



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

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## Summary

Until recently, the Russian economy was one of the fastest growing economies in the world. The growth brought an improvement in the standard of living of the average Russian citizen and also brought economic stability that Russia had not experienced in at least a decade. This strong economic performance had been a major factor in the popular support that the Russian leadership enjoyed and was also arguably a factor in the boldness with which that leadership reasserted Russia's status as a world power, challenging the United States, Europe, the neighboring former Soviet states in economic and national security areas.

However, as has been the case with most of the world's economies, the Russian economy has been hit hard by the global financial crisis and recession, the effects of which have been readily apparent since the fourth quarter of 2008. The crisis brought an abrupt end to the decade's long (1999-2008) economic growth with real gross domestic product (GDP) increasing 6.9% annually on average. Russia is expected to experience negative growth in 2009 and only modest growth at best in 2010. Its real GDP decreased 9.8% during the first quarter of 2009.

The high oil prices were a major factor in the economic success Russian enjoyed, especially in the early and middle parts of this decade; however, the collapse of world prices for oil and other commodities in 2008 exposed the downside of Russia's dependence on the production and export of oil, gas, and other natural resources. The failure of Russia to complete important economic reforms and the government's penchant for re-asserting its control over key economic sectors loom among the possible roadblocks to a return to high economic growth rates down the road.

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, it is an important market for U.S. exporters of poultry, energy equipment, and technology. 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. Congress may consider in the near future whether to extend permanent normal trade relations (PNTR) status to Russia.

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As has been the case with most of the world's economies, the Russian economy has been hit hard by the global financial crisis and resulting recession that became readily apparent in the last quarter of 2008. Even before the financial crisis, Russia was showing signs of economic problems when world oil prices plummeted sharply around the middle of 2008, diminishing a critical source of Russian export revenues and government funding.

The crisis brought an abrupt end to about a decade (1999-2008) of impressive Russian economic growth that helped to raise the Russian standard of living and brought economic stability that Russia had not experienced for more than two decades. This success was a major factor in the popular support that former President (now Prime Minister) Putin and the current president, Dmitrij Medvedev enjoyed, and it was also arguably a factor in the boldness with which the Russian leadership reasserted Russia's status as a world power, challenging the United States, Europe, the other former Soviet states, including its military confrontation with Georgia in August 2008. The sudden downturn could undermine the popular support and Russia's ability to project its foreign policy interests.

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.<sup>1</sup> Russia is also a member of the G-8 group of highly developed economies.

While U.S. exports to Russia are still relatively small, Russia is an important market to U.S. exporters of poultry, energy equipment, and technology. 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 been held on Russian economic performance and policies recently.<sup>2</sup> Congress may consider whether to pass legislation to extend permanent normal trade relations (PNTR) status to Russia.<sup>3</sup>

Russian economic policies and performance raise important policy questions for the United States and the U.S.-Russian relationship which this report addresses. Might Russia's robust economic growth return? 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?

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<sup>1</sup> 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.

<sup>2</sup> 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.

<sup>3</sup> 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.

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

|                                                 | Russia   | China   | United States |
|-------------------------------------------------|----------|---------|---------------|
| GDP (2008)                                      |          |         |               |
| -Nominal (billions of \$U.S.)                   | \$1,671  | \$4,194 | \$14,265      |
| -PPP (billions of \$U.S.) <sup>a</sup>          | 2,259    | 8,148   | 14,265        |
| Per Capita GDP (2008)                           |          |         |               |
| -Nominal                                        | \$11,785 | \$3,160 | \$46,950      |
| -PPP (U.S. Dollars)                             | 15,930   | 6,140   | 46,950        |
| Real GDP Growth Rates (2008)                    | 5.6%     | 9.0%    | 1.1%          |
| Average Annual Real GDP Growth Rate (1999-2008) | 6.9%     | 9.8%    | 2.6%          |

**Source:** CRS with data from the Economist Intelligence Unit.

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

## The Immediate Post-Soviet Period

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

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.<sup>4</sup> Russia also suffered very high rates of inflation—over 2,000% 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 sharply devalue the ruble 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.<sup>5</sup>

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.

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<sup>4</sup> CRS calculations based on official Russian data collected by the Economist Intelligence Unit (EIU).

<sup>5</sup> EIU.

Russia did not perform much better in the foreign sector. Foreign direct investments (FDI) flows were meager given the size and needs of the Russian economy. Furthermore, Russia was incurring serious capital flight—some \$150 billion worth between 1992 and 1999 by one estimate.<sup>6</sup> 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 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 then-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 Novoliet'sk Iron and Steel).<sup>7</sup> The banks held 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.”<sup>8</sup>

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<sup>6</sup> 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.

<sup>7</sup> OECD. *The Investment Environment in the Russian Federation*. 2001. p.148.

<sup>8</sup> Aslund, Anders. *Russia's Capitalist Revolution: Why Market Reform Succeeded and Democracy Failed*. Peterson Institute for International Economics. Washington. October 2007. p. 161-164.

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.<sup>9</sup>

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.<sup>10</sup>) In addition, foreign reserves declined sharply—between the end of July 1998 and August 1998. The reserves, including gold, dropped from \$18.4 billion to \$12.5 billion,<sup>11</sup> and real GDP declined 4.9% in 1998.<sup>12</sup>

The immediate cause of the crisis was the accumulation of Russian government short-term debt in the form of Treasury bills (the GKO's) 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, which occurred at the same time, made investors much more wary of holding risky short-term securities such as GKO's.

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 likely given its a transition from an economy that was 100% controlled by the state at the direction of

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<sup>9</sup> For a more detailed analysis of the financial crisis see (archived) CRS Report 98-578, *The Russian Financial Crisis of 1998: An Analysis of Trends, Causes, and Implications*, by William H. Cooper.

<sup>10</sup> Furthermore, the ruble continued to decline losing 71% of its value from April to the end 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.

<sup>11</sup> Ibid.

<sup>12</sup> Ibid. p.22.

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 level of popular support led him to relinquish the Presidency to his Prime Minister, Vladimir Putin, whom Yeltsin had appointed in July 1999. Putin became acting President on December 31, 1999, which set him up to win election as president in his own right in March 2000.<sup>13</sup>

## 10 Years of Economic Growth

Beginning in 1999 and through mid-2008, Russia's economic fortunes reversed on many accounts. The radical improvement was arguably a factor in the wide popularity that Putin enjoyed during his term. At the same time, improved economic conditions brought a significant degree of economic stability to Russia.

### Internal Economic Conditions and Trends

As **Figure 1** and **Table 2** show, Russia experienced strong economic growth over the last 10 years (1999-2008), during which time its real 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 1999-2008. In addition, real disposable income (the income that the average Russian resident has available from all sources after taxes) grew 7.9% from 1999 to 2008. The Russian unemployment rate also declined during the 1999-2008 period, from 12.6% to 6.3%.

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 2007, the rate had dropped to 13%.<sup>14</sup> In addition, private consumption increased—another sign of improved living standards—from 44.9% of Russian GDP in 1992 and to 49.0% of Russian GDP in 2008.<sup>15</sup>

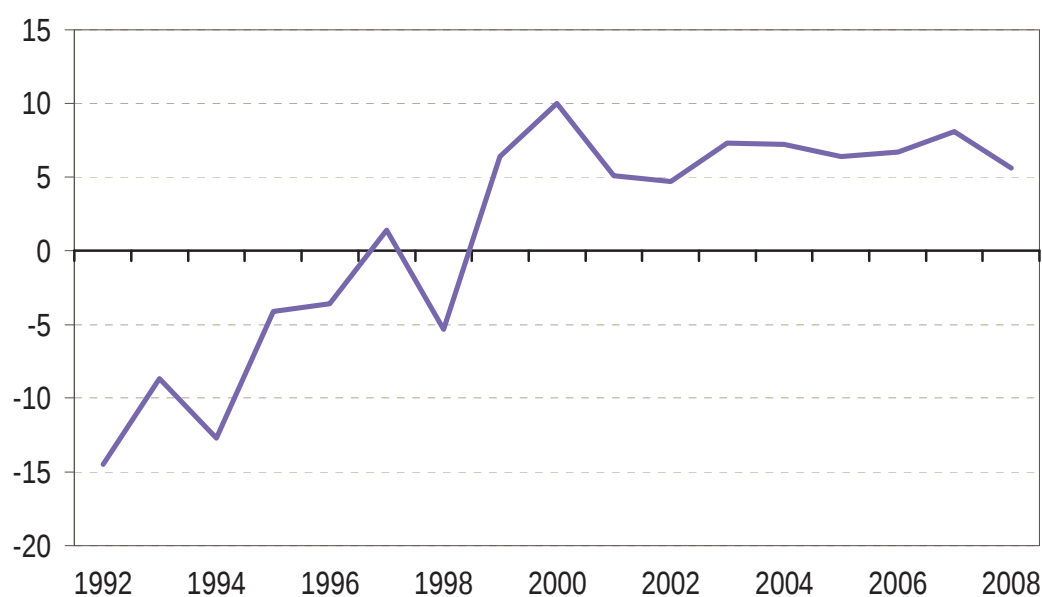
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<sup>13</sup> Economist Intelligence Unit. *Country Profile 2007: Russia*. p.5.

<sup>14</sup> Official Russian government data from Goskomstat. <http://www.gks.ru>. A World Bank study shows similar trends but using a different methodology. The World Bank. *The World Bank in Russia*. Russian Economic Report No. 18. p. 17.

<sup>15</sup> Economist Intelligence Unit.

**Figure 1. Annual Growth of Real Russian GDP, 1992-2008**  
(in percents)



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

**Table 2. Major Russian Internal Economic Indicators, 1999-2008**  
(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               |
| 2008 | 5.6             | 14.1                 | 10.3               | 2.7                             | 6.3               |

**Source:** Economist Intelligence Unit.

Despite this favorable picture, Russia has been plagued by continuing problems. Inflation, while down from the sky-high rates of the 1990s, inflation rates remained high. From 2006 to 2008, the consumer price index rose by 9.7%, 9.0% and 14.1%, respectively. The life expectancy of the

average Russian citizen, particularly males, remains low for an advanced country. In 2006, it was 73.2 years for a Russian woman and 60.4 years for a Russian male.<sup>16</sup> Increases in alcoholism and other diseases, some of which like tuberculosis have been nearly eradicated in developed countries, have contributed to relatively low life span, especially for males. 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 0.3% during 2002-2008 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 future economic growth.

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.<sup>17</sup> By 2007, it had increased to 0.422.<sup>18</sup>

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.<sup>19</sup> 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 until recently reaped the benefits of the surge in world energy prices.<sup>20</sup>

## Foreign Trade and Investment Trends

The roots of Russia's robust economic growth during the last 10 years are reflected in the surge in Russian trade and capital flows. (See **Table 3.**)

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<sup>16</sup> Goskomstat.

<sup>17</sup> Goskomstat.

<sup>18</sup> *Kommersant*. February 27, 2008.

<sup>19</sup> Goskomstat.

<sup>20</sup> Economist Intelligence Unit. *Country Profile 2007: Russia*. p. 42.

**Table 3. Select Russian External Economic Indicators, 1999-2008**

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

| Year | Exports | Imports | Merchandise Trade Balance | Current Account Balance | Foreign Exchange Reserves | Foreign Direct Investment Flows 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                     | 76.2                    | 476.4                     | 55.0                                        |
| 2008 | 471.6   | 291.9   | 179.7                     | 102.3                   | 427.1                     | 60.0                                        |

**Source:** Central Bank of Russia; Economist Intelligence Unit..

Russia foreign trade has increased sharply in the last ten years (1999-2008). During that period Russian exports grew close to 525%, from \$75.5 billion to \$471.6 billion and Russian imports rose close to 640%, from \$39.5 billion to \$291.6 billion. As a result, Russia has experienced rapidly increasing trade surpluses. Its merchandise trade surplus rose from \$36.0 billion in 1999 to \$179.7 billion in 2008. 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 \$102.3 billion in 2008. As a result, Russia accumulated one of the world's largest foreign reserve holdings that have skyrocketed from \$12.5 billion in 1999 to \$427.1 billion at the end of 2008.

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 2008, oil, natural gas, and other fuels accounted for 64.8% of Russian exports. If metals are included, the share of raw materials was 78.7% in 2008.<sup>21</sup> Machinery and equipment accounted for 43.9% of Russian imports, and food and other agricultural products accounted for another 16.9%.<sup>22</sup>

The 27-member European Union (EU) is by far Russia's most significant trading partner. In 2008, it accounted for 53% of Russian exports, mostly energy, and for 45% of Russian imports. China has emerged as the second most important trading partner, accounting for 6% of Russian exports and for 14% of Russian imports in 2008.<sup>23</sup>

<sup>21</sup> Economist Intelligence Unit.<sup>22</sup> Economist Intelligence Unit.<sup>23</sup> Russian Customs Service data collected by Global Trade Systems, Inc in World Trade Atlas. 2009.

Russia's investment climate had improved during the last few years, a byproduct of Russia's robust growth. Between 1999 and 2008, annual FDI flows into Russia rose from \$3.3 billion to an estimated \$60 billion.<sup>24</sup> 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 experienced from 1999 to 2008 was 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 then Prime Minister Primakov instituted measures to cut government spending and increase tax revenues. The Russian economy began to grow because of the severe depreciation of the ruble as a result of the 1998 financial crisis which boosted exports.<sup>25</sup> A key objective of the Putin regime was to maintain stability, especially after the effects of the depreciated ruble had disappeared.

## **Rationalizing 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 had to rein in profligate government spending to keep inflation under control.

Russian government national accounts data show that it 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 22.6% of GDP in 2008, 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 18.2% GDP in 2008. As a result, the Russian government had consistently earned budget surpluses, at least until recently, and had a surplus of 4.1% which equaled GDP in 2008.<sup>26</sup>

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<sup>24</sup> EIU. *Country Report: Russia*. March 2008.

<sup>25</sup> Aslund, p. 190-197

<sup>26</sup> Data obtained from the Bank of Finland. BOFIT Russia Statistics. <http://www.bof.fi>.

The Russian government's ability to maintain prudent fiscal balances has been 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. In addition, by law the government is to use funds in excess of a balance of 500 billion rubles (about \$20 billion) for purposes approved by the Federal Assembly, the legislature. At the end of 2008, the fund held an aggregate amount of \$225.1 billion. The Russian government has used these funds to pay off partially its International Monetary Fund (IMF) and Paris Club debts and also to finance a deficit in the government-operated pension fund.<sup>27</sup>

The Putin government attempted to reduce government social and industrial subsidies as a another step in rationalizing government spending. In January 2005, it 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, the government has maintained most of the reforms, thereby helping to keep expenditures in check.<sup>28</sup>

## **Implementing Structural Economic Reforms**

During Putin's first presidential 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.

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 not to 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.<sup>29</sup>

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%.<sup>30</sup> 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.<sup>31</sup> Another

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<sup>27</sup> Russian Ministry of Finance. <http://www.minfin.ru>. In 2008, the economic stabilization fund was divided into two funds—the Reserve Fund and the National Welfare Fund.

<sup>28</sup> EIU. *Country Profile 2007: Russia*. p.36.

<sup>29</sup> Åslund, Anders. *Russia's Capitalist Revolution: Why Market Reform Succeeded and Democracy Failed*. Petersen Institute for International Economics. November 2007. p.215.

<sup>30</sup> Ibid. p. 216.

<sup>31</sup> Ibid.

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.<sup>32</sup> These reforms have largely improved the business climate, although some authorities still conduct inspections contrary to the new regulations.<sup>33</sup>

The Russian government 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.<sup>34</sup>

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.<sup>35</sup>

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<sup>32</sup> Ibid., p. 217-218.

<sup>33</sup> EIU, 2007. p. 38.

<sup>34</sup> Organization for Economic Cooperation and Development. *OECD Economic Survey of the Russian Federation*. 2004. p. 66.

<sup>35</sup> Aslund, p.219; OECD (2006), p.72-74.

## **Integrating 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 preoccupied 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. He said:

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.<sup>36</sup>

Russia is the largest economy 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. However, in what has been largely considered a stunning announcement, Prime Minister Putin stated, on June 9, 2009, that Russia would be abandoning its application to join the WTO as a single entity, but instead would seek to join as a member of a customs union with Belarus and Kazakhstan. It is not clear at this time why Russian leaders decided to change substantially its application status. Belarus and Kazakhstan have also applied to join the WTO, but neither country was as far along as Russia was in the process. At the least, the change will likely further delay Russia's accession to the WTO. It is also unclear if the three countries would be allowed to join as one entity.<sup>37</sup>

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 31.3% in 2008. Russian imports as a percentage of GDP have declined from 22.9% in 1994 to 22.0% in 2008. On the other hand, trends in Russian foreign investment show clearer signs of economic integration. The stock of FDI in Russia as a percent of GDP rose from 0.1% in 1993 to 12.0% in 2008 and Russian foreign direct investment abroad has increased from 1.3% of GDP in 1993 to 10.6% of GDP 2008.<sup>38</sup>

## **Implementing 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. However, implementation of these reforms have been slow.<sup>39</sup>

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

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<sup>36</sup> Office of the President of Russia. *Annual Address to the Federal Assembly*. April 3, 2001. <http://www.kremlin.ru>.

<sup>37</sup> For more information on Russia and the WTO accession process, see CRS Report RL31979, *Russia's Accession to the WTO*, by William H. Cooper.

<sup>38</sup> Data obtained from the Economist Intelligence Unit.

<sup>39</sup> EIU. *Country Profile: Russia 2007*. p. 38.

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.<sup>40</sup> Beginning in 2004, the Russian government also began phasing in the use of internationally accepted financial standards to improve the transparency of Russian bank operations.<sup>41</sup>

In 2005, the regime launched “national projects” to strengthen education, health care, and housing. Critics have maintained that implementation of these projects, which began under then-First Deputy Prime Minister (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 those with vested interests in the status quo.<sup>42</sup> 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.<sup>43</sup>

## Reasserting 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 (2004-2008) 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.<sup>44</sup> 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.<sup>45</sup>

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<sup>40</sup> OECD, 2004, p. 200.

<sup>41</sup> Ibid., p. 204

<sup>42</sup> Delany, Max. “Life Gets Better, But Only for Some.” *Moscow Times*. February 27, 2007.

<sup>43</sup> OECD. 2004. p. 65.

<sup>44</sup> Aslund. p. 234-241. OECD 2006. p. 37-38.

<sup>45</sup> For more information, see (archived) CRS Report RL32873, *Key Environmental Issues in the Energy Policy Act of* (continued...)

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 from around 18% to over 50% between 2004 and 2007, according to one estimate.<sup>46</sup>

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.<sup>47</sup> 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.<sup>48</sup>

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.<sup>49</sup>

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 2008. 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.<sup>50</sup>

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(...continued)

2005 (P.L. 109-58; H.R. 6), coordinated by Brent D. Yacobucci, CRS Report RS21678, *Russia's Arrest of "Oligarch" Mikhail Khodorkovskiy: Background and Implications for U.S. Interests*, by Jim Nichol.

<sup>46</sup> Hanson, Philip. The Russian Economic Puzzle: Going Forwards, Backwards, or Sideways? *International Affairs*. vol. 83. no. 5. p. 876-877.

<sup>47</sup> EIU. *Country Profile 2007–Russia*. p.38-39.

<sup>48</sup> OECD. 2006. p.38.

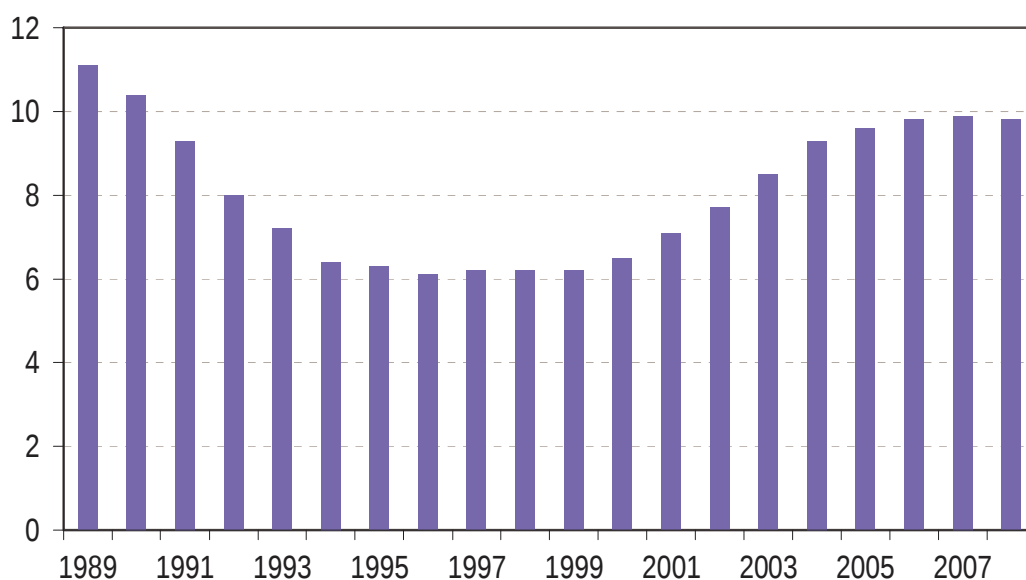
<sup>49</sup> EBRD. Economic Statistics and Forecasts. <http://www.ebrd.org>.

<sup>50</sup> 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.<sup>51</sup> 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, 1989-2008**  
(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 and global demand. 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 (mbd) to 6.1 mbd 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 9.8 mbd in 2008, still below the 1989 level.<sup>52</sup> Oil production has continued to increase but at a decelerating rate, with possible implications for the future.<sup>53</sup>

<sup>51</sup> EIA. *Country Analysis Briefs: Russia*. April 2007. <http://www.eia.doe.gov>

<sup>52</sup> Data were obtained from <http://www.bp.com>.

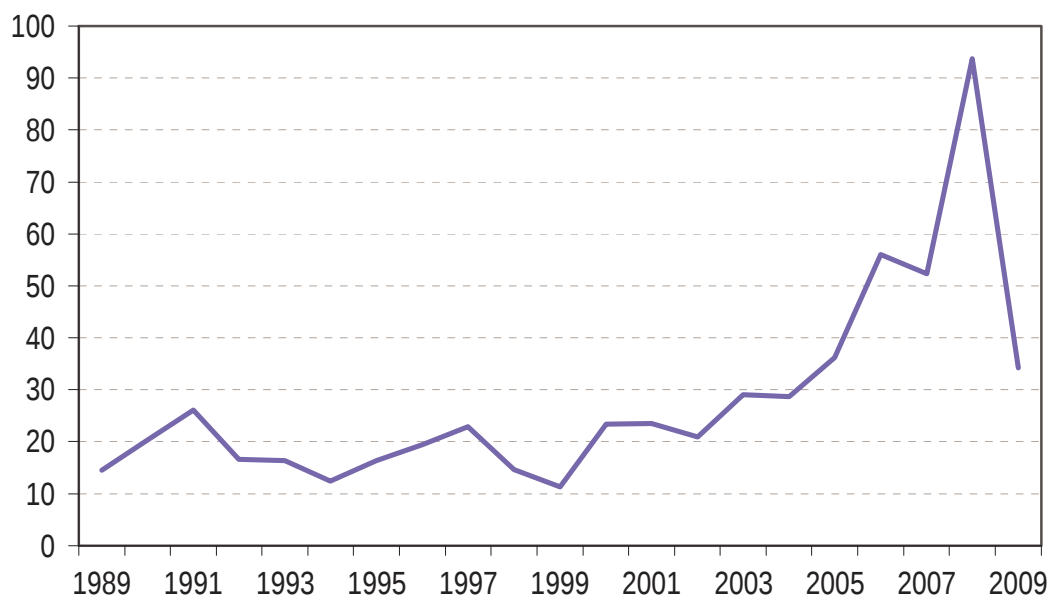
<sup>53</sup> EIU. *Country Profile Russia*. 2007. p. 45.

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.<sup>54</sup>

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 IMF, the Russian federal government budget enjoyed a fiscal surplus equivalent to 4.6% of GDP in 2007; however, if oil-related revenues are excluded, the budget would have been in a deficit equivalent to 4.7% of GDP.<sup>55</sup> 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.

**Figure 3. Oil Prices, 1989-2009**

(\$/barrel—Urals-32 at the end of the first week of the year)



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

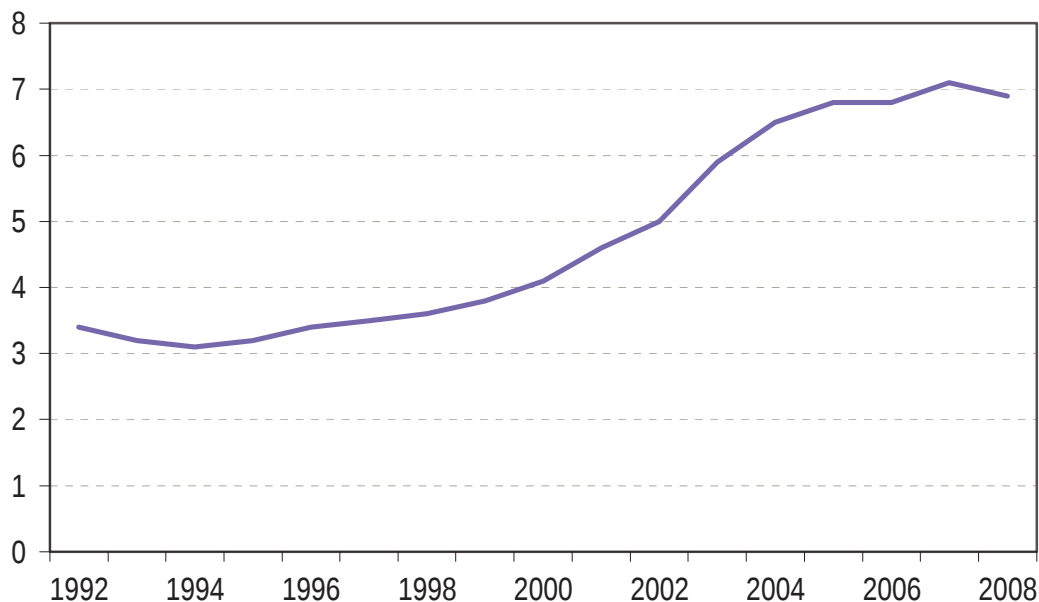
The significance of oil and other natural resources to the Russian economy is perhaps no more evident than in Russian foreign trade. Even during the Soviet period, oil and other natural resources were by far the primary source of hard currency revenues. They have maintained and, at times increased, their importance in post-Soviet era Russian foreign trade. In 2007, energy

<sup>54</sup> OECD, 2006. p. 29-30.

<sup>55</sup> IMF. IMF Country Report No. 08/309. September 2008.

resources (oil, natural gas, and coal) accounted for 65% of total Russian export revenues. Metals accounted for another 14% of Russian exports.<sup>56</sup> Russia's increasing reliance on exports oil and other energy resources and raw materials has made Russian trade vulnerable to the volatility of international commodity prices. Exports of machinery and equipment accounted for only 5% of Russian exports.<sup>57</sup>

**Figure 4. Net Russian Exports of Oil, 1992-2008**  
(millions of barrels/day)



Source: Data from the Department of Energy. Energy Information Administration.

While the volume of Russian energy production and net exports (exports minus imports) have increased significantly since the mid-1990s, the rate of increase has reached a plateau, suggesting that the growth, and perhaps even the maintenance, of surplus of oil-dependent revenues will depend on world oil prices growing or at least remaining high. In 2005, the volume of net oil exports reached 6.8 mbd and remained at that level in 2006. The volume of net exports rose to 7.1 mbd in 2007 and declined slightly to 6.9 mbd in 2008. Nevertheless, the overall (current account) 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 \$102 billion in 2007, up from the previous record of \$94 billion in 2006. However, world oil prices have plummeted (as noted in **Figure 3**). After having peaked at \$134.37 per barrel in mid-July 2008, the price Urals-32 declined to \$34.20 per barrel on January 2, 2009, a 75% decline. The price has risen since that time to \$57.02 per barrel as of May 22, 2009. The decline in oil prices has contributed to a projected current account deficit of \$7 billion in 2009.<sup>58</sup>

<sup>56</sup> Economist Intelligence Unit data base.

<sup>57</sup> EIU. *Country Profile Russia*. 2007. p. 52.

<sup>58</sup> Department of Energy. Energy Information Administration. <http://www.eia.doe.gov>.

## The Global Economic Crisis and the Outlook for the Russian Economy

As the case with most of the world's economies, the Russian economy has been hit hard by the global economic crisis and resulting recession, the effects of which have been apparent since the last quarter of 2008. Even before the financial crisis, Russia was showing signs of economic problems when world oil prices plummeted sharply around the middle of 2008, diminishing a critical source of Russian export revenues and government funding.

The crisis and other factors, brought an abrupt end to a decade of impressive Russian economic growth. In 2008, it faced a triple threat with the financial crisis coinciding with a rapid decline in the price of oil and the aftermath of the country's military confrontation in August 2008 with Georgia over the break-away areas of South Ossetia and Abkhazia.<sup>59</sup> These events exposed three fundamental weaknesses in the Russian economy: substantial dependence on oil and gas sales for export revenues and government revenues; a decline in investor confidence in the Russian economy; and a weak banking system.

The rapid decline in world oil prices discussed earlier has been a major factor in the overall decline in Russia's economy. Russian government revenues are expected to be adversely affected because of the drop in oil revenues, but also because of the decline in income tax revenues, which will cause the Russian government to incur a budget deficit for the first time in ten years, a deficit of perhaps 8% of GDP.<sup>60</sup> Russia has also been adversely affected by the world-wide credit crunch that ostensibly began with the proliferation of subprime mortgages in the United States and the subsequent burst of the real estate bubble. Because low interest credit was not available domestically, many Russian firms and banks depended on foreign loans to finance investments. As credit tightened, foreign loans became harder to obtain.

The economic downturn is showing up in Russia's performance indicators. Although Russia real GDP increased 5.6% in 2008 as a whole, it increased more slowly than it did in 2007 (8.1%) and grew only 1.2% in the fourth quarter of 2008.<sup>61</sup> The economic slowdown has been reflected in the Russian ruble exchange rate as well. 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 ruble had declined as much as 45.6% between July 29, 2008 and April 21, 2009; it has recovered somewhat so, that by June 5, 2009, it had depreciated 31.8% since July 29. Russian official reserves have declined substantially in part because of Russian Central Bank has intervened to defend the ruble and current account surpluses have shrunk. Russian official reserves declined from \$597 billion at the end of July 2008 to \$384 billion at the end of February 2009, although they have increased to \$404 billion by the end of May 2009.<sup>62</sup> Another sign of financial trouble for Russia was a rapid decline in stock prices on Russian stock exchanges. At the close of business on May 10, 2009, the RTS index had lost 62%

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<sup>59</sup> For more information on the conflict, see CRS Report RL34618, *Russia-Georgia Conflict in August 2008: Context and Implications for U.S. Interests*, by Jim Nichol.

<sup>60</sup> Economist Intelligence Unit. *Country Report—Russia*. June 2009. p. 3.

<sup>61</sup> INS Global Insight. June 3, 2009.

<sup>62</sup> Economist Intelligence Unit. June 8, 2009.

of its value from its peak reached on May 19, 2008, although the index has shown signs of rising recently.<sup>63</sup>

The Russian government has responded to the crisis with various 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 2008.<sup>64</sup> 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.<sup>65</sup> In 2009, the government changed strategies by focusing on macroeconomic measures rather than measures to assist specific industries or firms. For example, the government reduced the corporate tax rate from 24% to 20% and the tax rate on small companies to try to stimulate investment.<sup>66</sup> The government expects to rein in expenditures as it anticipates lower revenues but still anticipates its first budget deficit in 10 years, which the government will be able to finance at least for the time-being from accumulated reserves.<sup>67</sup> While cutting expenditures might be considered fiscally responsible on the one hand, it could retard government investment in obsolete infrastructure and expenditures on pensions and other social income transfers, contributing to a drag on the rest of the economy.

The Russian political leadership headed by former President, now Prime Minister, Putin had enjoyed unprecedented popularity since 2000 in part because of the economic stability and growth that many Russians have attributed to him over the last ten years. The economic success also likely contributed to confidence that Putin and now President Medvedev had shown in projecting Russia's national interests beyond its borders, for example, in Georgia and other neighboring states. It is possible that the global economic crisis and its impact on the Russian economy could lead to at least popular discontent and could force Russia to limit its foreign ambitions. A recent poll indicated that in May 2009 Russians were less inclined to believe that the Russian economy was on the right track than they were in May 2008 (42% vs. 59%), although they largely approved of the job performances of Prime Minister Putin and President Medvedev, 78% and 72%, respectively.<sup>68</sup>

What are the prospects for the Russian economy? The IMF projects that Russia's real GDP will decline over 6% in 2009.<sup>69</sup> INS Global Insight, and the Economist Intelligence Unit (EIU), both private economic forecasting firms, project Russia's GDP to decline in 2009 by 4.7% and 5.0%, respectively.<sup>70</sup> These forecasts are supported by data showing a continuing decline in both domestic and external demand (exports), among other things, although the rates of decline have

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<sup>63</sup> RTS.

<sup>64</sup> Ibid. 6-7.

<sup>65</sup> Economist Intelligence Unit. *Country Report—Russia*. October 2008. p. 6

<sup>66</sup> Economist Intelligence Unit. *Country Report—Russia*. June 2009. p. 5.

<sup>67</sup> Ibid. p. 6.

<sup>68</sup> Economist Intelligence Unit. *Country Report—Russia*. June 2009. p. 4.

<sup>69</sup> IMF. Statement of IMF Mission to the Russian Federation. June 1, 2009.

<sup>70</sup> INS Global Insight. June 3, 2009. Economist Intelligence Unit. *Country Report—Russia*. June 2009. p.7.

slowed possibly indicating bottoming out, if not a full-fledged economic recovery. INS Global Insight, Inc. and the EIU each forecasts mild recoveries in 2010 of 1.5% and 2.3%, respectively.

Russia remains highly dependent on oil and natural gas exports as a source of income. If world oil prices continue to be depressed, the Russian economy would likely experience slow growth, if any. Many economists have argued that, in the long run, for Russia to achieve sustainable growth, it must reduce its dependence on exports of oil, natural gas, and other commodities and diversify into more stable production.

Until the economic crisis hit in late 2008, Russia had shown signs of some diversification. Russian fixed capital investment increased 12.3% on average per year 1999-2008. In 2007 alone, it increased 21.1% , the highest in recent Russian history, but declined to a still robust 10.0% in 2008.<sup>71</sup> Official Russian economic data show that investment is spread throughout the economy. About 14% of the fixed investments (in 2007) were in the energy sector, 15% were in manufacturing, 22% were in transportation and communication, and 17% were in real estate, renting, and business activities.<sup>72</sup> Growth in fixed investment indicates confidence in the future as firms replenish or add to production capacity. However, the EIU estimates that gross fixed investment will *decline* by 16% in 2009 and increase only modestly, about 3%, in 2010.<sup>73</sup>

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.<sup>74</sup> One study has concluded much of the economic growth prior to the current downturn could be attributed to Russia employing increasing amounts of unused production capacity inherited from the Soviet period., but this capacity was being used up or getting out of date and will have to be replaced if Russia is to achieve sustainable economic growth. The same study concluded that the Russian labor force is shrinking due to low birth rates and low average life-spans which will impede increases in labor productivity and overall growth.<sup>75</sup>

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 181 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 96<sup>th</sup>.<sup>76</sup> In April 2008, it ranked 106<sup>th</sup>, although it had improved from 112<sup>th</sup> during the previous year. In April 2009, Russia had slipped to 120<sup>th</sup>. Russia has ranked behind such former Soviet republics as Azerbaijan (33rd), Armenia (44<sup>th</sup>), Georgia (15<sup>th</sup>), and Kazakhstan (70<sup>th</sup>). Singapore was ranked first and the United States was ranked

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<sup>71</sup> Economist Intelligence Unit. *Country Report—Russia*. June 2009. p. 7.

<sup>72</sup> Russian Federal Statistics Service.

<sup>73</sup> Economist Intelligence Unit. *Country Report—Russia*. June 2009. p. 7.

<sup>74</sup> OECD 2006. p. 27.

<sup>75</sup> McKinsey Global Institute. *Lean Russia: Sustaining Economic Growth Through Improved Productivity*. April 2009. p. 12.

<sup>76</sup> Cited in Hanson, Philip. The Russian Economic Puzzle: Going Forwards, Backwards, or Sideways? in *International Affairs*. vol. 83. no. 5. p. 872.

third. The Congo Democratic Republic was ranked 181<sup>st</sup>.<sup>77</sup> Another indicator is Russia's economic growth compared to those of other former Soviet states. In 2008, Russia's real GDP increased 5.6%, and it was only 8<sup>th</sup> among the 15 former Soviet states.<sup>78</sup>

However, it is highly likely that Russia's continued dependence on oil and the world price of oil will be a dominant factor in Russia's economic prospects for foreseeable future. This is a double-edged sword for Russia. On the one hand, Russia has benefitted 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 \$26.8 billion in 2008. 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 (64% in 2008). U.S. exports have increased from \$2.1 billion in 1992 peaking at \$9.3 billion in 2008. Major U.S. exports to Russia consist of machinery, vehicles, and meat (mostly chicken).<sup>79</sup>

**Table 4. U.S. Merchandise Trade with Russia, 1992-2008**

(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                 | 2001 | 2.7          | 6.3          | -3.5                |
| 1993 | 3.0          | 1.7          | 1.3                 | 2002 | 2.4          | 6.8          | -4.4                |
| 1994 | 2.6          | 3.2          | -0.6                | 2003 | 2.4          | 8.6          | -6.2                |
| 1995 | 2.8          | 4.0          | -1.2                | 2004 | 3.0          | 11.9         | -8.9                |
| 1996 | 3.3          | 3.6          | -0.3                | 2005 | 3.9          | 15.3         | -11.3               |
| 1997 | 3.4          | 4.3          | -0.9                | 2006 | 4.7          | 19.8         | -15.1               |
| 1998 | 3.6          | 5.7          | -2.1                | 2007 | 7.4          | 19.4         | -12.0               |
| 1999 | 2.1          | 5.9          | -3.8                | 2008 | 9.3          | 26.8         | -17.5               |
| 2000 | 2.1          | 7.7          | -5.6                |      |              |              |                     |

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

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<sup>77</sup> <http://www.doingbusiness.org>. Accessed April 14, 2008.

<sup>78</sup> Azerbaijan's GDP increased 10.8%, Armenia 10.0%, Uzbekistan 9.0%, Tajikistan 7.9%; Kyrgyz Republic 7.6%; Moldova 7.2%; and Armenia 6.8%. Economist Intelligence Unit.

<sup>79</sup> CRS calculations based on data from the Department of Commerce, Bureau of the Census. Global Trade Information System.

| Year             | U.S.<br>Exports | U.S.<br>Imports | U.S.<br>Trade<br>Balances | Year | U.S.<br>Exports | U.S.<br>Imports | U.S.<br>Trade<br>Balances |
|------------------|-----------------|-----------------|---------------------------|------|-----------------|-----------------|---------------------------|
| aluminum; steel. |                 |                 |                           |      |                 |                 |                           |

**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 2008, Russia accounted for about 0.7% of U.S. exports and 1.3% of U.S. imports. It was the 17<sup>th</sup> largest source of imports and 28<sup>th</sup> largest export market for the United States. The United States accounted for 3.4% of Russian exports and 5.4% of Russian imports. It was the fifth largest source of imports and 10<sup>th</sup> largest export market for Russia.<sup>80</sup>

According to Russian government data, by the end of 2008, the United States accounted for 3.3% of total accumulated foreign direct and portfolio investments in Russia and was the eighth largest source of foreign investment. However, the first three countries were Cyprus (21.5%), the Netherlands (17.5%), and Luxembourg (13.0%), suggesting that at least 50% of the investments might have been repatriated Russian funds.<sup>81</sup>

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 and more recently with the 2008-2009 crisis. Promotion of economic stability in Russia has been a basis for U.S. support for Russia's membership in international economic organizations, including the IMF, the World Bank, and the 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 2006, Russia accounted for 20% of France's, 25% of Italy's, and 36% of Germany's consumption

<sup>80</sup> Global Trade Information Systems, Inc. World Trade Atlas.

<sup>81</sup> *Tendentsii i perspectiva (Trends and Outlook). Russian Economic Report.* April 2006. p. 24..

of natural gas, making these allies possibly vulnerable to political pressure.<sup>82</sup> On several occasions, most recently on January 1, 2009, Russia has temporarily shut-off gas supplies to Ukraine over a price dispute, and in so doing cut supplies to Europe. Although supplies were resumed two weeks later, the disruptions have affected European views of Russia as a reliable supplier of gas.<sup>83</sup> 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.

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<sup>82</sup> Department of Energy. Energy Information Administration.

<sup>83</sup> CRS Report RL34261, *Russian Energy Policy Toward Neighboring Countries*, by Steven Woehrel. p. 9.