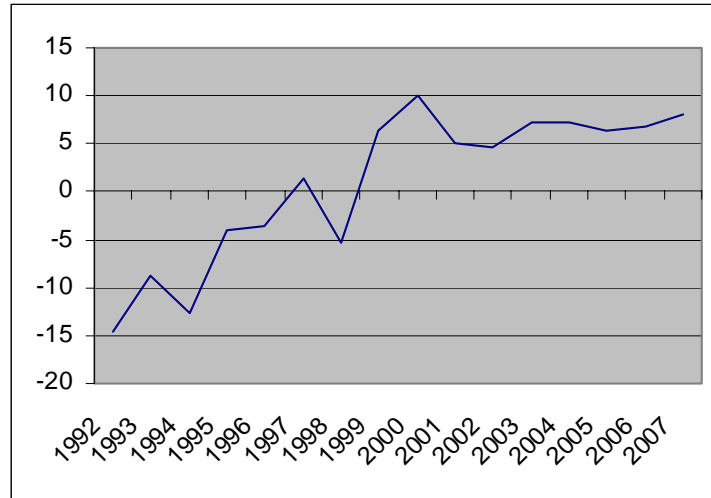
As **Figure 1** and **Table 2** show, Russia has experienced strong economic growth over the last nine years (1999-2007), during which time its GDP has *increased* 6.9% on average per year in contrast to an average annual *decline* in GDP of 6.8% during the previous seven years (1992-1998). The positive GDP trends are reflected in other measurements that point to an improved Russian standard of living throughout the period. Average real wages in Russia increased 10.5% per year from 1999-2007. (Real wages actually increased 14.7% from 2000-2007, having declined by 23.2% in 1999 because of spike in inflation that year.) In addition, real disposable income (the income that the average Russian resident has available from all sources after taxes) increased 10.7% from 2000 to 2007 (8.5% from 1999 to 2007). The Russian unemployment rate has also declined during the 1999-2007 period, from 12.6% to 6.2%.

During the first years after the collapse of the Soviet Union, the Russian population was plagued by increasing rates of poverty. In 2000, 29% of the Russian population was living below the officially calculated poverty line. By 2006, the rate had dropped to 15%.¹⁵ In addition, household consumption has increased—another sign of improved living standards-- from 42.8% of Russian GDP in 1992 and to 57.3% of Russian GDP in 2006.¹⁶

¹⁴ Economist Intelligence Unit. *Country Profile 2007: Russia*. p.5.

¹⁵ Official Russian government data from Goskomstat. [<http://www.gks.ru>].

¹⁶ Ibid.

Figure 1. Growth of Real Russian GDP, 1992-2007

Source: CRS constructed from data collected by the Economist Intelligence Unit.

Table 2. Major Russian Internal Economic Indicators, 1999-2007
(percentage growth from previous year)

Year	Real GDP Growth	Consumer Price Index	Average real wages	Real personal disposable income	Unemployment rate
1999	6.4	85.7	-23.2	-8.8	12.6
2000	10.0	20.8	18.0	11.3	10.5
2001	5.1	21.5	19.9	8.7	9.0
2002	4.7	15.8	16.2	9.7	8.1
2003	7.3	13.7	9.8	13.5	8.6
2004	7.2	10.9	10.3	8.6	8.2
2005	6.4	12.7	12.6	11.5	7.6
2006	6.7	9.7	14.4	10.2	7.2
2007	8.1	9.0	16.2	12.0	6.2

Source: Economist Intelligence Unit.

This favorable picture is somewhat tainted by continuing problems. While the Russian economy has been able to greatly temper inflation from the sky-high rates of the 1990s, inflation rates remain high. In 2006, the consumer price index rose 9.7%, and is estimated to have risen 9.0% in 2007, a rate that was above the government target. The life expectancy of the average Russian citizen, particularly males, remains low for an advanced country. In 2006, it was 72.4 years for a Russian woman and 58.9 years for a Russian male.¹⁷ Increases in alcoholism and other diseases, some of which like tuberculosis have been nearly eradicated in developed countries, have contributed to the decline. It is also explained by the poor and deteriorating health system which has been slow to adjust to the transition from central planning. The high mortality rate is contributing to shrinkage of the Russian population of an average of 0.5% during 2002-2006 period. That means that the average age of the Russian population will increase, leading to a decline in the pool of working age individuals— a trend that does not bode well for economic growth in the future.

Economic data indicate also that, as the Russian economy has grown, the distribution of income within Russia has become increasingly unequal during the post-Soviet period. A standard measure of income distribution is the Gini coefficient (or index) which is on a 0.00 to 1.00 scale. The lower the number the more equal the income distribution. Thus, 0.00 is perfectly equal income distribution, while 1.00 is totally unequal. In 1992, Russia's Gini-coefficient was 0.289.¹⁸ By 2007, it had increased to 0.422.¹⁹

Before the collapse of the Soviet Union, the richest 20% of the Russian population accounted for 30.7% of Russian income while the poorest 20% accounted for 11.9%. In 2006, the richest 20% held 46.8% of the income while the poorest 20%'s share had declined to 5.4%. The middle 60% of the population's share had declined from 57.4% in 1992 to 47.8% in 2006.²⁰ The two sets of income distribution measurements mean that while the Russian standard of living has improved, a small segment of the population is enjoying close to half of the benefits. Inflation might explain at least part of the skewed distribution as those who hold hard assets can protect themselves from inflation more easily than the less wealthy. The income distribution trends might also be explained by the large role played by exports, especially oil and natural gas, in Russian GDP growth as owners of energy-related assets reap the benefits of the surge in world energy prices.²¹

Foreign Trade and Investment Trends

The roots of Russia's robust economic growth during the last eight years are reflected in the surge in Russian trade and capital flows. (See Table 3)

¹⁷ Ibid.

¹⁸ Goskomstat.

¹⁹ *Kommersant*. February 27, 2008.

²⁰ Goskomstat.

²¹ Economist Intelligence Unit. *Country Profile 2007: Russia*. p. 42.

Table 3. Select External Economic Indicators, 1999-2007

(billions of U.S. dollars unless otherwise noted)

Year	Exports	Imports	Merchandise Trade Balance	(CA)Trade Balance (mil\$)	Foreign Reserves	Foreign Direct Investments into Russia
1999	75.5	39.5	36.0	24.6	12.5	3.3
2000	105.0	44.9	60.1	46.8	28.0	2.7
2001	101.9	53.8	48.1	33.9	36.6	2.7
2002	107.3	61.0	46.3	29.1	47.5	3.4
2003	135.9	76.1	59.9	35.4	76.9	8.0
2004	183.2	97.4	85.8	59.0	124.5	15.4
2005	243.6	125.3	118.3	83.3	182.2	12.9
2006	304.5	163.9	139.3	94.4	303.7	30.8
2007	355.5	223.4	132.0	78.3	476.4	55.0

Source: Central Bank of Russia.

Russia foreign trade has increased sharply in the last nine years (1999-2007). During that period Russian exports grew close to 400%, from \$75.5 billion to \$355.5 billion and Russian imports rose over 450%, from \$39.5 billion in 1999 to \$223.4 billion in 2007. As a result, Russia has experienced rapidly increasing trade surpluses. Its merchandise trade surplus rose from \$36.0 billion in 1999 to \$132.0 billion in 2007. Russia's current account balance (which includes balances on merchandise trade, trade in services, investment income and unilateral transfers) increased substantially, from \$24.6 billion in 1999 to \$78.3 billion in 2007. As a result, Russia has accumulated one of the world's largest foreign reserve holdings that have skyrocketed from \$12.5 billion in 1999 to \$476.4 billion in 2007.

Oil and petroleum-related products have dominated Russia's exports for some time, even during the Soviet period. However, they have become even more significant. In 2006, oil, natural gas, and other fuels accounted for 64.6% of Russian exports. If metals are included, the share of raw materials was 78.6% in 2006.²² More than half (51.7%) of Russian imports consisted of machinery and equipment and another 16.9% consisted of food and other agricultural products.²³

The 27-member European Union (EU) is by far Russia's most significant trading partner. In 2007, the EU accounted for 53% of Russian exports, mostly energy, and for 43% of Russian imports. China has emerged as the second most important trading partner, accounting for 5% of Russian exports and for 13% of

²² CRS calculations based on data from EIU. *Country Profile—Russia*. 2007. p.66.

²³ Ibid.

Russian imports in 2007. If the EU members are considered separately, the Netherlands is the leading market for Russian exports, accounting for 15% in 2007, while Germany is the leading source of Russian imports, accounting for 13% in 2007.²⁴

Russia's investment climate has improved significantly during the last few years a byproduct of Russia's robust growth. Between 1999 and 2007, annual foreign direct investment flows into Russia rose from \$3.3 billion to an estimated \$55.0 billion, or 4.5% of GDP, nearly double the FDI flows in 2006, and close to the flows recorded by China.²⁵ However, the Russian government recently passed a law which will restrict foreign investment in key sectors, which could hamper foreign investment in the future.

Russian Economic Policies

The 1998 financial crisis proved to be a blessing in disguise, albeit one that exacted a huge price in terms of Russian financial credibility. The economic growth that Russia has experienced since 1999 has been largely driven by favorable trends in the Russia's international economic interactions. The sharp depreciation of the ruble in 1998 cut demand for imports and encouraged domestic production of goods. But by definition, such factors are ephemeral. When Putin took the reins of authority in 1999-2000, first as acting President, then in March 2000 as President, his task was to avoid the economic chaos that had plagued Russia earlier and to put Russia on track toward long-term economic growth. To do so required the Putin leadership to take advantage of the window of opportunity of the post-1998 crisis economic surge and undertake some major economic reforms.

By the end of 1999, the Russian government had achieved a degree of financial stabilization as former Prime Minister Primakov had instituted measures to cut government spending and increase tax revenues. The Russian economy had begun to grow because of the severe depreciation of the ruble as a result of the 1998 financial crisis which boosted exports.²⁶ A key objective of the Putin regime would be to make sure to maintain stability especially after the effects of the depreciated ruble had disappeared.

Rationalize Government Expenditures and Revenues

The high inflation and general economic chaos of the 1990s contributed to political and social instability. The instability undermined the government's ability to build a market economy. In order to attain economic stability, the government would have to rein in profligate government spending to keep inflation under control.

²⁴ Russian Customs Service data collected by Global Trade Systems, Inc in World Trade Atlas. October 27, 2007.

²⁵ EIU. *Country Report: Russia*. March 2008.

²⁶ Aslund. p. 190-197

Russian government national accounts data show that the government has improved budget balances and maintained tight control over fiscal policy. At the end of 1998, the Russian federal government had a budget deficit equal to 6.0% of Russian GDP with revenues equal to 11.4% of GDP and expenditures equal to 17.4%. In 1999, the budget deficit declined slightly to 4.2% GDP. During the ensuing years, Russian government revenues soared from 12.6% of GDP in 2000 to 23.6% of GDP in 2006, largely because of tax revenues generated by the surge in oil revenues. At the same time, the government managed to resist expanding expenditures, keeping them far below revenues with expenditures equal to 16.1% GDP in 2006. As a result, the Russian government has consistently earned budget surpluses and had a surplus of 7.5% of GDP in 2006.²⁷

The Russian government's ability to maintain prudent fiscal balances is due in part to the establishment in January 2004 of a stabilization fund. The Ministry of Finance deposits in the fund government tax revenues obtained from oil production at oil prices (Urals crude) above \$27/barrel. (When the fund was established in 2004, the threshold price was \$20). The funds are to be used to finance government deficits that result when the oil price falls below \$27. On February 15, 2008, the price of Urals crude was \$90.75/barrel.²⁸ In addition, by law the government is to use funds in excess of a balance of 500 billion rubles for purposes approved by the Federal Assembly, the legislature. On January 30, 2008, the fund held an aggregate amount of 3.9 trillion rubles. The Russian government has used these funds to pay off partially its IMF and Paris Club debts and also to finance a deficit in the government-operated pension fund.²⁹

The Putin government attempted to reduce government social and industrial subsidies as a another step in rationalizing government spending. In January 2005, the government replaced free access to transportation and health care with cash payments to vulnerable groups and also reduced energy subsidies for residents. The monetization program proved unpopular and protests erupted, a rarity during an otherwise very popular regime. While having to slide back on some of the measures, though, the government has maintained most of the reforms, thereby helping to keep expenditures in check.³⁰

Implement Structural Economic Reforms

During Putin's first term (2000-2004), his government initiated some critical economic reforms that helped Russia emerge from the post-1998 financial crisis period more stable and stronger. During this period, reformers seemed to play the dominant role in economic policymaking.

²⁷ Data obtained from the Bank of Finland. BOFIT Russia Statistics. [<http://www.bof.fi>].

²⁸ U.S. Department of Energy. Energy Information Administration. Official Energy Statistics from the U.S. Government. [<http://www.eia.doe.gov>].

²⁹ Russian Ministry of Finance. [<http://www.minfin.ru>].

³⁰ EIU. *Country Profile 2007: Russia*. p.36.

One of the factors that had harmed business environment in Russia for both foreign and domestic investors was a plethora of high and overlapping taxes. They reflected the decentralized structure of the Russia government at the time where local, regional and federal government authorities were not clearly delineated. At times, competing levels of government placed a claim on the same revenues. As a result, businesses found it more advantageous to not pay taxes and risk getting caught. The tax regime encouraged under-reporting of economic activity and hiding income abroad. Tax delinquencies encouraged corruption. As a result, collected revenues were a fraction of potential revenues. At one point, Russian residents and businesses were subject to around 200 separate taxes, 30 of which were federal and 170 were regional and local.³¹

By 2004, the government had reduced the number of taxes to 16, 10 of which were federal and the remainder regional and local. Among the changes was an introduction of a 13% flat tax to replace a graduated personal income tax that peaked at 30%.³² Four social taxes were compressed into one. Tax collection was centralized into the tax ministry which eliminated tax collection competition among several collection agencies that bred corruption and abuse.³³ Another important reform was the elimination of various turnover taxes that were legacies of the Soviet period.

During the early post-Soviet period, the business climate was also hampered by a large number of licensing requirements, inspections, and other regulations often promulgated and implemented by different local, regional, and federal government entities in conflict with one another. The burden and the capricious manner that the regulations were implemented made the system ripe for corruption and avoidance and also impeded the development of new business. The Putin government introduced regulatory reform by cutting the number of mandatory licenses and inspections to encourage the development of new small and medium sized enterprises.³⁴ These reforms have largely improved the business climate, although some authorities still conduct inspections contrary to the new regulations.³⁵

The Russian government has also addressed the issue of corporate governance, particularly the protection of the rights of minority shareholders that were notoriously subjected to abuse in the 1990s. For example, the government established regulations on the times and venues for shareholders' meetings to ensure that a majority bloc of shareholders do not try to impair minority rights by holding meetings in secret and or at times and at places inaccessible to those shareholders.³⁶

³¹ Åslund, Anders. *Russia's Capitalist Revolution: Why Market Reform Succeeded and Democracy Failed*. Petersen Institute for International Economics. November 2007. p.215.

³² Ibid. p. 216.

³³ Ibid.

³⁴ Ibid., p. 217-218.

³⁵ EIU. 2007. p. 38.

³⁶ Organization for Economic Cooperation and Development. *OECD Economic Survey of* (continued...)

Agriculture has been one of the slowest sectors of the Russian economy to shed the legacies of collectivism rooted in Soviet central planning and even in earlier Russian history. Russian policymakers have had trouble dealing with the issue of land and agricultural reform, particularly converting land that been held collectively during the Soviet period to individual holdings and private ownership. Russian agriculture had been hard hit during the early transition period as demand for local production fell when it faced foreign competition from the United States and Europe.

The Russian government kept agriculture afloat with subsidies and low-interest loans that were eventually written off by the government. The sector rebounded, along with much of the rest of the Russian economy, as a result of the sharp depreciation of the ruble in the wake of the 1998 financial crisis and the resultant increase in import prices. But, the temporary drop in foreign competition reduced the incentives for reform and restructuring.

The agriculture sector once again faces problems as foreign competition has strengthened. Agriculture and land reform have remained challenges. In 2003, the Duma, the lower house of the Russian legislature, enacted a framework law on the sale and purchase of agricultural land, but its implementation had been dependent on regional governments passing and implementing laws, which they have been reluctant to do. The issue still remains a challenge for the government.³⁷

Integrate Russia with the Global Economy

Russia first applied to accede to the General Agreement on Tariffs and Trade (GATT) in 1993. The application was converted to one for the World Trade Organization (WTO) in 1995 when that organization was formed and became the administrative body for the GATT and other multilateral trade agreements. The process slowed down during the Yeltsin period as the leadership was pre-occupied with other political and economic issues. Putin adopted WTO membership as part of Russian economic reform and a way to integrate Russia into the world economy:

It is our duty to ... speed up the work on Russia's accession to the WTO on conditions that are acceptable to us and generally work to make Russia competitive in all senses of the word.³⁸

Russia is the largest country not yet a member of the WTO. WTO members' concerns about weak protection of intellectual property rights (IPR) protection and Russian agriculture subsidies have been among the issues impeding Russia's accession.

³⁶ (...continued)

the Russian Federation.2004. p. 66.

³⁷ Aslund, p.219; OECD (2006), p.72-74.

³⁸ Office of the President of Russia. *Annual Address to the Federal Assembly*. April 3, 2001. [<http://www.kremlin.ru>].

Putin also called for total convertibility of the ruble, completing a process begun under Yeltsin, to ease the flow of capital between Russia and developed countries in order to facilitate trade and investment.

Despite the declared policies, the results in integrating with the world economy have been mixed. From 1994 to 2000, Russian exports as a percentage of GDP increased from 27.7% to 44.1% but declined to 30.3% in 2007. Russian imports as a percentage of GDP have declined from 22.9% in 1994 to 21.9% in 2007. On the other hand, trends in Russian foreign investment show clearer signs of economic integration. The stock of foreign direct investment in Russia as a percent of GDP rose from 0.1% in 1993 to 11.4% in 2007 and Russian foreign direct investment abroad has increased from 1.3% of GDP in 1993 to 9.7% of GDP 2007.³⁹

Implement Other Reforms

In 2002, the Putin government instituted pension reform to increase the level of retirement funds and reduce poverty among retirees. In addition, the reform was to move the responsibility for pensions from the government to employers. Implementation of pension reform has been slow.⁴⁰

The Russian banking system has been notoriously inefficient. For much of the 1990s, the industry was dominated by state-owned banks, especially, the Sberbank, which held more than 70% of household savings deposits, and the Vneshtorgbank. The private-sector banking industry was dominated by many small banks that were owned by one investor or a financial group and acted as a financial conduit for the owners. Many of those banks failed during the 1998 financial crisis. In 2003, the Russian government implemented a government deposit insurance program, to partially level the playing field for private sector banks that had no such insurance, and the state banks that were backed by state funds. The deposit insurance program also was a way to introduce tighter supervision over the private sector banks that were required to meet financial health criteria by the Russian central bank before being eligible for the insurance.⁴¹ Beginning in 2004, the Russian government also began phasing in the use of International Financial Reporting Standards (IFRS) to improve the transparency of Russian bank operations.⁴²

In 2005, the regime launched “national projects” to strengthen education, health care, and housing. Critics have maintained that implementation of these projects, which has been under then-First Deputy Prime Minister and now President Dmitriy Medvedev, has been inadequate and a sign that the Putin regime “dropped the ball” on reform during his second administration and that the reforms have been stalled by

³⁹ Data obtained from the Economist Intelligence Unit.

⁴⁰ EIU. *Country Profile: Russia 2007*. p. 38.

⁴¹ OECD, 2004, p. 200.

⁴² Ibid., p. 204

those with vested interests in the status quo.⁴³ The Russian government also undertook reform of its judiciary— to establish clear lines of responsibility for the levels of courts and to root out corruption by increasing the salaries of judges.⁴⁴

Reassert State Control of “Strategic” Sectors

If President Putin’s first term of office was marked by achieving economic stability and launching some critical reforms, the second term was largely characterized by the government’s re-establishing control over critical sectors of the Russian economy. It has done so by acquiring the assets of companies that had been privatized during the Yeltsin regime and taken over by so-called oligarchs via questionable transactions. The Putin Administration has been re-nationalizing companies directly by taking control of assets or indirectly through ostensibly private sector companies in which the Russian government has substantial ownership.

The first major step in this direction was the government’s attack on the Yukos oil company and its president, Mikhail Khodorkovsky. On October 25, 2003, Khodorkovsky was arrested and charged with tax evasion. Other Yukos executives were also arrested. Eventually Khodorkovsky was sentenced to eight and a half year in an East Siberian prison. Khodorkovsky had acquired Yukos and several other companies in the loans for shares auctions in the mid-1990s. While his ostensible violation was tax fraud, many experts contend that Khodorkovsky’s real “crime” was to have crossed a “red line” in challenging Putin politically by financing several opposition political parties. Khodorkovsky also challenged the government’s monopoly on oil transport by proposing the construction of privately owned oil pipelines. In the end, the government seized Yukos’s assets to pay tax penalties and sold them at below market value prices to Rosneft, a state-owned oil company. Yukos was left bankrupt.⁴⁵ The case is noteworthy not only for the government’s reassertion of control of the oil sector but also for the apparent weakness of the judicial system which allowed the government to skirt legal procedures that might have ensured impartiality.⁴⁶

From 2005-2007, the government increased its stake in the oil industry through Gazprom, the state-controlled company that has a monopoly on Russian gas exploration and production. It bought controlling shares in Sibneft, a once private company. It also bought Sakhalin Energy company, which had been led by Shell Oil and in TNK-BP, a joint venture between BP and a group of private Russian companies. The latter two acquisitions occurred after the Russian government cited projects by these companies for environmental regulation infringements and licensing issues. As a result of these acquisitions, state control of the oil industry increased

⁴³ Delany, Max. “Life Gets Better, But Only for Some.” *Moscow Times*. February 27, 2007.

⁴⁴ OECD. 2004. p. 65.

⁴⁵ Aslund. p. 234-241. OECD 2006. p. 37-38.

⁴⁶ For more information, see (archived) CRS Report RS21673, *Russia’s Arrest of Mikhail Khodorkovsky: Background and Implications for U.S. Interests.*, by James Nichol.

from around 18% to over 50% between 2004 and 2007, according to one estimate.⁴⁷

From 2004 to 2006, the government took control of formally privatized companies in certain “strategic” sectors. oil, aviation, power generation equipment, machine-building and finance. For example, the state-owned defense equipment company Rosoboronexport took control of Avtovaz, the primary producer of Russian cars. In June 2006, it took 60% control of VSMPO-Avisma, a company that accounts for two-thirds of the world’s titanium production. In 2007, United Aircraft Building Corporation (UABC), a company that is 51% government controlled, combined all of the Russian companies producing aircraft.⁴⁸ The OECD estimates that the government’s share of Russia’s equity market capitalization increased from 20% in mid-2003, to 30% in early 2006. In the oil sector alone, state-owned companies controlled 16.0% of crude oil production in 2003 and 33.5% in 2005, a figure that the OECD estimates to have risen eventually to over 40% after all of Yukos’s assets had been distributed.⁴⁹

According to the European Bank for Reconstruction and Development (EBRD), in 1991, just prior to the collapse of the Soviet Union, 5% of Russian GDP was accounted for by the private sector. By 1997, that share had grown to 70%, but decreased to 65% in 2005 where it has remained. In comparison, in the Ukrainian economy, the share of GDP accounted for by the private sector increased from 10% in 1991 to 65% in 2002 where it has remained. In contrast, the share of the private sector in Poland’s GDP rose from 40% in 1991 to 75% in 2001 where it has remained.⁵⁰

The EBRD monitors the progress of former communist states’ transition to market economies. One of the elements the bank examines is the degree to which the country has privatized state-enterprises. It does so using a scale of 1.00-4.00 with 1.00 indicating little private ownership and 4.00 indicating more than 50% private ownership. According to the EBRD, the status of Russia’s privatization of large-scale enterprises fell from 3.33 in 2004 to 3.00 in 2007. At 3.00, Russia ranked ahead of Turkmenistan (1.00) and Tajikistan (2.33), is on par with Ukraine (3.00) and Moldova (3.00), and is behind Romania (3.67), Armenia (3.67) and Georgia (4.00). EBRD indices of small-enterprise privatization indicated that Russia has done better at 4.00 where it has been since 1995.⁵¹

⁴⁷ Hanson, Philip. The Russian Economic Puzzle: Going Forwards, Backwards, or Sideways? *International Affairs*. vol. 83. no. 5. p. 876-877.

⁴⁸ EIU. *Country Profile 2007–Russia*. p.38-39.

⁴⁹ OECD. 2006. p.38.

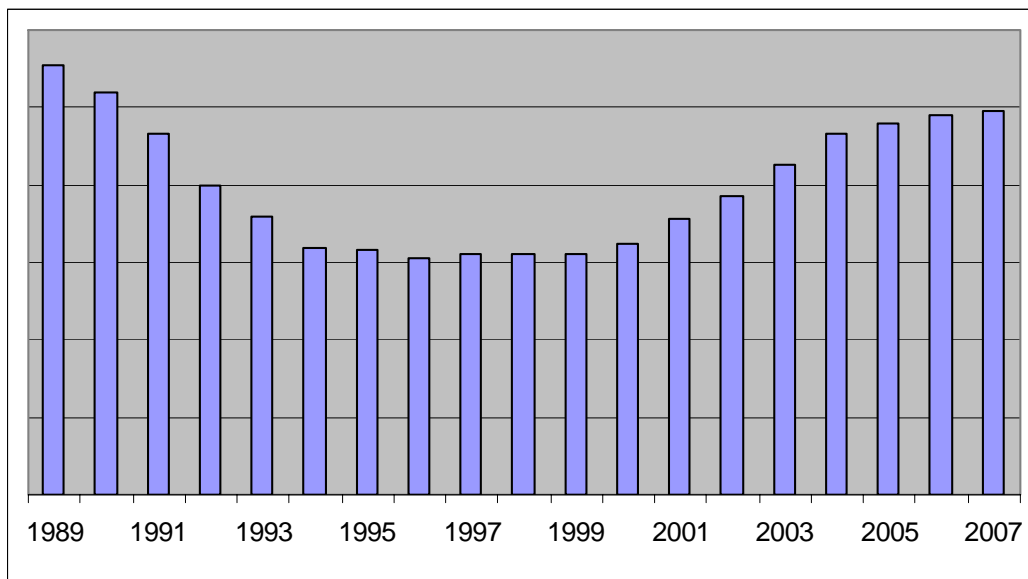
⁵⁰ EBRD. Economic Statistics and Forecasts. [<http://www.ebrd.org>].

⁵¹ Ibid.

The Role of Oil and Other Natural Resources

Russia possesses the world's eighth largest reserves of oil and is the world's second largest oil exporter (next to Saudi Arabia). It also possesses the world's largest natural gas reserves and is the largest exporter of natural gas. In addition, Russia has the second largest coal reserves.⁵² These natural resources, particularly oil, have been a major driving force of the Russian economy for a long time and a significant determinant of Russia's economic health. Therefore, the role of oil requires special attention in a discussion of Russia's economic conditions.

Figure 2. Russian Oil Production, 1989-2007
(millions of barrels/day)



Source: CRS from data of U.S. Department of Energy. Energy Information Administration.

The levels of Russian oil production have varied over the years and have roughly mirrored overall conditions of the Russian economy. The graph in figure 2 above indicates that from 1989 to 1996, the volume of oil production decreased appreciably, from 11.1 million barrels/day to 6.1 million barrels/day or about 45%. This period is contemporaneous with the deep slide in Russian economic growth shortly before and immediately after the collapse of the Soviet Union. The decline was caused by a dramatic drop in world demand for oil, a decrease in world oil prices, the depletion of exploited Russian oil fields, and the lack of investment in discovering new ones. Production began to grow in 1997, at first gradually, then more rapidly reaching 9.9 million b/d in 2007, still below the 1989 level.⁵³ Oil production has continued to

⁵² EIA. *Country Analysis Briefs: Russia*. April 2007. [<http://www.eia.doe.gov>]

⁵³ Data were obtained from [<http://www.bp.com>].

increase but at a decelerating rate, with possible implications for the future.⁵⁴ One report estimates that Russian oil production may have already peaked in early 2008 and could begin to decline.⁵⁵

Among the factors which contributed to the deceleration of oil production was the Yukos case which led Russian oil companies to reduce investment in upstream activities. Also, the heavy taxation of oil revenues is another contributing factor. Most oil-sector investment in Russia is aimed at increasing current production rather than developing new fields; therefore, any slowdown in the growth of capital spending is soon reflected in slower growth of production and exports. Russia will be not be able to sustain oil production over the long term if the investment in the sector is not increased.⁵⁶

While oil production activities represent a small direct part of Russian GDP, the income derived from oil production has contributed significantly through the multiplier effect to overall GDP growth. According to the International Monetary Fund (IMF), the Russian federal government budget enjoyed a fiscal surplus equivalent to 7.4% of GDP in 2006; however, if oil-related revenues are excluded, the budget would have been in a deficit equivalent to 3.8% of GDP.⁵⁷ Of course, the IMF calculation assumes that the Russian government would have maintained the level of expenditures. This analysis suggests that Russia is becoming more reliant on world oil prices increasing or at least remaining high.

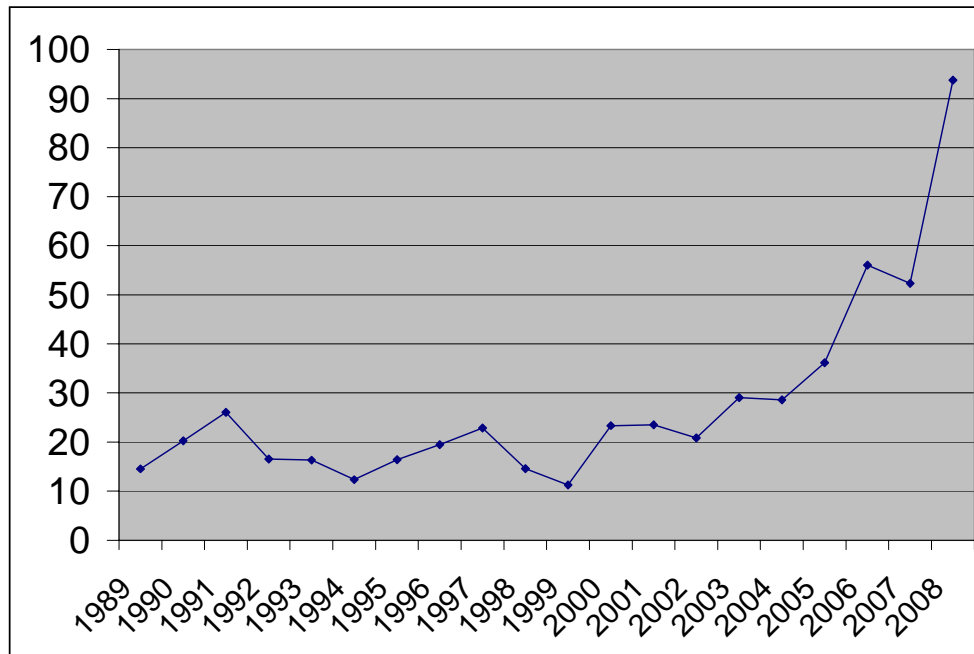
⁵⁴ EIU. *Country Profile Russia .2007.* p. 45.

⁵⁵ Hoyos, Carola and Catherine Belton. Russia Braced for First Oil Production Fall in 10 Years. *Financial Times.* April 15, 2008. p. 2.

⁵⁶ OECD, 2006. p. 29-30.

⁵⁷ Ibid. p. 26.

Figure 3. Oil Prices, 1989-2008
(\$/barrel—Urals-32)

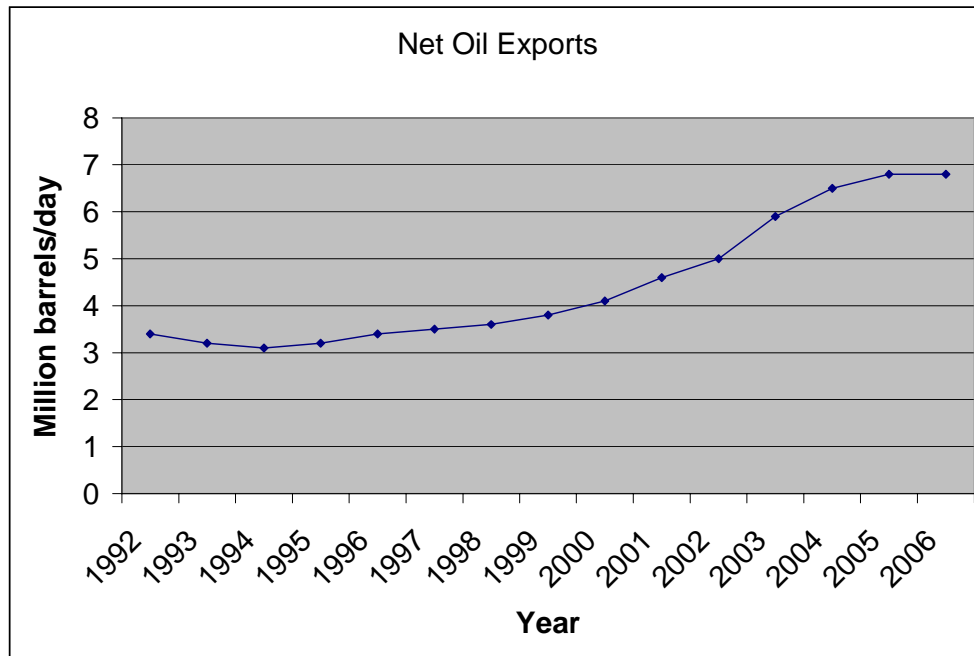


The significance of oil and other natural resources to the Russian economy is perhaps no more evident than in Russian foreign trade. Even during the Soviet period, oil and other natural resources were by far the primary source of hard currency revenues. They have maintained and, at times increased, their importance in post-Soviet era Russian foreign trade. In 2006, energy resources (oil, natural gas, and coal) accounted for 65% of total Russian export revenues. Exports of crude oil accounted for 34% of that share.⁵⁸ Russia's increasing reliance on exports oil and other energy resources makes Russian trade vulnerable to the volatility of international commodity prices. Exports of machinery and equipment accounted for only 6% of Russian exports outside the former Soviet Union.⁵⁹

⁵⁸ IMF. *Russian Economic Report*. November 2007. p. 29.

⁵⁹ EIU. *Country Profile Russia*. 2007. p. 52.

Figure 4. Net Russian Exports of Oil, 1992-2006
(millions of barrels/day)



While the volume of Russian energy production and net exports (exports minus imports) have increased significantly since the mid-1990s, the rate of increase may have plateaued, suggesting that the growth and, perhaps, even the maintenance of surplus of oil-dependent revenues will depend on the world oil prices growing or at least remaining high. In 2005, the volume of net oil exports reached 6.8 million barrels/day and remained at that level in 2006. Nevertheless, the overall Russian trade surplus continued to expand in U.S. dollar terms, as the increase in oil prices offset both the weak export performance and the rise in imports. The trade surplus reached a record of \$140 billion in 2006, up from \$118 billion the year before, owing to an increase of more than 20% in export prices.

Is Russia's Economic Growth Sustainable?

According to some economic forecasts, Russia's economic growth will continue for the next few years, albeit at lower rates. The IMF, for example, projects Russia's real GDP to average 6.1% between 2008 and 2013.⁶⁰ Global Insight, Inc. forecasts Russia's economic growth to average 5.9% between 2008 and 2012.⁶¹

The importance of Russia's economic growth leads to the question of how long can these trends continue, a question that itself requires an examination of some of the factors that will influence Russia's economic prospects. Some factors indicate good times ahead, others suggest trouble, and still others are ambiguous.

⁶⁰ IMF. World Economic Outlook database. [<http://www.imf.org>].

⁶¹ Global Insight, Inc. database.

One favorable sign for continued growth is that the sources of GDP economic growth are becoming more balanced. For example, Russia has experienced double-digit growth in domestic consumption. In 2006, household consumption increased by 11.1% and by 12.9% in 2007, outpacing overall GDP growth.⁶² Furthermore, the sources of growth have spread from the metropolitan areas, such as Moscow and St. Petersburg, to outlying industrial regions in the Ural mountains and in the Volga river basin.⁶³

Russian fixed capital investment has increased 11.7% on average per year 1999-2007. In 2007 alone, it increased 21.1% , the highest in recent Russian history.⁶⁴ Official Russian economic data show that investment is spread throughout the economy. About 14% of the fixed investments (in 2006) were in the energy sector, 16% were in manufacturing, 24% were in transportation and communication, and 16% were in real estate, renting, and business activities.⁶⁵ Growth in fixed investment indicates confidence in the future as firms replenish or add to production capacity.

The OECD indicates that despite the surge, Russia still lags far behind other emerging economies in terms of capital investment. The OECD calculated that from 2000-2005, Russia's average capital investment as a percent of GDP was around 18%, while that of China was close to 40%, South Korea's was 30%, and the Czech Republic's was 27%. These data would indicate that Russia still has much room to catch up with similar economies.⁶⁶ Philip Hanson, an expert on the Russian economy, has suggested that the excess industrial capacity that Russia inherited from the Soviet period has been used up or has become obsolete implying that Russia will need large amounts of new investments to ensure continuing economic growth.

⁶² EIU. Country Indicators.

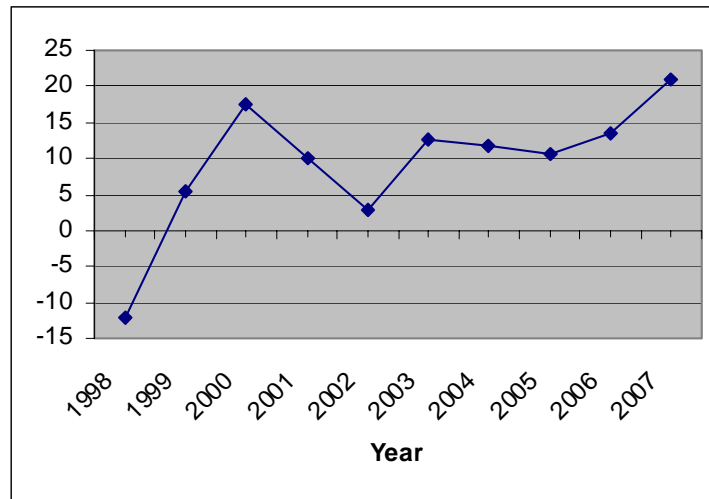
⁶³ Sutela, Pekka. "The State of the Russian Economy. Economic Growth Remains Surprisingly High." *Russian Analytical Digest*. April 2, 2008. no. 38.p. 3.

⁶⁴ Ibid. p. 6.

⁶⁵ Russian Federal Statistics Service.

⁶⁶ OECD 2006. p. 27.

Figure 5. Percentage Changes in Russian Annual Fixed Investment, 1998-2007



Source: CRS from data collected by the Economist Intelligence Unit.

Other factors could present problems for the Russian economy. One factor is ruble appreciation. Between 1998, the year of the financial crisis, and 1999 the ruble depreciated 25% in real effective terms.⁶⁷ The ruble appreciated in real terms from 1999 onward but only gradually, reaching its pre-financial crisis level not until 2002. During that period Russia's domestic producers benefitted from diminished competition from imports because they had become much more expensive. Since 2002, the ruble has appreciated much more rapidly, 43% by the end of 2007.⁶⁸ The rapid appreciation is causing concerns, particularly among Russia's manufacturing industries which are facing stronger import competition while they are still trying to develop.

The ruble appreciation has been caused in part by the strong demand for Russian energy exports, particularly oil. The trend has led some observers to surmise that Russia may have caught the "Dutch disease." This is a term that is applied when a country that is heavily dependent on one product, such as oil, in its exports, experiences a surge in export revenues. That country's currency will appreciate accordingly, forcing other industries to face stronger foreign competition and dampening exports of those other products. While ruble appreciation makes imports cheaper and help to dampen inflation, it also makes diversification of Russia's export base much more difficult.⁶⁹ Whether or not Russia has the "Dutch Disease," the strong ruble has put downward pressure on Russian non-energy exports. The OECD

⁶⁷ Real effective terms means that it is calculated on trade-weighted basis with an emphasis on dollars and euros, Russia's primary trade currencies, and adjusted for relative prices changes.

⁶⁸ CRS calculations based on data collected by the Economist Intelligence Unit.

⁶⁹ "Dutch disease" is so-called because of the decline in the Netherlands's manufacturing sector as a result of surge in natural gas exports and the rapid real appreciation of the currency. OECD 2006. p. 82.

reported that the non-fuel trade balance has deteriorated beginning in 2005 even though the overall trade balance had remained strong because of rising oil prices.⁷⁰

Inflation has been another factor of concern for Russia. Russia had been making considerable progress in controlling inflation, which had been a constant problem since the collapse of the Soviet Union. At the end of 2006, inflation was 9%, still high by U.S. standards but the first single-digit inflation since 1991. However, consumer prices in Russia began to rise more rapidly in 2007, 11.9% by the end of 2007. The rate of inflation has continued to increase, reaching 14.3% in April 2008 compared to April 2007.⁷¹ A sharp rise in food prices has been the primary cause of the inflation spike, as well as increases in prices for raw materials and other industrial inputs.⁷² Another contributing factor may be the increase in government spending. In 2007, Russian government expenditures rose to 18.1% of GDP from 16.0% GDP the year before, and are projected to increase to 21.2% GDP in 2008.⁷³ High inflation causes economic instability and political instability as it reduces consumer buying power and saps savings.

The Russian government's seizure of "strategic sectors" of the economy (discussed earlier) could be a factor that will impede Russian economic growth and development. The OECD cites the tendency of state-owned companies in Russia to be associated with corruption, lack of transparency, and rent-seeking. State representatives tend to interfere in day-to-day operations, which undermines the commercial effectiveness of the company.⁷⁴

The increase in state control over the economy has also coincided with a sharp decline in the pace of economic restructuring and reforms that occurred during Putin's first term. One indicator of the decline in economic reforms is the measure of the business environment in Russia. Each year the World Bank evaluates the ease of doing business in 178 countries by examining a range of criteria, such as ease of starting a business, closing a business, employing workers and, protecting workers. In April 2006, Russia ranked 96th.⁷⁵ In April 2008, it ranked 106th, although it had improved from 112th during the previous year. Nevertheless, Russia ranked behind such former Soviet republics as Azerbaijan (96th), Armenia (39th), Georgia (18th), and Kazakhstan (71st). Singapore was ranked (1st) and the United States was ranked (3rd) The Congo Democratic Republic was ranked 178th.⁷⁶ Another indicator is Russia's economic growth compared to those of other former Soviet states. In 2007, even

⁷⁰ OECD. 2006. p. 80

⁷¹ *Financial Times*. May 7, 2008. p. 3.

⁷² EIU. *Country Report. Russia*. April 2008. p. 16.

⁷³ *Ibid.* p. 17.

⁷⁴ OECD. 2006. p.39.

⁷⁵ Cited in Hanson, Philip. The Russian Economic Puzzle: Going Forwards, Backwards, or Sideways? in *International Affairs*. vol. 83. no. 5. p. 872.

⁷⁶ [<http://www.doingbusiness.org>]. Accessed April 14, 2008.

though Russia's real GDP increased 8.1%, it was only 9th among the other former Soviet states.⁷⁷

However, it is Russia's continue dependence on oil and the world price of oil that will be a dominant factor in Russia's economic prospects for the time being. As indicated earlier, this is a double-edged sword for Russia. On the one hand, Russia is clearly benefitting from record-high prices. On the other, its oil production capacity is limited and showing signs of strain.

Implications for the United States

Russia's economic prospects have direct and indirect implications for the United States. One way to measure the direct implications is by examining the status of U.S.-Russian economic ties.

U.S.-Russian trade and investment flows have increased in the post-Cold War period reflecting the changed U.S.-Russian relationship. Many experts have suggested that the relationship could expand even further. U.S. imports from Russia have increased substantially, rising from \$0.5 billion in 1992 to a peak of \$19.8 billion in 2006. A slight decline in 2007 to \$19.4 billion was due to a sharp drop in imports of steel and aluminum products. The large increase in U.S. imports reflects not so much an increase in the volume of trade but the rise in world prices of raw materials, particularly oil, that comprise the bulk of those imports (57% in 2007). U.S. exports have increased from \$2.1 billion in 1992 peaking at \$7.4 billion in 2007. Major U.S. exports to Russia consist of machinery, vehicles, and meat (mostly chicken).⁷⁸

Table 4. U.S. Merchandise Trade with Russia, 1992-2007
(in billions of dollars)

Year	U.S. Exports	U.S. Imports	U.S. Trade Balances	Year	U.S. Exports	U.S. Imports	U.S. Trade Balances
1992	2.1	0.5	1.6	2000	2.1	7.7	-5.6
1993	3.0	1.7	1.3	2001	2.7	6.3	-3.5
1994	2.6	3.2	-0.6	2002	2.4	6.8	-4.4
1995	2.8	4.0	-1.2	2003	2.4	8.6	-6.2
1996	3.3	3.6	-0.3	2004	3.0	11.9	-8.9
1997	3.4	4.3	-0.9	2005	3.9	15.3	-11.3
1998	3.6	5.7	-2.1	2006	4.7	19.8	-15.1
1999	2.1	5.9	-3.8	2007	7.4	19.4	-12.0

Major U.S. exports: machinery; vehicles; meat; aircraft. Major U.S. imports: mineral fuels; inorganic chemicals aluminum; steel.

⁷⁷ Azerbaijan's GDP increased 25.0%, Armenia 13.7%, Georgia 12.5%, Latvia 10.7%, Uzbekistan 9.5%, Lithuania 8.8%, Kazakhstan 8.5%, and Kyrgyz Republic 8.2%.

⁷⁸ Global Trade Information System.

Source: Compiled by CRS from U.S. Department of Commerce, U.S. Census Bureau data. FT900.

Despite the increase in bilateral trade, the United States and Russia still account for small shares of each others' trade. In 2007, Russia accounted for about 0.6% of U.S. exports and 1.0% of U.S. imports. The United States accounted for 2.5% of Russian exports and 4.9% of Russian imports. On June 10, 2007, the Russian airline, Aeroflot, signed a contract to purchase 22 long-range Boeing 787 aircraft, a deal worth an estimated \$3.5 billion.⁷⁹

The United States accounted for \$4.6 billion in foreign direct investment in Russia in 2006 most of which were in energy-related assets. The United States was technically the third largest source of foreign direct investment; however, the first two, Cyprus and Luxembourg, are considered to be largely sources of repatriated Russian capital rather than of original foreign capital.⁸⁰

Russia and the United States have never been major economic partners, and it unlikely that the significance of bilateral trade will increase much in the near term. However, in some areas, such as agriculture, Russia has become an important market for U.S. exports. Russia is the largest foreign market for U.S. poultry. Furthermore, U.S. exports to Russia of energy exploration equipment and technology, as well as industrial and agricultural equipment, have increased as the dollar has declined in value. Russian demand for these products will likely grow as old equipment and technology need to be replaced and modernized. Russia's significance as a supplier of U.S. imports will also likely remain small given the lack of international competitiveness of Russian production outside of oil, gas, and other natural resources. U.S.-Russian investment relations could grow tighter if Russia's business climate improves; however, U.S. business concerns about the Russian government's seemingly capricious intervention in energy and other sectors could dampen the enthusiasm of all but adventuresome investors.

The greater importance of Russia's economic policies and prospects to the United States lie in their indirect effect on the overall economic and political environment in which the United States and Russia operate. From this perspective, Russia's continuing economic stability and growth can be considered positive for the United States. Because financial markets are interrelated, chaos in even some of the smaller economies can cause uncertainty throughout the rest of the world. Such was the case during Russia's financial meltdown in 1998. Promotion of economic stability in Russia has been a basis for U.S. support for Russia's membership in international economic organizations, including the International Monetary Fund (IMF), the World Bank, and the World Trade Organization (WTO). As a major oil producer and exporter, Russia influences world oil prices that affect U.S. consumers.

The impact of Russian economic policies and prospects also plays a role in U.S. national security interests. For example, Russia is a major supplier of natural gas to many U.S. European allies. In 2005, Russia accounted for 26% of France's, 30% of

⁷⁹ *Financial Times*. June 11, 2007. p. 16.

⁸⁰ *Tendentsii I perspectiva (Trends and Outlook)*. 2007.

Italy's, and 43% of Germany's consumption of natural gas, making these allies possibly vulnerable to political pressure. On January 1, 2006, Russia temporarily shut-off gas supplies to Ukraine over a price dispute which affected supplies to Europe.⁸¹ While Europe was not the target of the action, the disruption affected European views of Russia as a reliable supplier of gas. Russia is also a primary supplier of natural gas to other former Soviet republics, providing it with potential political leverage. The United States has been promoting the construction of pipelines that by-pass Russia, thus decreasing Moscow's monopoly control of Caspian and Central Asian energy flows.

Recent Developments: Russia and the World Credit Crisis

In 2008, Russia has faced a triple threat, some of its own making, some beyond its control: a rapid decline in the price of oil; Russia's military confrontation with Georgia over the break-away areas of South Ossetia and Abkhazia; and the world credit crisis that originated with the subprime mortgage meltdown in the United States. These events have exposed three fundamental weaknesses in the Russian economy despite its success over the past decade: substantial dependence on oil and gas sales for export revenues and government revenues; rise in foreign and domestic investor concerns; and a weak banking system.

One sign of problems has been the decline in world oil prices in 2008 as a result of a decrease in world demand. At the close of business on October 24, 2008, the price of a barrel of Urals-32 (the benchmark price for Russian crude), stood at \$64.45, a 53.1% decline from its peak of \$137.61 reached at the close of business on July 4, 2008.⁸² For Russia, such a decline is significant given its dependence on oil. Should the price of oil go below 60\$/barrel, the government budget would go into deficit.⁸³ Should the price drop to \$30-35/barrel, the Russian economy would stop growing, according to one estimate.⁸⁴

Another sign of financial trouble for Russia has been the rapid decline in stock prices on Russian stock exchanges. At the close of business on October 1, 2008, the RTS index had lost 69.0% of its value from its peak reached on May 19, 2008.⁸⁵ (The decline was the largest since Russia experienced the financial crisis in August 1998.) On September 16 alone, the RTS index lost 11.5% of its value leading the government to close stock markets for two days. The overall drop in equity prices was blamed on the loss of investor confidence in the wake of the August 2008 conflict between

⁸¹ Department of Energy. Energy Information Administration. *Country Analysis Briefs. Russia*. April 2007. p. 10.

⁸² Department of Energy. Energy Information Administration.

⁸³ Open Source Center. *Government Bails Out Oil Companies Suffering From World Financial Crisis*. October 30, 2008.

⁸⁴ Economist Intelligence Unit. *Monthly Report—Russia*. October 2008. p. 7.

⁸⁵ RTS.

Russia and Georgia but also because of the decline in oil prices and as a result of the credit crisis that has affected markets throughout the world. In addition, the ruble has been declining in nominal terms because foreign investors have been pulling capital out of the market to shore up domestic reserves putting downward pressure on the ruble.

The decline in oil prices and a decline in investor confidence have hit major Russian companies and their stock market values. Russia's banking system remains immature and high interest rates prevail; therefore, Russian companies have relied on foreign bank loans for financing rather than equity-based financing or domestic bank loans. However, these foreign loans were secured with company stocks. Because of the drop in stock values and because of the overall tightening of credit availability, foreign banks have declined to rollover loans.

The Russian government, led by President Medvedev and Prime Minister Putin, has implemented several packages of measures to prop up the stock market and the banks. The packages, valued at around \$180 billion, are proportionally larger in terms of GDP than the U.S. package that Congress approved in September.⁸⁶ In mid-September, the government made available \$44 billion in funds to Russia's three largest state-owned banks to boost lending and another \$16 billion to the next 25 largest banks. It also lowered taxes on oil exports to reduce costs to oil companies and made available \$20 billion for the government to purchase stocks on the stock market. In late September, the government announced that an additional \$50 billion would be available to banks and Russian companies to pay off foreign debts coming due by the end of the year. On October 7, 2008, the government announced another package of \$36.4 billion in credits to banks.⁸⁷

⁸⁶ Ibid. 6-7.

⁸⁷ Economist Intelligence Unit. *Monthly Report–Russia*. October 2008. p. 6