

# CRS Report for Congress

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## **Putin's Economic Strategy and U.S. Interests**

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# Putin's Economic Strategy and U.S. Interests

## Summary

President Putin has set as a goal the conversion of Russia to a functioning market system in this decade. Without successful reform to develop a functioning market system with sustained growth, the Russian economy is likely to recede in performance toward the level of a developing country. Putin's strategy calls for rapid and comprehensive changes in the structure of the Russian economy, including radical changes in fiscal, financial, enterprise and administrative systems. Whether Putin is able and willing to implement the difficult decisions to bring about successful market reform in Russia may become evident in 2001 to 2002.

Several American and Russian empirical studies support Putin's reform strategy. Putin's reforms are designed to convert the Russian economy from a disinvestment and disincentive to a functioning market system. Elements of successful reform center on changes deemed necessary to increase productivity and attract investors.

Reform prospects have been improved by the action program in Putin's State of the Nation address of April 2001. Putin is building on the blueprints and programs established in the year 2000 to move toward rapid legislation and implementation of these structural reforms. Unparalleled current economic growth may, if continued, provide a window of opportunity for gaining political support for reform and funding to facilitate reform implementation.

Authoritarian trends in governance would tend to deter the development of a rule of law regime central to successful market reform. Possible economic crises in debt management, demographic and infrastructure problem areas may pose difficult budgetary choices and draw future political and economic support away from reform. Resistance to reform and increased defense spending, which have been especially favored by some oligarchs, may be tempered and reversed. Acceptance of international market rules and corporate governance would facilitate an increase in productivity and generate larger inflows of investment. Support in place of previous strong opposition by Gazprom, the world's largest energy company, may be the single most important factor in the success or failure in initiating Putin's comprehensive structural reforms.

A functioning market system in Russia might benefit U.S. interests by providing profitable investment opportunities and a less threatening and more cooperative Russia. Successful reform could open opportunities for Russia and its creditor nations to better manage official Paris Club debt and for Russia to accede to the World Trade Organization (WTO). The dangers of a failed Russian reform to U.S. interests might come from the revival of a security threat with potential confrontations in foreign, security, and domestic policies averse to U.S. national interests.

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# Putin's Economic Strategy and U.S. Interests

President Vladimir Putin has adopted a goal of converting the Russian economy into a functioning market system with sustained growth during this decade.<sup>1</sup> Specifically he has called for a development strategy emphasizing rapid comprehensive structural reforms.<sup>2</sup> Whether these goals are attained may have a material impact on U.S.-Russian relations. The Bush-Putin Summit in Slovenia on June 16, 2001 set in motion a series of economic dialogues on U.S. - Russian relations

This report first explores President Putin's commitment to economic reform.<sup>3</sup> Second, Putin's reforms to date are assessed. Third, the elements of successful reform are assessed. Fourth, prospects for attaining successful reform are explored. Fifth, the implications of Russian reform success or failure to the interests of the United States are examined.

## Putin's Goal for Russia: A Functioning Market System

Vladimir Putin has stated that "Russia is in the midst of one of the most difficult periods in its history. For the first time in the past 200, 300 years, it is facing a real threat of sliding to the second, possibly the third echelon of world states."<sup>4</sup>

Putin established as a primary goal for Russia the transition to a functioning market system in a strong central state. Obtaining a sustainable growth rate of eight percent Gross Domestic Product (GDP) per annum would assure rising living standards for Russian citizens and set Russia on the course to reemergence as a global power, according to the Russian President.<sup>5</sup> He stated further that by applying new market mechanisms, Russia could overcome the "progressive backwardness" of the

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<sup>1</sup> Vladimir Putin, *Russia at the Turn of the Millennium*, December 13, 1999 and *State of the Nation Address to the Federal Assembly*, July 13, 2000, and *State of the Nation Address to the Federal Assembly*, April 3, 2001.

<sup>2</sup> German Gref, *Russian Development Strategy to the Year 2010*, July 28, 2000. Minister of Economic Development and Trade Andrei Illarionov, *Long Term Strategy for Russia*, April 2000, Office of the Russian President.

<sup>3</sup> This report updates CRS Report RL30266, *Russia's Economic Policy Dilemma and U.S. Interests*, July 23, 1999.

<sup>4</sup> Vladimir Putin, *Russia at the Turn of the Millennium*, op. cit.

<sup>5</sup> Ibid.

traditional Russian economy. Putin highlighted the high upside in successful reform and the low downside in failure.

Putin also noted that Russia had to apply a hard lesson learned from its Soviet Communist past:

Communism and the power of Soviets did not make Russia a prosperous country with a dynamically developing society of free people. Communism vividly demonstrated its ineptitude for sound self development, dooming our country to a steady lag behind economically advanced countries. It was a road to a blind alley, which is far away from the main stream of civilization.<sup>6</sup>

This route leading down a blind alley was set by Josef Stalin in 1931 when he called on the Soviet Union in its first five-year plan to overcome Russia's traditional security weaknesses by following an authoritarian economic development path to becoming the most militarized economy in modern history.<sup>7</sup>

Putin stated that "a strong state power in Russia is a democratic, law-based federative state." Putin's political and economic supporters, however, interpreted this prescription differently in the year 2000. The economic reformers considered a law-based state necessary to provide the regulatory framework for economic decisions based on market forces.<sup>8</sup> Putin's "democratic" market reform requires a rule of law in the economic realm to assure a functioning market system. Some political supporters considered an economy directed by the political leadership as necessary and sufficient to attain Putin's goal of sustained growth. Putin's Kremlin staff, security advisors, and many financial industrial magnates, or oligarchs, counseled development of a strong central state that would preserve the power, prerogatives and privileges of the leadership in determining economic policy and governing the state. These pro-authoritarian forces argued that a directed economy could, by controlling demand and state investment, generate increased growth.<sup>9</sup>

Yegor Gaidar, "the father of Russian reform," has called this the conflict between power and property:<sup>10</sup> Power is based on political control of major banks, key

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<sup>6</sup> Ibid.

<sup>7</sup> Josef Stalin called for authoritarianism of "One man management" to overcome their military backwardism. *The Tasks of Business Executives*, February 4, 1931, Problems of Leninism, Foreign Language Publishing House, March, 1940. Clifford G. Gaddy, *The Price of the Past, Russia's Struggle With the Legacy of a Militarized Economy*, Brookings Institution, 1996.

<sup>8</sup> G. Gref and A. Illarionov, op. cit. For more discussion of Russian economic performance, see CRS Report RL30879, *Russian Economic Performance and Prospects: Implications for Russia and the United States*, by William H. Cooper.

<sup>9</sup> Viktor Ishayev, *Strategy for the Development of the State to the Year 2010*, as reported in Executive Intelligence Review, March 2, 2001.

<sup>10</sup> Yegor Gaidar discussed this conflict between power and property while supporting Putin's reform strategy at a meeting with the Librarian of Congress, James H. Billington, on January (continued...)

enterprises, media and political parties; property is based on ownership, contracts, and playing by the rules of a civil, market-friendly society.

President Putin has supported speedy and comprehensive market reform in principle, but not in practice during 2000. President Putin brought economic reformers into his government and presidential staff. German Gref was made Minister of Economic Development and Trade and Andrei Illarianov was made principal economic advisor to the President. Valentina Matveyanko was made Deputy Prime Minister for Social Questions in order to address the social safety net. Reformers in the year 2000 proposed comprehensive reforms for implementation based on Russian economic experience to date and successful transitions elsewhere, but in each case sufficient changes were not approved and implemented in the critical structural areas of fiscal, financial, enterprise and administrative systems.<sup>11</sup> These reformers were given prominent roles in preparing Putin's April 2001 address and legislative agenda.

Putin appears to have proceeded in 2000 as if each small reform step or stated commitment to reform would be incremental in its impact on the growth performance of Russian economy, rather than explicitly recognizing the need for comprehensive change. Half measures continued to be characteristic of reform in 2000.

Putin has moved to clarify and resolve what is necessary in state organization to bring about successful economic reform. He called in his State of the Nation address of April 3, 2001 for further development of a law-based, federative state supporting his economic reforms. The challenges are to strengthen federative governance with clear division of power between the central government and the regions, to harmonize federal and regional laws, and to increase development of efficient fiscal federalism.<sup>12</sup> High on Putin's priority list is comprehensive judicial reform, deemed imperative to establishing rule of law governance and combating crime and corruption.

Putin emphasized his commitment to action in his recent State of the Nation address.<sup>13</sup> He noted that "attempts to carry out structural reform do not merely end with writing blueprints and programs."<sup>14</sup> Clear theses on change must be translated into legislation needed to accelerate implementation of comprehensive structural reform. "It is clear that if we fail to take vigorous action today and implement structural reform that we may enter a prolonged economic stagnation." The investment environment is to be significantly improved by across-the-board efforts to meet World Trade Organization (WTO) criteria according to Putin.<sup>15</sup>

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<sup>10</sup> (...continued)  
31, 2001.

<sup>11</sup> German Gref, *Russian Development Strategy for the Year 2010*, op. cit.; Andrei Illarianov, *Long Term Strategy for Russia*, op. cit.

<sup>12</sup> Putin, State of the Nation address, April 3, 2001, op. cit.

<sup>13</sup> Ibid.

<sup>14</sup> Ibid.

<sup>15</sup> Ibid.

Putin reaffirmed the specific reform policies being articulated by his reformers in 2001. For example, the Deputy Prime Minister, Alexei Kudrin, at the Davos World Economic Forum, stressed the commitment for “creating an effective state which is capable of ensuring stable economic growth ... equal rules for all players in the market, a reliable judicial system, a reliable tax system, protection for the rights of property owners.”<sup>16</sup> Alexander Shokhin, Chairman of the Duma Committee on Credit Organizations and Financial Markets, stressed the need for rapid and comprehensive financial reform.

Concurrent with Putin’s address, Boris Nemtsov, new leader of the consolidated center-right parties in the Russian Parliament, supported Putin’s legislative priorities for 2001.

Land reform and the creation of a real estate and agricultural land market; judicial reform to render the court system functional; pension reform to allow individuals to accumulate funds for retirement; the transition to a professional military; and reform of the inefficient state-dominated monopolies, such as electric power, natural gas and railways.<sup>17</sup>

Putin, as a reformer, will be defined by what he does to follow up his policy statements. Putin may be unwilling or unable to bring about the changes necessary for developing a functioning market in the near term or at all. Encouraging as progress in 2001 may seem to some of Russia’s economic reformers, the die has not yet been cast for comprehensive structural reform and sustained growth. It may prove impossible for necessary changes to be made in the near term, e.g., to 2010 as set out in the Gref reform plans prepared for Putin.

James Millar raises relevant questions on the viability of Putin’s reform plans in the near term. Millar stresses the necessary comprehensiveness and simultaneity of structural changes if Russian reform is to be successful.

Partial measures would fail because the institutions of the old planned economy would resist change to return to a kind of institutional equilibrium. Introduction of capitalist institutions also apparently requires a wholesale approach, for the same reason. Prices need to be free to fluctuate in competitive markets to equilibrium levels and private decisions are to be made efficiently with respect to output and investment. Enterprises must be privately owned for these decisions to reflect resource scarcities. Competition in these markets is also necessary, and so on. Thus, it would appear that all prices need to be freed, enterprises privatized, competition established, a legal structure enforcing contracts created, and so forth, all simultaneously.<sup>18</sup>

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<sup>16</sup> Aleksey Kudrin, *The Role of the State in Russia Has to Change*, ITAR-TASS, World Economic Forum, Davos, Switzerland, 27 January, 2001.

<sup>17</sup> Russian News Agency, April 3, 2001. Robert Cottrell, Putin tries to ensure that more is done than said, *Financial Times*, April 4, 2001.

<sup>18</sup> James Millar, “Papa Schaeg on Economic Reform in Russia” *Problems of Post Communism*, May-June 2001.

Peter Stavrakis goes further in his reservations on the viability of Putin's reforms by making the case that a functioning market economy will never be developed in Russia.

Russia can absorb the western institutions and the vocabularies of micro-economic theory, yet remain unchanged in its traditional authoritarian proclivities for elite rule. The new Russia conforms neither to the West's desired image of it, nor is it a simple return to the past. Rather than slipping into the past, Russia is actually moving forward in a direction that Western institutions and norms cannot comprehend--tsars, boyars, and democrats (both red and white) have blended the dark arts of autocracy with the dismal science, holding "reform" to preserve their interests.<sup>19</sup>

The ball is clearly in Putin's court to demonstrate that changes necessary to create a functioning market system in Russia are attainable.

## Putin's Reforms

In Putin's first year "blueprints and programs for structural reform" were developed by his reformers, but implementation was slow.<sup>20</sup> In order to understand the likely action program for 2001, these blueprints and programs of 2000 should be reviewed.

### Fiscal: Tax Code and the Budget

The overhaul of the ineffective tax system was promised and partially approved by the Parliament with initial implementation of a flat tax. Many tax inequities that tended to discourage business activities were dropped and tax collection efforts were stepped up.

However, potential investors called for further changes in the tax code that would change the investment climate: (1) Reduction or elimination of all turnover or excise taxes on roads and housing, lowering and making uniform import and export duties. (2) Harmonization of the value-added tax (VAT), profits and personal income taxes with international practices. The incidence of the VAT remained on business not on consumption, as intended. (3) Simplification and increased transparency of the tax system intended to improve reporting and effectiveness of collection efforts.<sup>21</sup> A new comprehensive tax code might expand the coverage of tax payments, stimulate and reward productivity.

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<sup>19</sup> Peter Stavrakis, "Post-Imperial State Crisis in Eurasia and Africa: The Case of Russia", Study Paper for National Intelligence Council and Bureau of Intelligence and Research, Department of State, Dec. 2000.

<sup>20</sup> Putin's State of the Nation address, April 2001, op. cit.

<sup>21</sup> *Commercial Issue Briefs*, Prepared for the Clinton-Putin Presidential Summit, June 3-5, 2000, by American Chamber of Commerce in Russia and U.S.-Russian Business Council in Washington.



With revived economic growth in the year 2000, GDP expanded by 8.3%, tax and other revenue was increased, permitting the projection of a balanced budget for 2001. The new budget policy was designed to reduce the burden of external debt service, hold down expenditures for the military through force reduction and professionalization, and move toward eliminating most subsidies. Restructuring of the budget to stimulate growth was deferred. The major claimants for budgetary outlays were still debt service payments, increased security expenditures, subsidies to housing, utilities, loss-making enterprises and regions, and substantial payment of arrears in wages and pensions. A restructured budget that would stimulate reform and growth would have included funds for recapitalization of working banks, restructured pension, health and education systems, severance pay for unemployed workers and demobilized soldiers, and funds to stimulate refurbishing the Russian infrastructure.

## **Financial: Banking, Capital, and Securities Markets**

Putin's reformers recognized the need for an independent, central bank, a working commercial banking system and effective capital and securities markets. Interest in the government and the parliament in developing a secondary market for mortgage financing of residential housing was to address a critical problem affecting the quality of Russian life and would have promised a reduction in the largest single subsidy in the budget.

*However*, the lack of implementation of banking reform led to the failure to attract savings to Russia's banks where they might be used to generate investment funds. An estimated \$65 billion in dollarized savings still resided in Russian mattresses or pickle jars.<sup>22</sup> Sberbank, Russia's largest bank, attracted some savings because the state protected depositors. In providing working capital, often at a loss, the residual claimant for Sberbank losses was the state budget.

Capital flight increased to an estimated \$24.6 billion in 2000.<sup>23</sup> New foreign direct investment was still small, at about \$5 billion going to capital formation in 2000, in large part due to the lack of a working banking system and ineffective capital and securities markets. As a result, *monthly* exits of flight capital substantially exceeded *annual* entries of foreign direct investment.

The Central Bank of Russia was neither an independent nor a prudent regulator of the banking system. Largely as a result of the absence of financial reform, Russia's investment credit rating remained on the lowest rung of the international credit rating scale.<sup>24</sup>

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<sup>22</sup> This estimate for dollarized savings was provided by the Banking Committee of the Duma at a meeting at Congressional Research Service, December 14, 2000.

<sup>23</sup> Federation Council Chairman, Stroeve, estimated capital flight for the year 2000. The Institute of International Finance, Inc., the prime source for reliable estimates on capital flight, estimated \$20.8 billion in capital flight through October 2000.

<sup>24</sup> J.P. Morgan, Emerging Market Research, January 2001. Standard and Poors with a B (continued...)

## Enterprise: Property Rights and Judiciary

Commitments have been made by Putin to the development of productive, competitive, privately owned enterprises. A land code establishing property rights and legal ownership of real estate and land that could be transferred by sale was high on the government's agenda for implementation. More attention was to be given to securing freedom of entry and bankruptcy proceedings for Russia's privatized enterprises. Restructuring, regulation, and reorganization of the natural monopolies in energy and transportation might have made these sectors more competitive and profitable and were to be accompanied by a major step toward full liberalization of prices. Putin's call for increased funding for judicial reform was encouraging as a means for institutionalizing enforcement of new rules of the game. Putin personally approved production sharing agreements with several major foreign oil enterprises in order to stimulate investment.

*However*, judicial reform progress needed to ensure property rights, sanctity of contracts and effective management of bankruptcies was slow to develop in law and practice. Lack of improvement in corporate governance necessary to generate increased productivity and encourage foreign investment was impeding progress toward improving enterprise productivity. The contentious restructuring and reform of Gazprom, United Energy Systems, and the Railroad Ministry had seriously delayed reform. Modest improvement in enterprise transparency and protection of shareholder rights was deferred. As a result flight capital continued to increase and little foreign direct investment was generated.

## Administrative: Professional Bureaucracies

Recognition of the need to reform overstuffed, under productive, unregulated state bureaucracies and security forces was encouraging. Increased pay was promised for these bureaucracies, when reformed. Military manpower was to be sharply cut and reform was intended to provide for professionalism in the forces.<sup>25</sup> Some of the military reforms may have been scheduled to be funded by arms sales reported to total \$3.4 billion in 2000.<sup>26</sup> Harmonization of laws between federal and regional governments was to facilitate developing a level playing field for enterprises that

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<sup>24</sup> (...continued)

rating and Moody's with a B-2 rating, placed Russia's credit at the lowest non-investment grade rating level.

<sup>25</sup> A sharp reduction in military manpower from 1.2 million to .85 million by 2003 has been approved by Putin. The doubling of expenditures has been requested by the military but not approved, *Moscow Times*, January, 29, 2001. Christopher Hill of the Ministry of Defense, London, estimates Russia's defense spending was close to \$5 billion in the year 2000, roughly 5% of its GDP. Lecture at CSIS, Washington, D.C., January 31, 2001.

<sup>26</sup> *Moscow Times*, *ibid*. The income from arms sales may be as much as twice what was reported. CRS report RL30640, *Conventional Arms Transfers to Developing Nations, 1992-1999*, by Richard Grimmett April 18, 2000..

would provide the basis for antimonopoly and bankruptcy procedures, assuring freedom of entry and exit.<sup>27</sup>

*However*, reforming the cadres of government was generally deferred by Putin's lack of action on administrative reforms. Putin had apparently not decided in the year 2000, as evidenced by his actions at the time, whether his strengthened Russian state should be staffed by market-friendly reformers or authoritarian bureaucrats as his Kremlin security advisors and many oligarchs would favor. A market friendly state would be expected to develop a professional civil service and military. Funding military support or reform from military sales was not desirable from the perspective of those who provided foreign aid. While harmonization of laws and regulatory frameworks mandated by the European Union accession programs may have been a model for some of these administrative reforms, implementation of corruption-averse administrative programs was slow to develop in 2000.<sup>28</sup>

## The Elements of Successful Reform

Several empirical studies by American and Russian research teams support Putin's strategic view that structural reforms are necessary to develop an efficient market economy, and if comprehensively implemented, would generate sufficient investment for ensuring sustainable growth.<sup>29</sup> According to these studies, timely introduction of the structural reforms prepared by Putin's reformers, would result in the development of a functioning market economy. These empirical studies add weight to Putin reforms prospects because they are made by institutions that are prime consultants to potential investors in Russia.

The major result from implementing Putin reforms would be a qualitative improvement in both the Russian investment climate and its economic incentive system. The disinvestment trend in the Russian economy might be reversed by an investment-friendly environment that would help revitalize the capital base; its disincentive nature would give way to a functioning market economy.

Partial reform in Russia, initiated in 1992, led to some beneficial changes in economic stabilization, price liberalization and privatization of enterprises, but the Russian economy under Boris Yeltsin lost economic ground as measured by sector productivity and total output. The recent decade (1990-1999) of partial reform was characterized by persistent disinvestment and disincentive systems which accounted for the decline of Russian economic growth. GDP per capita was 27% of the U.S.

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<sup>27</sup> Alexei Lavrov and Alexei Makushkin, *The Fiscal Structure of the Russian Federation*, Institute of East/West Studies, Moscow, M.E. Sharpe, 2001.

<sup>28</sup> Andrei Illarianov, *Long Term Strategy for Russia*, op. cit.

<sup>29</sup> McKinsey Global Institute, *Unlocking Economic Growth in Russia*, Moscow, October 1999 with assistance from Advisory Committee chaired by Robert Solow, including Olivier Blanchard, Richard Cooper, and Theodore Hall. (Hereafter referred to as McKinsey Study). Ernst and Young with Expert Institute of Russia, chaired by Professor Yevgeni Yasin, *Investment Climate in Russia*, July, 2000. (Hereafter referred to as Ernst and Young).

level in 1991. It fell to 15% in 1998.<sup>30</sup> The economy for the decade of the 1990s not only did not grow but the value of output was reduced to as little as half the level of performance that Russia had inherited from the Soviet Union, according to official Russian reports.<sup>31</sup> The McKinsey studies further noted that endowment of natural resources and quality of skilled labor were not likely constraints on increased growth. The key constraints were systemic, i.e., the lack of structural reform.<sup>32</sup>

## **Investment Requirements: Revitalization of the Capital Assets**

Substantial new investment would be needed to restore the diminished capital assets in Russia. The value of capital assets in Russian enterprises fell in the 1990s. Assets inherited by the Russian Federation were estimated to be 30% as productive as assets in comparable sectors of the United States economy in 1991. By 1997 the average labor productivity of selected Russian economic sectors had been cut to 19% of the U.S. level.<sup>33</sup> The reasons for the fall in productivity during this period include lack of new investment, deterioration of productivity of old assets due to obsolescence, a lack of maintenance, and change of demand leading to idling or negative value of output of many enterprises.

New domestic investment was not generated in the 1990s since politically controlled banks did not attract savings and failed to convert savings to capital investment. Even the profitable Russian enterprises did not have the stimulus to invest. Monopolistic profits of privatized enterprises left the country; as much as \$165 billion in flight capital went abroad prior to the Putin regime. Foreign direct investment in the same period was minuscule at less than one percent of the GDP.<sup>34</sup> Little of the \$25 billion external financing provided by the IMF and World Bank was for capital asset improvement. State investment was negative for the 12-year period from 1988 to 2000 as budget deficits exceeded the allocation of state funds for investment.<sup>35</sup>

The disinvestment trend hit Russian infrastructure especially hard. Anatoli, chairman of Russia's energy system, noted that "during the past 15 years no major

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<sup>30</sup> McKinsey Study, op. cit.

<sup>31</sup> The official statistics estimated the fall to be about one-half of the 1989 level in 2000. This fall in performance may have been somewhat exaggerated as performance was declining before the fall of the Soviet Union. Anders Åslund, *The Myth of Output Collapse after Communism*, Carnegie Endowment for International Peace, Working Paper Number 18, March 2001.

<sup>32</sup> Ibid.

<sup>33</sup> Allowing for the increase in U.S. productivity in that six-year period, the fall in relative labor productivity between Russia and the U.S. was still appreciable. Labor productivity represents about 80% of total productivity in the McKinsey sectoral studies. Ibid.

<sup>34</sup> EBRD, *Transition Report 2000*, November 2000. Polish foreign direct investment was close to seven percent of its GDP.

<sup>35</sup> Ernst and Young, op. cit.

new generating capacity was put into operation ... Today five times more generating capacity is withdrawn from service than is commissioned.”<sup>36</sup> The railroads, most industries, and housing are in similar straits.<sup>37</sup>

Massive new private foreign investment would be required to restore Russia’s capital stock. The Russian economy may need more than \$2 trillion in the next 20 years.<sup>38</sup> An estimated three quarters of Russian investment would need to come from private foreign sources in the coming decade.<sup>39</sup> A substantial part of long-term capital investment will be required to restructure natural monopolies such as the United Energy Systems and the railroads. With comprehensive structural reform Chubais expects \$30 to \$60 billion private Russian and foreign investment would be available.<sup>40</sup>

## **Market Forces: Replacement of the Disincentive System**

Adopting a “functioning market mechanism” as projected by Putin is the central requirement for improved productivity in the McKinsey studies. The Russian system largely lacks incentives for enterprises to be efficient, show profits, pay wages and pensions, and attract investment. The nonpayment system led to development of a barter economy, with unpaid wages and pensions and non working loans. A World Bank study concluded that “the process of institutionalizing nonpayment was incentive driven.” Central bankers could own stock in the banks they regulated, oligarchs could own the banks from which they borrowed, and loans from politically controlled banks were not required to be repaid. Nonpayment systematically prevented the resumption of growth.<sup>41</sup>

The McKinsey study team noted that the disincentive system at the enterprise level was especially characterized by an “uneven playing field, (e.g., cheap energy is provided to non viable steel plants and wholesale markets are subject to eight times fewer tax liabilities than some supermarkets).” Furthermore, “tax rules meant little as taxes were effectively tailored for individual enterprises.” Enterprise budget constraints were “soft,” and profits were not required to avoid bankruptcy.

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<sup>36</sup> Interview with Anatoli Chubais, Chairman of the Board of United Energy Systems, Address to American Chamber of Commerce in Moscow, March 20, 2001.

<sup>37</sup> Ibid.

<sup>38</sup> Ernst and Young, op. cit.

<sup>39</sup> Ibid.

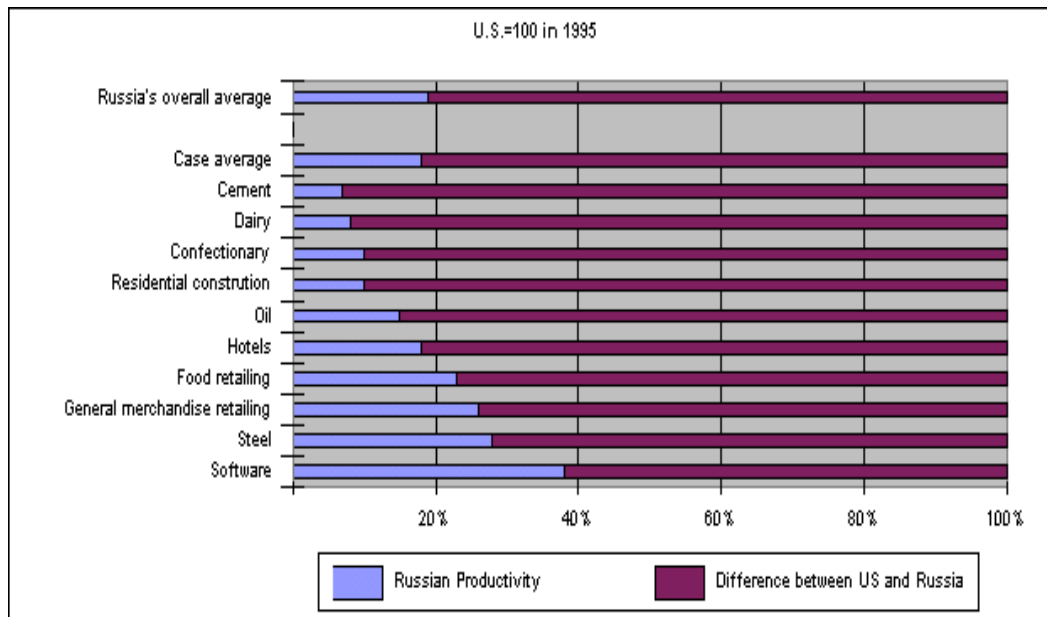
<sup>40</sup> Chubais, op. cit.

<sup>41</sup> Bryan Pinto et al., *Dismantling Russia’s Nonpayment System: Creating Conditions for Economic Growth*, World Bank, Technical Working Paper, WTP 471, June 2000. Cf. Padma Desai and Todd Ibson, *Work Without Wages, Russia’s Nonpayment Crisis*, MIT Press, November 2000.

Substantial production was generated for barter in order to provide politically desirable employment but did not create value<sup>42</sup>.

In the year long study in Russia by industrial specialists, the McKinsey team came to a conclusion for all the ten sectors studied in depth, that it was the “market distortions” or the disincentive nature of the system that accounted for the low level of productivity. If the Putin structural reforms were carried out, they concluded that potential productivity as measured against the U.S. level of performance could be approached (Figure 1). A significant closing of the gap toward the U.S. level would have a major positive effect on economic growth in Russia.

**Figure 1. Comparative Russian-U.S. Productivity, by Sector**



**Source:** McKinsey Global Institute, *Unlocking Economic Growth in Russia*. Moscow, October 1999.

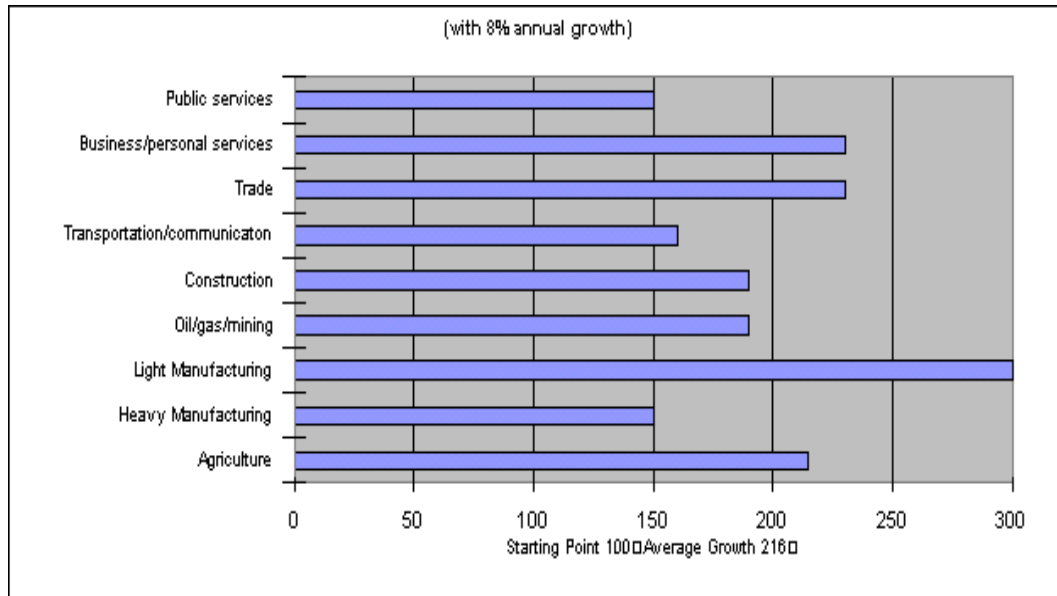
Productivity in Russia’s economic sectors, according to the McKinsey team, was consistently more constrained by Russian disinvestment and disincentive systems than that of its Soviet predecessor. If the Russian economy were not reformed, it would continue to regress. This economy was likely, without reform, to fall further toward that of a developing economy.

The McKinsey study also assessed the comparative productivity of the Russian economy as a whole. This macroeconomic assessment drew on experience from studies of productivity of twenty-four sectors in eleven countries, including Brazil, Japan and Poland. The comprehensive studies of the McKinsey team concluded that with a functioning market incentive system and adequate investment, the Russian economy could take advantage of the potential productivity in all sectors, and sustained growth could be expected. (See figure 2.)

<sup>42</sup> Clifford Gaddy and Barry Ickes, “The Virtual Economy and Economic Recovery in Russia” *Transition*, February-March 2001.

We have estimated the relative potential of output growth in Russia's economic sectors based on the experience of other countries, Russia's starting point, and sources of comparative advantage ... removing the market distortions, especially in the sectors with high growth potential, could enable Russia to achieve and sustain rapid economic growth. Eight percent per annum would be within range, allowing the standard of living to double in less than ten years.<sup>43</sup>

**Figure 2. Implied Relative Output Growth Evolution after 10 Years**



**Source:** McKinsey Global Institute, *Unlocking Economic Growth in Russia*, Moscow, October 1999.

The 210% average growth of all sectors over a 10-year period would set Russia on course to becoming an industrially developed economy. This growth decade would presumably begin as soon as sufficient structural reform had converted the Russian economy to an incentive system based on a favorable investment environment.

The McKinsey study also argued that successful reform would lead to a change in the structure of the Russian economy making it similar after reform to developed economies. With further liberalization of prices facilitated by effective reform of the natural monopolies and increasing demand from rising real income, the relative rates of growth of each sector would reflect competitive market forces. By responding to a new incentive system with liberalization of prices, new capital investment would be drawn to the sectors that had the greatest promise for increased productivity and for fulfilling increased consumer demand. The future structure of the Russian economy reflecting the market's response to relative productivity and consumer demand would then be comparable to the sectoral distribution of other countries in transition such as Poland and Brazil. Significant growth would then be expected to occur in the

<sup>43</sup> McKinsey Study, op. cit.

general merchandising and the food retailing sectors in the light manufacturing and agriculture sectors, respectively.<sup>44</sup>

In sum, the McKinsey and Ernst and Young studies support the Putin comprehensive structural reform strategy. Attainment of sustained growth, according to these empirical studies, requires the turning around of the disinvestment and disincentive systems of pre-Putin Russia.<sup>45</sup>

## Reform Prospects

### April Theses Reform Agenda

Putin called in April 2001 for rapid passage of legislation and implementation of structural reform to encourage and increase productivity to create a market-friendly environment.<sup>46</sup> The litmus issues for Putin's reforms in 2001 and 2002 might start with the blueprints and programs of 2000 and include the additional reform measures that might assure a qualitative change in the incentive system and a favorable environment for investment. The following changes toward a market-friendly state might then be sufficient to assure progress toward necessary reform leading to sustained growth.

**Fiscal: Tax Code and the Budget.** Completion of the legislation and implementation of the second part of the tax code providing for an improved budgetary process may be more likely and necessary in order to obtain additional revenue for funding reform. Added revenue may also be received from prudent sale of government-owned assets (e.g., privatization through auctions open to both foreign and domestic bidders). Restructured reform-friendly budgets, increased domestic and foreign investment, better debt management and return of some flight capital may be encouraged by using the current window of opportunity of improved economic performance for instituting comprehensive fiscal reform. The budget may then include funding to: (1) Restructure and recapitalize the working commercial banks; (2) Restructure and recapitalize the social safety net, including pensions, enhancing

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<sup>44</sup> William Lewis, Director of McKinsey Global Institute, at State Department meeting, Meridian House, Washington, D.C., February 14, 2001.

<sup>45</sup> Cf Viktor Ishayev, *Strategy for Development of the State in the Year 2010*, op. cit.

<sup>46</sup> Putin's State of the Nation address, April 2001, op. cit. Some of Putin's supporters likened his new action program in April 2001 to the political tactics of Lenin in April 1917. On returning to Russia in April 1917 Lenin adopted an action program called his April Theses, which were considered by some historians to be the tactical turning point in the Bolshevik Revolution.



programs for health and education<sup>47</sup>; (3) Provide government funding necessary to spur domestic and foreign investment for refurbishing Russia's infrastructure.

**Financial: Banking, Capital and Security Markets.** Radical reform of the Central Bank of Russia may be necessary to make it independent and responsible for prudent monetary policy. Privatization of the savings bank, Sberbank, and restriction of its access to the state's budget may also be required.<sup>48</sup> Significant restructuring of the commercial banks has been called for to make them working banks with international accounting standards and to have many Russian banks teamed with foreign banks.<sup>49</sup> Rehabilitation of the Federal Securities Commission may be required to make it an effective SEC-like watchdog of property and shareholders' rights. These programs may be more likely if Gazprom becomes a normal enterprise respecting the rules of the international market place.

**Enterprise: Property Rights and Judiciary.** Effective actions have been projected to reform the natural monopolies, liberalize and restructure Gazprom, the United Energy System and the Railroad Ministry. If carried out, these reforms would ensure rights, including those of minority stockholders, in Gazprom and other enterprises, reduce risk, and increase expectation of repatriable profits. Adoption of a wide-ranging plan for restructuring United Energy System was approved May 20, 2001. A similar approach to Gazprom is sought by reformers but has not as yet been implemented.<sup>50</sup> Passage of the land code by the Parliament, including establishing property rights for agricultural land, may be completed. Land reform, if legislated and implemented, might serve to unleash growth prospects of private farms and open the opportunity for developing a modern food chain. A far reaching judicial reform was announced by Putin in his April address. Putin's priority list in developing a law-based state emphasizes a comprehensive judicial reform including training, funding, and reappraisal of qualifications of sitting judges trained in the Soviet period.

**Administrative: Professional Bureaucracies.** A major administrative reform of the structure and operations of the Putin administration may be needed and implemented. This may include the retirement of key figures opposing reform, e.g., Viktor Gerashchenko, head of the Russian Central Bank, and Rem Vyakhirev, director of Gazprom. The federal bureaucracy which has grown to over one million needs to be pared, according to Putin. Administrative reform to support development

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<sup>47</sup> President Putin's Budget Message to the Federal Assembly, "On Budget Policy for 2002," *Rossiyskaya Gazeta*, April 24, 2001. Deputy Prime Minister Matveyanko called for a major reform in 2001 of pension, health, education and housing, including lengthening the retirement age from 65 and eliminating the housing subsidy over the next two years. Valentina Matveyanko, op. cit.

<sup>48</sup> Sberbank cannot be privatized by the government directly as it is owned by the Central Bank. Sberbank's reform would have to be included in the reform of the Central Bank.

<sup>49</sup> "Russia would lift restrictions on foreign bank operations in the domestic market to ease Russia's entry to WTO", Reuters, January 23, 2001. "Western banks hope for reform of Russian banking sector in 2001", Interfax, January 2, 2001.

<sup>50</sup> Andrew Jack, "Russia Adopts Reform Plan for Electricity", *Financial Times*, May 21, 2001.

of a professional civil service might facilitate market efficiency and deter corruption. Professional bureaucrats are needed to oversee the implementation of new rules, but “government interference in enterprises” should be sharply reduced.<sup>51</sup> The military reform, if implemented, might also result in reduction of staff, better military pay, and the prospect of a smaller, more professional military force.

## **Window of Opportunity Facilitating Reform**

Putin acknowledged that the economic boom initiated in 1999, fueled by high oil prices and a cheap ruble, might be fragile or short lived and that a window of opportunity for initiating comprehensive structural reform might be closed. The window of opportunity may be defined as a period of good economic performance that might facilitate political support for adoption of reform legislation and an economic basis for funding of reform. The adoption by the Russian Parliament of the legislative agenda arising out of Putin’s April theses may facilitate favorable economic performance. Economic growth in 2000 permitted the elimination of arrears: Pensions, wages, and other overdue payments were brought up to date. Continued growth and increased revenue might provide funding support for reform leading to reduced poverty and rising real income in the future.

The end of high levels of growth of GDP, generating increased revenue and foreign exchange accumulation, could deter adoption of reform measures. The economic growth of eight percent in the year 2000 is now projected to be four percent in 2001. A continued substantial growth rate would keep open the window of opportunity.<sup>52</sup>

Incremental reform changes may have been necessary but not sufficient to have major beneficial effect on increased productivity and an improved investment environment. Now Putin considers the year 2000 was a preparation period for the action program of 2001. With an action program for reform, increased revenue is necessary.

The official reformers have expressed differing views on the need for significant reform progress in the year 2000. Reformers, such as German Gref and Yegor Gaidar, did not appear to be disturbed by the slowness in implementing comprehensive structural reforms. Gaidar noted the difficulty in developing effective coalitions for supporting key aspects of reform and the need to develop priorities for focusing support for necessary reform efforts to speed adoption of reform.<sup>53</sup> However, another key reformer, Andrei Illarionov, argued that, “The government squandered the opportunity to implement structural reform this year.”<sup>54</sup> Putin

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<sup>51</sup> Putin, State of the Nation, April 2001, op. cit.

<sup>52</sup> Plan Econ, Monthly Report, February 2001. CRS Report RL30879 by William Cooper, op. cit. The Russian State Statistical Agency, Goskomstat, reported the annual growth for 2000 was 8.3%, AP, April 1, 2001.

<sup>53</sup> Gaidar discussion with Librarian of Congress, op. cit.

<sup>54</sup> Illarionov, Reuters, December 5, 2000.

recognized that the window of opportunity was still open and provided him an opportunity for securing rapid adoption of legislation and implementation of reform.

## **Authoritarian Impediments to Reform**

Some aspects of authoritarian rule that ran counter to the development of the rule of law in Russia were implemented in 2000. Putin took steps to consolidate his political power in the center by appointing his own security and military officers as administrators in the consolidated regional governments. Strengthening the National Security Council, headed by KGB General Sergei Ivanov, served to recentralize security and foreign policy. The media and religious organizations were more closely controlled with some consolidation of ownership of facilities and enhanced control by the state. Freedom of speech and religion were limited by greater state control through the reenforcement of the state's right to intervene. Media unpopular with the state leadership, such as the television network NTV, were publicly attacked, ownership changed, and the freedom of the press constrained. Religious faiths expressed fear of state intervention in their right to worship as they chose.<sup>55</sup>

This reserved "right" to intervene by the leadership is an essential feature of an authoritarian rule mentality that may also be applied in the economic arena. Even if economic reform leads to enactment of laws protecting property and shareholders' rights, the government may retain the right to intervene in order to favor some investors, enterprises, or regions.

In short, Putin's choice between a state favoring functioning market forces governed by a rule of law and authoritarian rule may be influenced both by the spirit and the letter of the law. In the year 2000, Putin reinforced the authoritarian character of his governance both in substance and in spirit. The case can be made that the authoritarian lobbies of the Kremlin, the security apparatus and the oligarchs have had more influence over the government and Parliament than the lobbies for reform in the year 2000.<sup>56</sup> Putin's stress on the a need for a normal judicial system in his April Theses will be watched carefully at home and abroad as an indication of whether the rule of law concept is winning out over the authoritarian state.<sup>57</sup>

## **Economic Crises Impediments to Reform**

The lack of progress in reform for converting the Russian economy to an incentive market system may doom the economy, as Putin noted, to a trend of

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<sup>55</sup> The National Council of Soviet Jewry, *Russia Update: Jews Facing Old and New Challenges*, January 12, 2001. Giles Whitte, *Moscow Tightens Grip on Rival Faiths*, Times (UK), January 2, 2001.

<sup>56</sup> Illarionov, op. cit.

<sup>57</sup> "Vladimir Putin is Flexing his Muscles, But Biffing is Easier Than Building," *London Economist*, June 9, 2001. Anatoli Chubais expressed concern that protection of human and civil rights in Russia may be of greater concern to liberal forces than Russian economic reforms. "The Political and Economic Situation in Russia," Carnegie Endowment for International Peace, May 21, 2001.

“progressive backwardness.” Moreover, if the “window of opportunity” from favorable growth were closed, then the political basis for support of reform legislation might be reduced and the decreasing revenue might make it more difficult to finance reforms.

Putin has been fortunate to have the strong upsurge of economic growth as he assumed leadership in Russia. However, if the window of opportunity is not used to implement comprehensive reform while it is available, the Russian economy may not be put on a new trend line of sustained growth and balanced budgets. Economic growth and increased revenue do not assure adequate funding for reform. Military reform will require a substantial increase in the budget for 2002. An increase of \$1.5 billion in military procurement may augment additional spending for military reform. These increases may be carried over to 2003 and unbalance the budget.<sup>58</sup> More ominously, Russia may also face serious growth retarding crises that put strong pressure on the federal budget and political stability.

In Russia “most analysts are predicting a general crisis in 2003.”<sup>59</sup> This crisis year may be triggered by a combination of serious debt, demographic and infrastructure problems. Assuming that each of these problem areas may reach a crisis level in the same year may seem a bit dramatic, even hyperbolic, but the potential of serious crises in any or all of the areas is a clear and present possibility as they represent the negative fundamentals in the current Russian economy. A general crisis in 2003 might further erode the political support for Putin’s regime and his reforms and place new priority claims on already burdened budgets.

**Debt Crises.** The debt service burden for the government’s external debt payment is expected to peak in 2003. Russian leaders predict that making the required payments on all of the external debt may require either reduced funding for reform, or lead to default on debt payment, especially for servicing Paris Club Soviet Era debt.

The total external debt service in 1999 was \$9.46 billion; it is projected to be close to \$13 billion in the year 2001 and \$18.2 billion in 2003. (See table below). If the growth of revenue were to continue to 2003 at its present rate of increase, debt servicing would absorb about 27% of the revenue. However, with a possible growth slowdown, Russia’s debt servicing share of reduced revenue might rise above 40%.<sup>60</sup>

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<sup>58</sup> “A Deadly Embrace, The Finance Ministry Is Out to Buy the Military.” *Vremya Novostei*, June 7, 2001.

<sup>59</sup> Politruk, a summary of weekly and daily publications in Russia, January 17, 2001. A conference entitled “Crisis 2003: Myth and Reality,” is scheduled for June , 2001. *Moscow News*, April 18, 2001.

<sup>60</sup> See table below.

**Table 1. Russian External Debt Service**  
(Billions of Dollars)

	1999	2000 Projected	2001 Projected	2002 Projected	2003 Projected
<b>Total, Principal and Interest</b>	<b>9.46</b>	<b>10.22</b>	<b>12.98</b>	<b>12.44</b>	<b>18.20</b>
Paris Club, Soviet and Russian Era	1.74	1.98	3.94	3.94	5.90
Paris Club, Soviet Era	(1.39)	(1.58)	(3.15)	(3.15)	(4.70)
IMF	3.88	3.66	3.33	3.35	3.26
Euro Bonds	1.58	2.96	2.57	2.55	2.53
World Bank	.52	.64	.82	.93	.98
EBRD	.06	.07	.09	1.00	.12
Ministry of Finance Bonds	.00	.00	.00	.00	2.94
Others	1.88	1.21	1.43	1.17	3.63
<b>Total Debt Service as of % of Total Revenue</b>	<b>39.5%</b>	<b>26.7%</b>	<b>25.4%</b>	<b>23.6%</b>	<b>27.4%</b>

**Source:** Michael Marrese, Chase Manhattan International Limited, London, November 17, 2000.

Russia tried unsuccessfully to negotiate reduction of the debt servicing payments for Paris Club Debt due in February 2001. The creditor conditions for non-payment became unacceptable to President Putin. As a result, Russia chose to meet what turned out to be its debt-servicing obligation of \$3.6 billion when the Duma included the Paris Club debt payment in the 2001 budget.<sup>61</sup>

In 2003, a debt service crisis is projected to arise because of the higher debt service level, as indicated in the table above. An IMF program would have to be approved before possible Paris Club restructuring were initiated.<sup>62</sup>

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<sup>61</sup> *Financial Times*, 28 February 2001.

<sup>62</sup> Finance Minister Kudrin indicated after discussion with Secretary of Treasury O'Neil that Russia and the United States would set up a bilateral commission to discuss debt management and other commercial issues. Kirill Glebov in *RIA Novosti*. See also CRS Report RL30617, *Russian Paris Club Debt and US Interests*, January 18, 2001, by (name redacted)

**Demographic Crises.** Russia is a country with progressively worsening demographic, health, and ecological problems. Declining population, deteriorating health and health threatening environmental problems may pose threats to the political support of the regime and may require significant new budgetary outlays that compete with funding for reform programs. These demographic issues represent long term problems for Russia. By considering them a part of a general crisis in 2003, many Russians assume that population, health and environmental problems will rise to the general crisis level in that year.<sup>63</sup>

Putin noted that Russia's population was declining at a rate of 750,000 a year, causing "the most acute problem facing our country."<sup>64</sup> Professor Murray Feshbach summarized the population and health problems,

Its birthrate has reached extraordinary low levels, with a death rate high and rising. ... Only about 25% of Russian children are born healthy. ... The immediate health concerns are from burgeoning epidemics, the incidence of HIV/AIDs, syphilis, tuberculosis, hepatitis C, and other infectious diseases are soaring. ... Perhaps 40% of the nation's hospitals and clinics do not have hot water or sewage.<sup>65</sup>

Health problems are aggravated by environmental pollution. Russia's legacy not only includes conventional air and water pollution but serious contamination from many nuclear and chemical sites throughout the country.<sup>66</sup>

At any time, this dismal catalogue of demographic problems could escalate into severe epidemic proportions, perhaps in 2003. Efforts to deal with each of these problem areas are currently underfunded. Were a number of health and environmental crises to escalate, a substantial budgetary response might be politically necessary, but practically ineffective. Nonetheless, the fiscal response might result in further diversion of funds necessary for implementing reform.

**Infrastructure Crises.** Lack of replacement and necessary retirement of many capital assets in Russia's infrastructure have made a major contribution to disinvestment trends. The obsolete and crumbling capital stock of infrastructure enterprises, such as transportation and communications, may develop a rash of critical shortfalls and bottlenecks (e.g., civilian counterparts of the Kursk submarine disaster). The electric power supply shortage currently in the far east (*Primorskii Krai*) of Siberia may be a harbinger of proliferating regional electric power disasters.<sup>67</sup> No new major electric power facilities have been commissioned in the last fifteen years,

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<sup>63</sup> Politruk, op. cit.

<sup>64</sup> Putin's State of the Nation, January 2000, op. cit.

<sup>65</sup> Murray Feshbach, Russia's Population Meltdown, Declining Birth Rates and Soaring Rates of Disease Now Threaten Russia's Very Survival as a Nation, *Wilson Quarterly*, Winter 2001. See also CRS Report RL30970, *Health in Russia and Other Soviet Successor States: Context and Issues for Congress*, by (name redacted) and Lois McHugh.

<sup>66</sup> Ibid.

<sup>67</sup> *Financial Times*, Editorial, January 6, 2001.

as noted above.<sup>68</sup> A series of concurrent infrastructure disasters might require mobilization of resources for a politically necessary response, but still fall short of meeting the crisis.

## Support Impediments to Reform

Putin's reform programs may gain support as a result of his popularity with the Russian public and Parliament due to the payment of pension and wage arrears and some increase in living standards. However, without a window of opportunity Putin may have future difficulties gaining support for reform programs that lead to austerity.

The strongest and most effective opposition to reform in the year 2000 came from the oligarchs. The Russian President has tried to woo the oligarchs to support reform. Putin informed the heads of financial industrial groups, the oligarchs, that he would not support renationalization of private enterprises and appealed to the oligarchs to support reform by accepting market rules and corporate governance.<sup>69</sup> Putin is now using direct means for the restructuring and reform of the natural monopolies as evidenced by the reform and restructuring of the United Energy Systems. Arguments based on oligarchs' self interest have been pressed by international capital circles.<sup>70</sup>

Ira Millstein, a leading US lawyer who chaired the OECD World Bank private sector advisor group, brought a financial group to Moscow responsible for nearly \$3,000 billion investments. The meeting was called 'Capital Meeting the Need for Capital.' The message to Russian entrepreneurs was they could expect substantial investment and access to western corporate governance if they accepted normal rules of the international capital market.<sup>71</sup>

One of the key conglomerates with the largest assets and the most influential lobby in the Duma is Gazprom. Vladimir Putin replaced Rem Vyakhriov, Chief Executive Officer of Gazprom on May 30, 2001. When Alexei Miller took over as CEO of Gazprom, he announced that his priorities included rapid expansion of gas production and construction of pipelines. "Speaking of his immediate plans, he primarily singled out the need to raise the capitalization of the company, to guarantee the transparency of expenses and raise the effectiveness of investments."<sup>72</sup> The new leadership and major stockholders in Gazprom may be convinced that they should support reform. Gazprom might choose to seek acceptance into the global capital and commercial markets as an enterprise that plays according to market rules and is therefore credit-worthy. According to *Troika Dialog*, "If Russia is to become a

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<sup>68</sup> Interview with Anatoli Chubais, Chairman of the Board of United Energy Systems, Address to American Chamber of Commerce in Moscow, March 20, 2001.

<sup>69</sup> Putin's second meeting with the oligarchs reportedly led to their general agreement that they would observe the new rules of the game. *Financial Times*, January 24, 2001.

<sup>70</sup> Russian Government Readies Itself to Curb its Oligarchs, *The Times* (UK), April 26, 2001.

<sup>71</sup> John Pender, Russia on the Gospel of Governance, *Financial Times*, November 22, 2000.

<sup>72</sup> "New Russian Gas Chief Sets Out Priorities," *Interfax*, May 30, 2001.

normal country, Gazprom has to become a normal company.”<sup>73</sup> This acceptance might serve the self interest of Gazprom’s major shareholders and leadership. Their asset evaluation might increase dramatically if they became a global player.

In 1999, their market capitalization stood at \$4 billion. Had it been valued on a western style multiplier, it would, according to an estimate from Troika Dialog, the Moscow investment bank, have been worth \$1,960 billion....that was on the basis of \$13 a barrel of oil or gas equivalent. With oil at \$33 a barrel, the potential is vastly greater in a company with more than ten times the reserves of BP Amoco.”<sup>74</sup>

If Gazprom accepts normal market rules, its credit ratings might also improve dramatically with foreign investors buying shares of Gazprom stock and subscribing to large issues of its Eurobonds. Were all Russian enterprises to follow the same path in accepting normal market rules, stock market capitalization of Russian enterprises would be far greater than \$50 billion. Putin in his April address noted that Finland, a country that plays by the market rules, had five times the stock market capitalization of Russia with one Finnish company, Nokia, valued equal to the total Russian capitalization.<sup>75</sup> Acceptance by Gazprom of normal market rules abroad may also require rethinking of its support of financial reform at home. Action by Putin’s new Gazprom leadership may be critical to the overall success of reform.<sup>76</sup>

## **Implications to the United States of Reform Outcomes**

The consequences of alternative reform outcomes could be significant for U.S.-Russian relations.<sup>77</sup> A prosperous Russia could be an attractive trading partner, a profitable country to invest in, and an important member of the World Trade Organization (WTO). Russian reform and economic growth might be accompanied by greater political stability and a more cooperative foreign and security policy. At the same time, a stronger Russia would have the ability to challenge some U.S. policies. The negative reform scenario may reduce U.S. business opportunities in Russia, promote inimical nationalistic authoritarianism and revive security concerns that threaten U.S. interests. A weaker Russia might have less ability to challenge U.S. interests.

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<sup>73</sup> Andrew Jack, “Russian President Hints of Plan for Gazprom Shakeup,” *Financial Times*, April 16, 2001.

<sup>74</sup> Ibid. The International Financial Corporation of the World Bank estimated that Gazprom market capitalization in December 1999 was \$6.26 billion. EBRD, Transition Report, May 2000.

<sup>75</sup> Putin’s State of the Nation address, April 2001, op. cit.

<sup>76</sup> A Price-Waterhouse-Cooper study concluded that the lack of clear, accurate, widely accepted business practices is costing Russia \$10 billion a year in direct foreign investment. *Moscow Times*, April 25, 2001.

<sup>77</sup> For discussion of U.S.-Russian relations, see CRS Issue Brief IB92089, *Russia*, by Stuart Goldman and CRS Issue Brief 95077, *The Former Soviet Union and U.S. Foreign Assistance* by (name redacted).



Market reform may encourage more, possibly more effective, support from the U.S. government, international financial institutions, the U.S. private sector, and the G-7 collective.<sup>78</sup> Increased assistance and cooperation might then be based on a broad confluence of national interests without specific conditions related to foreign and security performance. U.S. economic policy as a whole might be driven more by the private sector interests of each country. Linkage of foreign and security policy to economic assistance policy involving sanctions might find less support, especially reflecting the views of multinational business circles and U.S. allies.

Russia may rely less on the U.S. government in the future. Russia may look more toward Germany, the Western private sector, and its own resources for support. Germany, as Russia's leading commercial partner in trade, investment, and debt management, may also play a central role in Western economic policy toward a reformed Russia.<sup>79</sup> The European Union under current leadership of Sweden may play a lead role in early discussions of Russian accession to the WTO. Dealing with a reformed Russia, the United States may favor Paris Club restructuring, including debt swaps;<sup>80</sup> and increased exchanges, such as the U.S.-Russian Leadership and the Meeting of Frontiers Programs.

A failure of economic reform may encourage authoritarian rule in Russia and revive security concerns that threaten U.S. interests. A negative reform scenario may reduce Russia's ability to challenge U.S. security interests. Investment opportunities may be reduced and U.S. response to Russia's economic needs may be modest. Broad conditionality involving political, security, and foreign policy performance might continue to be a precondition for any economic cooperation and assistance.<sup>81</sup> Sanctions to enforce foreign and security policy, in reference to Iraq, Iran, North Korea, and Cuba, may be kept in place, perhaps strengthened. Resolution of differences on the National Missile Defense (NMD) policy of the United States might be an overarching condition precedent for any economic accommodations.<sup>82</sup> Debt rescheduling for Russia's Paris Club Soviet-era may be held in abeyance until Russia implements specific cooperative foreign and security policies. Prospects for U.S. support of Russian access to WTO could be sharply reduced.

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<sup>78</sup> Carnegie Endowment for International Peace, *An Agenda for Renewal, U.S.-Russian Relations*, Fall 2000.

<sup>79</sup> Christian Meier, *Russia Under Putin: Foreign Economic Relations Policy Up For Reshaping?* Report #28/2000, Bundesinstitut für österrwissenschaftliche und internationale Studien, Cologne, Germany.

<sup>80</sup> James L. Fuller, *Debt for Ecology: A Concept to Help Stabilize Russian Nuclear Cities*, Pacific Northwest Center for Global Security, presented at Lake Como, April 9, 10, 2001.

<sup>81</sup> Speaker's Advisory Group on Russia, Christopher Cox, Chairman, *Russia's Road to Corruption*, U.S. House of Representatives, September 2000.

<sup>82</sup> CRS Report RL30967, *National Missile Defense: Russia's Reaction*, by Amy Woolf.

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