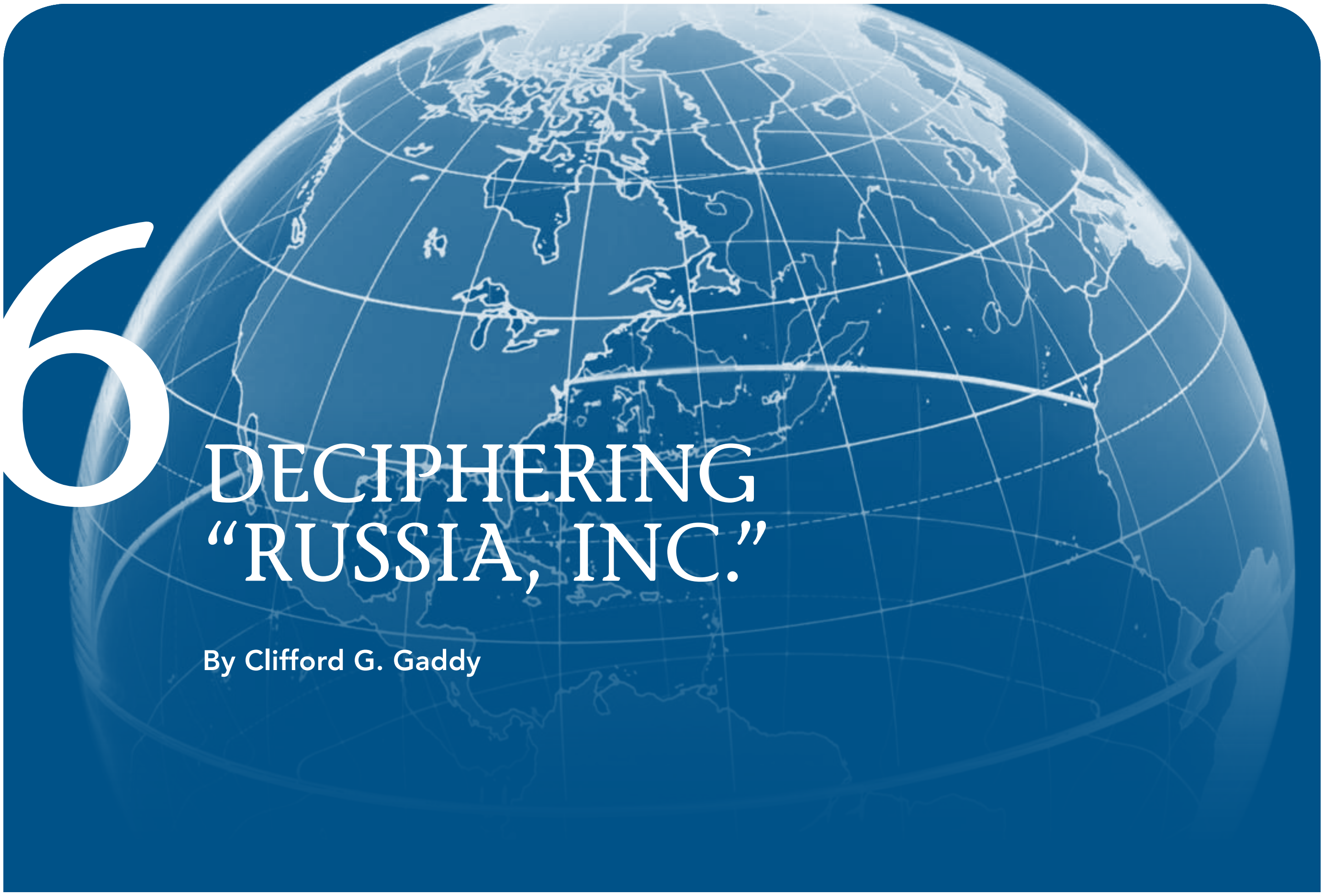

6 DECIPHERING "RUSSIA, INC."

By Clifford G. Gaddy

For more than eight years Russia, has benefited from the global commodities boom as have few other countries in the world. Prudent management of its oil and gas windfall has resulted in large fiscal and financial surpluses. At home, welfare and public and private wealth have risen dramatically. For the world, Russia has emerged as a major market for consumer and investment goods. As 2008 draws to a close, however, the outlook for Russia has begun to dim. Oil and gas output growth has slowed and even contracted. The Russian stock market has suffered from the combined drop in oil prices and the global credit crunch. Geopolitical tension since Russia's invasion of neighboring Georgia in early August 2008 has led to calls to exclude Russia from the global economy. All these developments threaten Russia's potential contributions to the global economy.

THE GLOBAL CONTEXT

Seventeen years into its transition from central planning to a free market economy, Russia presents a conflicting picture. It has the second-largest number of *Forbes* billionaires after the U.S. At the same time, the structure of its economy continues to bear a strong imprint from its Soviet past. The production structure—the type and size of factories and the location of entire cities—is highly unnatural from a market standpoint. Its management model is also distinct: a combination of companies operated by private owners but under the watchful eye of the closed inner circle of the country's political leadership. The description of the Russian economy as "Russia, Inc." is apt.

As a potential market, as an energy supplier and as a major financial power, Russia now occupies a prominent place in the global economy. Eight years of annual GDP growth exceeding 7 percent have made Russia's 140 million consumers, still with pent-up demand from decades of shortages under communism, one of the world's most attractive markets. And as the world's biggest producer of oil and natural gas, Russia plays a crucial role in global energy security. Finally, Russia now holds the world's third-largest foreign currency reserves.

THE CHALLENGE

The challenge for the next U.S. president and U.S. policymakers is to ensure that Russia can realize its potential as a market, that it can continue to supply oil and gas to the world economy and that it will remain committed to global economic integration. This is especially difficult in the wake of the global financial crisis and the geopolitical tensions stemming from the Georgia invasion. The U.S. challenge has several dimensions:

> **The market challenge:** The U.S. share of the Russian market has traditionally been small. The potential for growth is vast, but companies doing business in Russia face a difficult business climate permeated by corruption and overregulation.

> **The energy supply challenge:** The strong growth of Russian oil production in the past decade was an important moderating force on oil prices globally. Russia's current decline is therefore a cause of general concern for consumers worldwide. Russian oil is high-cost oil, and thus all investment in future supply is subject to great risk from price volatility. Russia is likely to continue to underinvest unless the West can help solve the fundamental problem for the Russians: large risk.

> **The financial challenge:** Russia is third only to China and Japan as a foreign holder of Western—mainly U.S.—government securities. These massive funds represent a transfer from Western consumers to Russia's state coffers. America would be better off if these funds were recycled back into its economy in the form of equity investments.

> **The geopolitical challenge:** In the desire to punish Russia for its invasion of Georgia in August 2008, some Western policymakers have proposed using economic levers such as blocking Russian accession to the World Trade Organization or restricting trade and investment flows. Such an approach could damage the global system itself.

AMERICA'S OPPORTUNITY

Russia's economy operates according to a model that remains distinctively different from that of other leading nations. It is not only in Russia's but also our own interest that its economy evolve toward the international norm. The most realistic approach to achieve that goal is to promote the further integration of Russia into the global economy. Direct influence on Russian economic policymaking is out of the question. In the 1990s, there was no shortage of bold American interventionist plans and programs to reform the Russian economy. Today, American policymakers must think primarily of how to interact with, not act upon, the Russian economy. A few guidelines in that effort might include:

> **Support Russia's full role in the global economy:** To show that it is serious about supporting Russia's equal participation in the global economy, the U.S. should repeal the Jackson-Vanik Amendment, a piece of Cold War legislation that denies most-favored-nation trade status to countries with nonmarket economies that restrict emigration rights.

> **Insist that Russia play by the rules:** While the U.S. encourages Russia to integrate into the global economy, it must at the same time insist that Russia play by the rules. But America needs to be scrupulous in applying all rules fairly; they should not be applied in a discriminatory fashion as a political lever.

> **Encourage U.S. investment in and trade with Russia:** The U.S. government should strongly encourage American firms to invest in and sell to Russia, despite the current difficult investment climate. But the U.S. will have to make it clear that it can do little as a government to directly change that climate. Ultimately, the burden rests with the businesses.

> **Deal seriously with Russia on the energy issue:** This urgent challenge will require sustained attention at the highest level on the U.S. side. It is an illusion to think that Russians will "need" to turn to the outside world for help simply because their output of oil and gas is stagnating or declining. There is a real danger that the enormous costs and risks of massive new energy investment will cause the Russians to postpone critical decisions for too long. The U.S. administration must work with the Russians and the Europeans to find risk-sharing mechanisms. Political distrust will only raise the West's risk premium.

The new U.S. administration must resist the temptation to use integration with the global economy as a carrot that can then be withdrawn as a stick—this would undermine the very premise that greater mutual economic dependency promotes both prosperity and security. Thus, it would be counterproductive to try to make Russia pay for political behavior by blocking its accession to the WTO, expelling it from the Group of Eight or restricting its trade and investment flows with West. It would hurt America more than the Russians, and it would risk leaving the U.S. with a Russia that is more, not less, difficult to deal with. The West has two choices for Russia: Keep it out or bring it in. If it is pushed out and kept out, it will have no stake. Nothing good will happen inside Russia as a result of less interaction with the outside world.

WANT TO READ MORE?

Gaddy, Clifford G. and Barry W. Ickes. *Russia's Addiction: The Political Economy of Resource Dependence*. Brookings Institution Press, forthcoming.

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