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Executive Summary

Russia has enjoyed a decade of high economic growth because of the eventually successful market reforms in the 1990s but also an oil boom. For the last six years, however, the Russian economy has become increasingly dysfunctional because the authorities have done nothing to impede corruption. The energy sector has been a generator of corrupt revenues, and its renationalization has concentrated these corrupt incomes in the hands of the security police elite. Russia depends on the European Union for most of its exports and imports, but no free trade agreement is even on the horizon. Investments, by contrast, are relatively well secured through international conventions. In global governance, Russia has changed its attitude from being a joiner to becoming a spoiler. The disruption of supplies of Russian gas to Europe in January 2009 displayed all the shortfalls both of the Russian and Ukrainian gas sectors and of EU policy. The EU needs to play a more active role. It should monitor gas supplies, production, and storage. It should demand the exclusion of corrupt intermediaries in its gas trade. It should demand that Russia and Ukraine conclude a long-term transit and supply agreement. The EU should form a proper energy policy with energy conservation, diversification, unbundling, and increased storage. This is a good time to persuade Russia to ratify the Energy Charter. The EU should also demand that Ukraine undertake a market-oriented and transparent energy sector reform.

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1. Introduction

Russia has enjoyed a decade of high economic growth because of the eventually successful market reforms in the 1990s but also an oil boom. For the last six years, however, the Russian economy has become increasingly dysfunctional because the authorities have done nothing to impede corruption. The energy sector has been a generator of corrupt revenues, and its renationalization has concentrated these corrupt incomes in the hands of the security police elite. Russia depends on the European Union for most of its exports and imports, but no free trade agreement is even on the horizon. Investments, by contrast, are relatively well secured through international conventions. In global governance, Russia has changed its attitude from being a joiner to becoming a spoiler. The disruption of supplies of Russian gas to Europe in January 2009 displayed all the shortfalls both of the Russian and Ukrainian gas sectors and of EU policy. The EU needs to play a more active role. It should monitor gas supplies, production, and storage. It should demand the exclusion of corrupt intermediaries in its gas trade. It should demand that Russia and Ukraine conclude a long-term transit and supply agreement. The EU should form a proper energy policy with energy conservation, diversification, unbundling, and increased storage. This is a good time to persuade Russia to ratify the Energy Charter. The EU should also demand that Ukraine undertake a market-oriented and transparent energy sector reform.

2. The State of the Russian Economy before the Financial Crisis

In the last decade, Russia has emerged as one of the big, rising economies. Its dramatic recovery began in 1999. Between 1999 and 2008, the Russian economy grew by an annual average rate of 7.0 percent in real terms.

Because of the sharp real appreciation of the ruble, however, Russian GDP measured in current US dollars expanded by an amazing average of 27 percent a year over the same period, from $196 billion in 1999 to a projected $1.8 trillion in 2008. This means that it grew nine times in nine years in current dollars. According to the IMF forecast for 2008, Russia is now the eighth economy in the world, measured by GDP in current dollars, coming just before Spain and after Italy. If GDP is measured in purchasing power parities, Russia is already the sixth biggest economy in the world, after Germany but ahead of the United Kingdom and France (IMF 2008).

Among the “BRICs” -- Brazil, Russia, India and China, Russia has by far the highest GDP per capita both in dollar terms and in purchasing power parity terms. In 2008, its GDP per capita in current US dollars was $12,000 and measured in purchasing power parities (PPP) some $16,000, one-third of the level of the 15 old members of the European Union. Russia’s GDP per capita in current US dollars is still four times larger than China’s (IMF 2008).Goldman Sachs forecasts that Russia will be the only BRIC country to approach the per capita income levels of developed European countries by 2050 (Wilson and Purushothaman 2003).

Russian politicians and economists are preoccupied with economic growth. The nation is suffering from a trauma of its sudden demise as a superpower and tries to come back through superior economic performance. The peer pressure from neighboring countries is also strong. This single-minded focus on economic growth permeates the Russian government. It has seized upon the Goldman Sachs vision of the BRICs as growth machines. In 2007-8, it formulated a large number of goals for 2020. Then President Vladimir Putin laid out the program, “Russia 2020,” in a speech on February 8, 2008. The Ministry of Economic Development and Trade presented a more detailed program in March 2008 (Putin 2008, Ministry 2008).

The dominant reason for growth has been European or capitalist convergence, which Russia has enjoyed thanks the hard-fought introduction of a market economy in the 1990s. The transition to a market economy consisted of deregulation, privatization and financial stabilization. The most fundamental step was to liberalize prices and trade and create a market economy, so that economic decisions are made by free individuals and independent firms. To judge by the transition index composed by the European Bank for Reconstruction and Development (EBRD), Russia became a full-fledged market economy by 1996 (Åslund 2007, pp. 278-80).

Another feature of a market economy is the dominance of private enterprise. Russia undertook the largest privatization in world history from 1992 until 1997. According to the EBRD (2008) assessment, the private sector contributed 70 percent of GDP from 1997 until 2004, but contrary to the trend in other transition countries that share fell to 65 percent in 2005. Essentially, all economic growth has come from private enterprise. Therefore, a decline in the share of the private sector bodes ill for future growth prospects. The government's contribution has been to keep the budget in surplus and reduce taxation. In May 2008, Russia’s stock market capitalization approximately equaled its GDP, as was common in Western Europe.

Until 1998, Russia’s lingering problem was a persistent large budget deficit of some 9 percent of GDP that held back growth. In August 1998, it unleashed a financial crash so severe that Russia switched to conservative and prudent macroeconomic policies for a decade. Since 2000, Russia has had persistent and large budget surpluses of several percent of GDP, amounting to 5.4 percent of GDP in 2007. Russia’s foreign currency reserves peaked at $598 billion in early August 2008. Meanwhile, Russia’s public foreign debt plunged from 100 percent of GDP in 1999 to 3 percent at present (BOFIT 2008). From 1998 until 2002, Russia undertook a profound tax reform, adopting a liberal tax system. It cut the number of taxes sharply, reduced the tax rates, and introduced a flat personal income tax of only 13 percent, while decriminalizing many tax violations. As a consequence, Russians started paying taxes, and public expenditures have hovered around 35 percent of GDP.

Russia’s structural reforms continued until 2002. Among the last important reforms were a comprehensive judicial reform, which means that businessmen sue both one another and the government on an increasing scale. Another important reform was the adoption of a land code, which legalized private ownership of agricultural land. New laws on licensing, certification, permits, and inspections eased the restrictions on small enterprises. A new customs code facilitated the previously exceedingly difficult customs procedures.

A second group of causes of the high growth has been the huge free capacity in production, infrastructure and human capital and structural changes after the collapse of communism. With the rise of the new capitalist service sector, a large structural change spurred growth. The recovery was coupled with re-monetization, as Russia enjoyed a great credit boom. Several profound structural changes have contributed to Russia’s growth. Its service sector has expanded from 33 percent of GDP in 1989 to 57 percent in 2007. Even so, Russia’s industrial sector is still large by international standards, contributing 38 percent of GDP in 2006, compared with 27 percent of GDP in the euro area (World Bank 2008). Partly, this sizable industrial sector reflects insufficient market adjustment yet to come, partly it shows Russia’s comparative advantage in raw-material-extraction.

Together, the systemic and structural changes amount to a gigantic catch-up effect or capitalist convergence that all postcommunist reform countries have experienced. The average annual real growth in former Soviet states from 2000 to

2007 was 9 percent, but it reached only 7 percent in Russia, so Russia has actually been comparatively less dynamic that its cohort. Growth leaders are Azerbaijan, Armenia, Estonia, Kazakhstan and Latvia (World Bank 2008). Growth accounting shows that after 2000, half of Russia's growth arises from capital and half from rising total factor productivity, while labor has given a minor positive input (Iradian 2007).

"Russia 2020" conveys the vision of Russia as an innovation leader and a middle class society. The key goal of "Russia 2020" is to raise Russia's GDP per capita from $12,000 in 2008 to $30,000 in 2020 and make Russia the fifth biggest economy in the world after the US, China, India, and Japan. Russia's GDP would increase on average 6.5 percent a year from 2007 to 2020. Its per capita GDP would rise from one quarter of the US level in 2008 to half in 2020, and Russia's share of world GDP in current dollars would expand from 2.8 percent in 2008 to 4.1 percent in 2020. This is a very ambitious goal, but not impossible.

The question is whether Russia's government will pursue a sufficiently good economic policy. In its conceptualization, "Russia 2020" appears more Soviet than market economic. The means for economic growth are problematic. Its emphasis lies on innovation and high technology, but catch-up growth is usually a matter of emulation and imitation, of pragmatism and opportunism rather than originality. Deregulation and improvement of the enterprise environment are ignored. If Russia were to succeed with its growth targets, substantial and comprehensive economic reforms would be needed, but no such major reforms have been elaborated or are intended. The program does not reflect any insight that Russia's main problem is its huge, inefficient, and corrupt public sector.

Moreover, as most of Europe, Russia is facing a decline in its native population, and the Russian population is set to shrink as discussed in chapter 6. The most positive scenario is that Russia's population will increase insignificantly until 2020. The potential labor force, however, is bound to decline from 90 million in 2007 to 78 million in 2020, according to the Ministry of Economic Development.

The most successful transition countries have investment ratios exceeding 30 percent of GDP, as in East Asia. But Russia's investment ratio never reached higher than 23 percent of GDP in 2007, and it is likely to fall sharply in the current business environment.

3. Role and Challenges of the Russian Energy Sector

Another major factor behind Russia's growth has been the oil price windfall since 2004. The Russian Ministry of Economic Development assessed that energy in all its forms contributed 18 percent of GDP in 2007 which is substantial but far less than in pure petrostates. It accounted for 50 percent of federal revenues and 61 percent of export revenues.

Since the international oil prices took off, a dominant theme in the Russian economic debate has been the danger of an "energy curse" for the Russian economy, referring to several problems.

After the Russian financial crash of 1998, the authorities were greatly concerned with any overvaluation of the exchange rate, which would price out other exports, the so-called Dutch disease. The Ministry of Finance has chosen to pay off its foreign debts as a main cure.

Another energy curse is that the abundance of energy revenues, that have boosted the country's budget surplus, current account balance and currency reserves, makes it difficult to motivate policymakers and the population to pursue and accept economic reforms that often bring about hardship in the short term. The elite focused on the distribution of oil rents rather than on the improvement of policy. Russia has seen no economic or social reforms worth mentioning for the past six years.

A third energy curse is that the concentrated energy revenues facilitate both the centralization of political power and rent seeking. According to authoritative Freedom House (2008), there are only eight countries in the world that are richer than Russia in per capita terms and also authoritarian. They are Singapore and seven small oil states. The prevalence of vast oil and gas revenues are a cause of Russia's current authoritarianism (Fish 2005).

Energy is a focus of Russia 2020. Although the energy windfall has facilitated Russia's economic rise and its authoritarianism, the government favors diversification. President Putin (2008) explained:

> So far we have only partially occupied ourselves with modernization of the economy. As a result, Russia has become increasingly dependent on imports of goods and technology, and our role as a raw material appendix to the world economy has been reinforced. In the longer term, this can lead to our lagging behind the leading economies of the world and our country being squeezed out from the world leaders.

4. The Evolution of State Capitalism and Renationalization in the Energy Sector

Russia's economic recovery has been driven by private enterprise, but since 2005 re-nationalization has prevailed. Such major companies as Yukos, Sibneft, Russneft, Vankor, United Heavy Machineries, VSMPO-Avisma, Sakhalin Energy and Rusia (Kovykta) have been renationalized, which aggravates corporate governance and political risk. The Yukos affair which started in 2003 was the turning point of most Russian policies.

On October 25, 2003, Mikhail Khodorkovsky, the CEO and main owner of Russia's largest oil company, Yukos, was arrested. Eventually, he was sentenced to eight years of prison for tax avoidance previously judged legal and used by millions of Russians. Similarly, Yukos was confiscated through arbitrary tax rulings. The best account by Stephen Fortescue (2006, 149) concludes: "Yukos was probably primarily about politics in the broad sense of setting new rules of the game, rather than Khodorkovsky's personal political interests. It was also about extracting more tax from the resource sector and, perhaps as a side benefit, also about giving Putin's *silovik* colleagues access to the resource sector."

The effects of the Yukos affair have been many, and almost entirely negative. Khodorkovsky's sentence for legal tax avoidance meant the government formalized tax terror. It appreciated keeping business in a state of uncertainty and fear. "There are also broader implications of the persistently Stalinist overtones of the anti-oligarch campaign – destruction of a class, exemplary justice, terror and enemies" (Fortescue 2006, 169). Putin has undermined the rule of law and private property rights in Russia through "the carefully cultivated threatening ambiguity in everything he has to say about business. He has no desire to encourage the general population to give legitimacy to business, since to do so would remove one of the pillars of his populist appeal" (ibid, 171).

Putin's chief project became to develop huge, unmanageable state-owned mastodons, considered "national champions." They have stalemated large parts of the economy through their inertia and corruption while impeding diversification.

The effects have been particularly conspicuous in the energy sector. First, the oil sector has been subject to nearly confiscatory taxation for oil prices over $27 per barrel, minimizing the incentives to invest. Second, the energy sector has been subject to a substantial nationalization. In 2008, the state accounts for 85 percent of gas production and 44 percent of oil production, while it was as little as 10 percent in 2003. Third, both oil and gas production has stagnated. Finally, the Russian gas sector has been permeated with possibly the worst corruption the world has ever seen.

Russia's nationalistic energy policy after 2003 has stalled the development of major new energy investments (apart from the Sakhalin projects, which date back to the Boris Yeltsin era). Gazprom and Rosneft have financed themselves with foreign debt rather than with equity capital, accounting for almost one-fifth of Russia's corporate foreign debt of $488 billion, aggravating the country’s currency risks. Gazprom's aggressive pricing and delivery disruptions have scared away customers, reducing the demand for its gas.

Huge public funds are being diverted to state corporations, which either hoard the money or siphon it off. In their book *Putin and Gazprom*, Boris Nemtsov and Vladimir Milov (2008) have offered a staggering but credible account of how Putin and his friends pilfered assets of $80 billion from Gazprom during his second term as president, through asset stripping and the siphoning off of revenues through trading companies. Investors have finally taken note, slashing Gazprom's market capitalization from $350 billion last spring to $70 billion at its nadir.

Gazprom’s production has been stagnant for many years, but previously Russia’s gas production increased because independent producers were allowed to expand, although they were subject to severe discrimination in prices and access to the trunk pipelines, which are a Gazprom monopoly. They were compelled to flare tens of billions of cubic meters of gas each year. In recent years, Gazprom has increasingly forced the independent gas companies to give up ownership to Gazprom or even limit production (Kovykta).

As a consequence of the immense power of the security elite, Russia’s business environment is poor, and it is getting worse. The state bureaucracy has proven to be an obstacle to efficient economic activity, adding costs to businesses in the form of time spent dealing with arbitrary regulations and the payment of bribes. The World Bank *Doing Business* (2008) index ranked Russia as 96^{th} among 175 countries in 2006 but 120^{th} out of 181 in 2008. Russia receives its best rankings for enforcing contracts (18), registering property (49), and starting a business (65), which makes it comparatively easy to establish a firm, while the regulatory environment is bad. In 2008, filing for and receiving the necessary permits and licenses for the construction of a warehousing facility took 704 days in Russia, compared to 161 in OECD.

Corruption that has always been severe in Russia is growing worse, while it is improving in the rest of the region. Although Russia is the 46th-richest country in the world in per capita terms (IMF 2008), it is ranked 147 out of 180 countries on Transparency International’s (2008) corruption perception index for 2008. Only Equatorial Guinea is both richer and more corrupt than Russia. One consequence is that the Russian state is so dysfunctional that it can barely undertake any major infrastructure projects.

Infrastructure, especially roads, has become an extraordinary bottleneck, as any visitor to Moscow may notice in its extraordinary traffic jams. In 2000, Russia had 754,000 km of paved road, according to the official statistics. Incredibly, by 2006 this figure has increased by only 0.1 percent to 755,000 km. It had 47,000 km of trunk (*magistral’nye*) oil pipelines, exactly as much as in 1995. The trunk gas pipelines increased from 213,000 km in 2000 by 5 percent to 2006. The little that is built costs at least three times as much as per kilometer as in the West.[1] Russia's public administration has proven itself too incompetent and corrupt to undertake major projects. Unless that changes, none of the many large planned infrastructure projects can be taken seriously.

5. Impact of the Financial Crisis on the Russian Economy

Apart from Russia's excellent fiscal policy, just about everything has been wrong with the country's economic policy since 2003. Eventually, the consequences of such a poor economic policy arrive. The global financial crisis had delivered a rude shock to the Kremlin.

As late as in July 2008, top Russian officials presumed that Russia would escape the international financial crisis. Yet the Russian stock market plummeted by 78 percent from its peak in May to its nadir (so far) in October. The international oil price plunged from an all-time high of $147 per barrel in July to a low of $34 per barrel in December. Russia has benefited from a long oil and commodity boom, but their international prices appear to have peaked out for this long cycle. As its energy production is stagnant, Russia's external account is bound to deteriorate quickly. Russia's industrial production started falling sharply in November by 8.7 percent, and forecast growth in 2009 fell from 7 percent to 0, which might still be optimistic. Russia's official international currency reserves sank from $598 billion in early August to $438 billion on December 26, or by 27 percent in four months.

Inflation reached 15 percent a year in the summer of 2008 because of a poor exchange rate and monetary policies. Russia's inflation rate was about double that of other emerging markets, because its macroeconomic policy relied too much on fiscal policy and too little on monetary and exchange rate policy. The inflation was driven by the large current account surplus, which was monetized into rubles because the Central Bank purchases hard currency to defend the fixed ruble exchange rate, tied to a basket of US dollars and euros, leaving Russia with a negative real interest rate. Until the summer of 2008, the pegged exchange rate policy provoked speculative capital inflows that boosted the money supply and inflation. Afterwards, the pegged exchange rate left the ruble overvalued, promoting speculative capital outflows and quickly reduced the currency reserves. Devaluations in very small steps convinced the market that a major depreciation is inevitable. The coming combination of loose fiscal policy, negative real interest rates, current and capital account deficits, and an overvalued ruble is unsustainable, provoking capital flight.

Russian private banks are largely small, while the Russian economy is dominated by large companies, leading to a mismatch between small banks and large creditors, which have to turn to international banks. If Russia had privatized its banking system as most other post-Soviet countries, its companies would suffer less from currency risks.

Russian big businessmen and their corporations have turned out to be much more leveraged than anybody had thought. Total Russian corporate foreign debt was $488 billion in October 2008. The government has made clear that it will refinance their foreign loans to secure "strategic" ownership, and big Russian businessmen often have pledged their strategic holdings of Russian stocks against foreign bank loans, forcing the Russian state to bail them out. Initially, $13 billion was paid, but such Russian private pledges are huge. In December 2008, VEB had $37 billion left to spend, but it had already asked for $30 billion more from the government, and more is

[1] Russian Statistic Yearbook. 2007. Available at http://www.gks.ru. Accessed on October 16, 2008.

likely. In this way alone, Russia can swiftly lose more than $100 billion of reserves, and incredibly its initially huge reserves may run short.

The government has persistently denied that anything is wrong with Russia's economic policy. Domestic and foreign businessmen realize that this does not tally with reality, which undermines their confidence to the Russian market. Without free public debate, rational policy decisions are unlikely.

It is difficult to assess the impact of all these effects, but they are all potent and negative. A sudden, zero growth seems likely, and the question is how the Russian people and leaders will react. The positive scenario is that the rulers face reality and return to all the progressive market reforms they pursued until 2002. The alternative is that they dig in and refuse to undertake necessary reforms, but status quo no longer appears plausible.

6. The Significance of Economic Interdependence for the Future of EU-Russia Relations

Russia is a relatively open economy with an average import tariff of 12 percent. Although it is a relatively large economy, its exports correspond to about 30 percent of its GDP. Russian exports have driven the country's high economic growth. In only nine years, they multiplied six and a half times from a low of $76 billion in 1999 to $493 billion in 2008. The share of exports in GDP has contracted moderately, from 38 percent in 1999 to 27 percent in 2007**,** as the rest of the Russian economy has caught up with the export sector.

Still, Russia's share of world merchandise trade remains small, only 2.5 percent in 2006, equal to its share of global GDP. Its share in world services trade is even less. Of Russia's total exports of goods and services in 2007, mineral fuels accounted for 61 percent. Soaring commodity prices, particularly for oil and gas, have propelled the export boom, though export volumes have also expanded fast. The second export group was base metals, primarily steel, comprising 12 percent. Services and chemicals took the third and fourth places, accounting for 10 percent and 4 percent respectively. Russia's exports of machinery and equipment amount to 4 percent of total Russian exports as well. "Non-specified commodities" account for a significant share of Russian exports, roughly 18 percent, of which about 3 percent are arms.

The 1998 financial crisis and ensuing devaluation seriously curtailed imports, which hit a low of $40 billion in 1999. Since then, Russia's imports increased over eight times to $334 billion in 2008.[2] They were set catch up with exports, persistently growing by 35-40 percent a year. With the dramatic fall in commodity prices, however, Russia's large trade surplus of probably $187 billion in 2008 (10.5 percent of GDP) is set to turn into a significant deficit in 2009. Depending on international commodity prices, Russia's exports are likely to decline by $150-200 billion in 2009 or 30-40 percent of total exports in 2008.

The EU dominates Russia's foreign trade. It accounted for as much as 53 percent of its exports and 52 percent of its imports in 2007. The runner up is East Asia, which provides Russia with 22 percent of its imports, but accepts only 9 percent of its exports. The CIS countries, which used to dominate in Russia's trade, have declined to an insignificant share of 12 percent of Russia's imports and exports. The US role in Russia trade is surprisingly minor, only 5 percent of Russia's exports and 3 percent of its imports.

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[2] UBS, *Russian Daily News*, December 16, 2008, p. 30.

A common concern is that Russia exports little but raw materials, and that it is not very competitive on foreign markets. Julian Cooper (2006a, 2006b) investigated Russia's competitiveness using an index of "revealed comparative advantage," which is defined as a country's share of world exports of a particular good divided by its share of total world exports. The higher the ratio, the stronger the country's comparative advantage in that particular product. As expected, Russia's revealed comparative advantage is overwhelmingly in hydrocarbons, other crude materials, metals, and chemicals. Out of 70 product groups in which Russia is competitive, only four pertain to machinery and transport equipment. These four are nuclear reactors, condensers for steam boilers, rail freight wagons, and steam turbines, traditional Soviet products, now being exported mainly to old captive markets in the former Soviet Union.

Russia's economic growth has been driven by international economic integration. World Bank and Economic Development Ministry assessed that World Trade Organization (WTO) membership would add a growth of 0.5 to 1 percentage points a year for the next five years, primarily from finance, foreign direct investment and services.[3] Foregoing WTO membership, Russia will not enjoy these benefits, but may on the contrary suffer from similar declines because of new protectionist measures both at home and abroad.

Unfortunately, at present little can be done to EU-Russia trade relations. Before Russia becomes a member of the WTO, a free trade agreement makes no sense. Yet Russia is utterly dependent on the European market, and EU-Russian trade is likely to become balanced with lower commodity prices in 2009. The EU is the dominant customer of Russian natural gas, which gives the EU enormous leverage over Russia in trade, which it so far has not utilized.

7. Foreign Direct Investment in Russia

Russia has a poor legal climate. The EU Commission stresses the lack of protection of contracts, specifically in the area of intellectual property rights, as the main concern of potential investors. Even so, since 2002 foreign direct investment (FDI) inflows have grown dramatically, reaching $45 billion in 2007, but both the total dollar stock of FDI and the share of GDP are still low. As of end-2007, Russia had accumulated an inward FDI stock of $198 billion, some 15 percent of GDP according to UNCTAD, largely concentrated in energy, wholesale trade, and metallurgy (UNCTAD 2007).

For foreign direct investment, legal protection is important. Russia has experienced quite a few property rights conflicts, and they are characteristically being fought out in international courts. Predominantly, such legal cases are instigated by

[3] The World Bank studies in question are Jesper Jensen, Thomas Rutherford, and David Tarr, "Economy-Wide and Sector Effects of Russia's Accession to the WTO," Washington, D.C.: World Bank, 2004; Jesper Jensen, Thomas Rutherford, and David Tarr, "The Impact of Liberalizing Barriers to Foreign Direct Investment in Services: The Case of Russian Accession to the World Trade Organization," Washington, D.C.: World Bank, 2004; Jesper Jensen, Thomas Rutherford, and David Tarr (2004c) "Telecommunications Reform within Russia's Accession to the World Trade Organization," Washington, D.C.: World Bank, 2004; Thomas Rutherford and David Tarr, "Regional Impacts of Russia's Accession to the WTO," Washington, DC: World Bank, 2006; Thomas Rutherford ,David Tarr, and Oleksandr Shepotylo, "Poverty Effects of Russia's WTO Accession: Modelling "Real" Households and Endogenous Productivity Effects," Washington, D.C.: World Bank, 2004; Thomas Rutherford, David Tarr, and Oleksandr Shepotylo, "The Impact on Russia of WTO Accession and the Doha Agenda: The Importance of Liberalization of Barriers Against Foreign Direct Investment in Services for Growth and Poverty Reduction," in Thomas W. Hertel and L. Alan Winters, eds., *Poverty and the WTO: Impacts of the Doha Development Agenda*, Washington, D.C.: World Bank, 2005.

relatively small individual investors, while the big institutional investors do not want to reveal how much they have lost.

Property rights remain a central concern for both Russian and foreign businesses in Russia. Primarily US portfolio investors lost an estimated $12 billion in the Yukos confiscation, and they are not likely to receive any compensation. Two major cases of foreign-owned companies that have lost out in property strife was Royal/Dutch Shell and its Japanese partners, which was forced to give up a majority to Gazprom in the Sakhalin II oil and gas venture. Similarly, BP was compelled to give up the Kovykta gas field in East Siberia to Gazprom. In both cases, administrative resources were deployed to pressure the foreign companies.

There are remedies to foreign expropriation, and members of the European Union have sensibly developed three major legal instruments with Russia. The most direct remedy is through a bilateral investment treaty; 38 countries, including 17 EU countries, have concluded bilateral investment treaties with Russia that have been ratified, allowing foreign claimants in those countries to sue the Russian government.

In 1994, the Energy Charter Treaty was signed by most European countries, the former Soviet countries and some other countries. A total of 51 countries signed it and 46 of them have also ratified this treaty, which also contained substantial clauses against confiscation. The treaty came into force in 1997, and all EU members have ratified it. Russia signed the Energy Charter Treaty. Although it has not ratified the treaty, it has committed itself to abide by this treaty, and major suits are under way on this basis.

Citizens in European countries have a third legal opportunity, namely to appeal to the European Court of Human Rights in Strassbourg. It is attached to the Council of Europe, an organization of which Russia is a member. The verdicts of the European Court of Human Rights are formally accepted by the Russian government, which renders them potent in commercial cases. Thousands of cases concerning Russia have been raised there, and the Russian government regularly loses. One prominent case that the Russian government lost was raised by the exiled Russian businessman Vladimir Gusinsky. The European Court of Human Rights established that the Russian state had forced him to give his media empire to a state-dominated company.

Thus, the EU has established quite an impressive array of major treaty obligations for the security of foreign direct investment in Russia, and the main concern is to make these agreements effective.

8. Integration of Russia into Global Economic Governance

Russia's attitude toward global governance has gone through profound changes in the last two decades. The Soviet Union was a member of all United Nations organizations as well as the (future) Organizations for Security and Cooperation in Europe (OSCE), but it stayed out of the "capitalist" organizations, the International Monetary Fund, the World Bank, and the General Agreement on Trade and Tariffs (GATT), and it was not accepted in the purely Western organizations, the European Union, the Council of Europe, the North Atlantic Treaty Organization, the G-8, and the Organization of Economic Cooperation and Development (OECD).

In the early 1990s, Russia wanted to be a "normal" country and join all the relevant international organizations. In the spring of 1992, it quickly joined the IMF and the World Bank, and in the mid-1990s the Council of Europe. Russia has still no formal relationship with the OECD. Russia's relationship with four major Western organizations have been complicated: the G-8, NATO, the European Union, and the World Trade Organization (WTO).

The Soviet Union started participating in part of the G-8 summits as early as 1990, and very gradually Russia became a member of the G-8. In 2006, Russia chaired the G-8 at its summit in St. Petersburg. Even so, the G-7 finance ministers and central bank governors still convene without Russia. As G-7 has expanded to the G-8, it has gradually lost relevance as its share of the world economy has declined.

Most sensitive for Russia has been its relationship with NATO. In the early 1990s, Russian leaders toyed with the idea of joining NATO, but they soon realized that they were not welcome. NATO developed new forms of cooperation with the former Soviet states. The most important development was the creation of the NATO-Russia Council in 1997, which was formed to accommodate Russia, when Poland, the Czech Republic, and Hungary became members of NATO.

Many Russians have wanted to join the European Union, but early on the EU made clear that Russia was not welcome. In 1994, Russia and the EU agreed on the Partnership and Cooperation Agreement (PCA), which came into in force three years later being delayed because of Russia's war in Chechnya. The PCA was supposed to last for ten years, but it has been prolonged in lieu of any alternative. The PCA is long on formal meetings and short on substance. PCAs were offered to all former Soviet states. In 2003, the European Commission launched its new concept of the European Neighborhood Policy, which was meant for North Africa and the Western states of the former Soviet Union. Ukraine and Moldova accepted it, while Belarus was discarded by the EU, and Russia discarded the European Neighborhood Policy (Milcher, Slay, and Collins, 2007). As a consequence, the EU is supposed to negotiate a new PCA with Russia, but the EU's negotiating mandate was held back by Poland because of Russia's trade sanctions against Poland. The EU and Russia are holding a large number of summits and high-level meetings but the substance is limited.

For longer than any other country, Russia has aspired to join the World Trade Organization (WTO). It applied for membership in June 1993, but it has not succeeded as yet. From 2000 until 2003, Russia adopted most of the legislation needed for WTO membership. In 2004, Russia concluded a bilateral protocol with the European Union on its WTO accession, and in November 2006 it did so with the US. At present, Russia is very close to enter the WTO. Only three big issues are outstanding: a bilateral protocol with Georgia, another bilateral protocol with Ukraine, and an agreement with the EU on Russia's export tariffs for lumber. Yet after the Russian war in Georgia in August 2008, Russia's efforts at accession have stalled as if to forestall possible Western protests.

Disturbingly, Russia's foreign economic policy has become more restrictive with regard to both trade and investment in the last few years. In 2008, the Russian government took many, substantial protectionist steps in both foreign trade and foreign direct investment. In May, Russia adopted a new Law on Foreign Investment in Strategic Industries. As global food prices were rising in the spring, Russia responded by introducing export tariffs and quotas on various agricultural products. After the war in Georgia in August 2008, Russia imposed general trade sanctions on Turkey, and on foods from the United States and Ukraine. But WTO membership is important for Russia's international status. About 96 percent of world trade is undertaken among members of the WTO, and Russia accounts for most international trade outside the WTO.

Russia's political aspirations in 2008 are very different from those in the early 1990s. The Kremlin no longer subscribes to Western or democratic ideals but cherishes its own authoritarian rule. The Soviet Union could be described as lawless domestically but legalistic in international relations. Putin's Russia is increasingly lawless both at home and abroad. The Kremlin is anxious that Russia is represented at all international meetings, but increasingly it behaves like a spoiler rather than as a responsible and constructive member of the global community. Even worse, Russia regularly ignores its multilateral commitments.

The Kremlin is trying to undermine the Council of Europe and the OSCE. It is blocking all decisions to make them more effective and it refutes their democratic ambitions. Then President Putin went to the NATO summit in Bucharest in early April and came close to declaring war on Georgia and Ukraine in his speech because these two nations wanted to join NATO. At the G-8 summit in Japan in July 2008, President Dmitri Medvedev promised not to block United Nations sanctions against Zimbabwe, which Russia in the UN Security Council. With its recognition of Abkhazia and South Ossetia, Russia violated its multiple treaties (OSCE and Commonwealth for Independent States, CIS) guaranteeing the sovereignty and territorial integrity of former Soviet republics.

At the G-20 summit in Washington on November 15, the only substantial commitment by the heads of the 20 leading nations present was not to undertake any new protectionist measure in the next year: "We underscore the critical importance of rejecting protectionism and not turning inward in times of financial uncertainty. In this regard, within the next 12 months, we will refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organization (WTO) inconsistent measures to stimulate exports."[4] But Russia immediately raised import tariffs for cars sharply. Similarly, in 2009 Russia plans to introduce prohibitive export tariffs for lumber to promote its domestic forestry industry.

Russia's attitude to global governance can be summarized in three points: to want to attend all important summits, to oppose most substantial decisions, and to ignore all inconvenient decisions. The European Union needs to adjust its actions to Russia's new international behavior. First, it should minimize the number of high-level meetings, which currently only breed public polemics and reinforce Russia's new authoritarianism. Second, the EU should focus on concluding clear and verifiable agreements, and, third, it should insist on penalties when an agreement is violated.

9. Implications for Europe of the Behavior of the Russian Gas Sector

The gas sector stands out as the most thoroughly regulated, state-dominated and corrupt part of the Russian economy. Not surprisingly, it is also the most stagnant sector. Europe's problem is that Gazprom is supplying one quarter of EU gas supplies or 40 percent of its imports (Stern 2005, Åslund 2008).

On January 1, 2009, Gazprom cut off gas supplies to Ukraine, claiming that it had not paid for gas deliveries in 2008, penalties for delayed payments, and no agreement on prices had been reached for 2009. Overtly, both Russia and Ukraine agreed to maintain gas deliveries to Europe, but Ukraine was left without payment for transit. Not surprisingly, it declared that it would charge an appropriate share of the transited gas as payment for its services, which Prime Minister Putin labeled "theft." On January 5, Putin commanded drastic cuts in gas supplies to Europe, which were

[4] Declaration of the Summit on Financial Markets and the World Economy, November 15, 2008, available at http://www.whitehouse.gov/news/releases/2008/11/20081115-1.html (Accessed on December 24, 2008).

effectuated on January 6. Instead, he ordered gas to be transported via Belarus/Poland and Turkey, but he must have known that no free capacity existed.

In reality, four-quarters of Russia's gas supplies to Europe was cut from January 6, and no less than 15 countries were left without Russian gas. Half of Europe suffered from gas shortages, especially the Balkans with emergency situations in Bulgaria, Slovakia, and Poland.

The commercial dispute is rather elementary. On New Year's Eve, Prime Minister Vladimir Putin publicly offered Ukraine a gas price of $250 per 1,000 cubic meters. In a joint statement on January 1, President Viktor Yushchenko and Prime Minister Yuliya Tymoshenko argued for a price of $201 per 1,000 cubic meters to compare with $179.50 in 2008. On October 2, 2008, Putin and Tymoshenko signed a memorandum of understanding on Russian-Ukrainian gas relations. Gradually over three years, they agreed, Ukraine would move to West European prices, paying 50 percent of them in 2009, 75 percent in 2010, and 100 percent in 2011. Since the European price for Ukraine would be $418 at present, according to Gazprom, 50 percent of that would be $209. Thus, both parties were in the same ballpark.

The other commercial dispute concerns the transit tariff Gazprom pays to Ukraine for its deliveries to Europe. Currently, it is $1.70 per 100 km per 1,000 cubic meters, according to a five-year contract concluded in January 2006, but Ukraine wants to raise it to at least $2, arguing that the European transit tariff is two-three times higher, which Gazprom implausibly denies.

Strangely, the commercial differences now seem non-existent. On the New Year, Chairman of Naftohaz Oleh Dubyna accepted $235 in gas price and $1.80 in transit tariff. On January 8, Putin stated that he accepted $235 and could agree to a normal European transit tariff of $3.40. Clearly, Putin hit full retreat on January 8 but tried to hide it behind even greater aggression than usual. Thus, the commercial differences were insignificant.

Gazprom's action was no surprise, because Russian top officials had warned loudly, and Gazprom is notorious for its aggressive monopoly pricing and its disrespect for its customers. It has repeatedly cut off deliveries to its post-Soviet customers: Belarus, Ukraine, Moldova, Georgia, Azerbaijan, and Armenia. Ukraine faced the same fate three years ago. In recent years, Russia has also cut oil supplies to Latvia, Lithuania, and the Czech Republic. To cut energy supplies is one of Russia's standard sanctions against postcommunist countries.

Its neglect of its European customers is more perplexing, because the West Europeans have previously been better treated, with the exception of Gazprom's two-day supply reduction in January 2006. After that experience of the unreliability of Gazprom, the main West European customers built up buffer stocks of three months, representing substantial costs, but the Balkans and most East Europeans had no such reserves.

Gazprom's current disregard will scare many European customers away. It behaves like a monopolist, but it is not in the EU. Because of its poor reputation, Gazprom has become a prime victim of the current economic slowdown. Its customers are cutting their energy consumption, and most of all purchases from Gazprom. Its production fell by a whopping 10.6 percent in November 2008 over November 2007 and 8.9 percent in December 2008 as its Central European customers avoided this unreliable and expensive supplier.

The mover and shaker in the Russian-Ukrainian gas trade is RosUkrEnergo (RUE), which was set up in a meeting between Presidents Putin and Leonid Kuchma in Yalta in July 2004 (Åslund 2009). It is a non-transparent trading intermediary that sells Turkmen gas to Ukraine through Gazprom's pipelines, which Edward Chow and Jonathan Elkind (2009, 80) pointedly characterized as "an entity with no assets, no track record, and no transparency was placed at the very center of the Ukrainian gas economy. Moreover, RUE did not even have to compete for this lucrative position… According to numerous press reports and industry rumors, RUE's ample profits flow into the pockets of well-placed officials in the Russian and Ukrainian gas industries and governmental structures." Until recently, RUE controlled the profitable part of Ukraine's domestic sales of gas through UkrGaz-Energo, its joint venture with Naftohaz, which never received any dividends from UkrGaz-Energo, which RUE has lawlessly appropriated.

Originally, half of RUE was owned by Gazprombank, whose ownership was mysteriously transferred to the Putin-connected Rossiya Bank in late 2006. Gazprom bought that half of RUE for no less than $3.5 billion, although all its assets derived from the Gazprom-sponsored trading contract (Nemtsov and Milov 2008).

The other half of RUE is controlled by a few top Ukrainians. Formally, it is owned by two Ukrainian businessmen, Dmytro Firtash (90 percent) and Ivan Fursin (10 percent). Firtash is a major financier of former Prime Minister Viktor Yanukovych's Regions party. Yury Boiko, who was Naftohaz Chairman 2002-4 and Minister of Energy 2006-7 under Yanukovych and currently a deputy in Yanukovych's party, was on RUE's management board from the outset. So was his deputy at Naftohaz, Igor Voronin, who was also chairman of UkrGaz-Energo (Global Witness 2006).

Since January 2006, RUE has controlled both imports of gas into Ukraine and most domestic gas trade in the country. It has sucked out money from Naftohaz, while it has financed much of Ukrainian politics, primarily the Regions party, and persistent rumors have connected it with the presidential administration as well. Strangely, when Naftohaz paid its gas debt on December 30, Gazprom's spokesman Sergei Kupryanov said that Naftohaz had paid RUE in Switzerland (where it is registered), but Gazprom had so far received no money. Does Gazprom not control its subsidiary? As Chow and Elkind (2009, 84) note: "Gazprom has allowed billions of dollars of value to flow into the pockets of a group middlemen…without compensating Gazprom's shareholders, or Russian taxpayers."

In January 2006, Gazprom's stock price surged when it cut off its deliveries to Ukraine for two days, because investors appreciated that Gazprom opted for higher prices (Stern 2006, Teylan and Gustafson 2006). This time the commercial logic is the opposite: By demanding a higher price than the market can bear and cutting supplies to innocent customers, Gazprom is pricing itself out of the market and alienating its shareholders.

A major Russian objective is to seize the gas pipeline systems of its clients. At his press conference on January 8, Putin complained loudly that Ukraine had prohibited the privatization of its gas pipelines, while Belarus had given up half of its system to Gazprom. Another Russian goal is to control Ukrainian politics through the corrupt money flow through RUIE. A third political Kremlin goal is to destabilize Ukraine to show how bad democracy is for Eastern Slavs, so that Russians do not think of it, while they face declining standards of living. Putin has become notorious for provoking fights with independent, democratic neighbors, such as Georgia, Ukraine, and Estonia to arouse his compatriots. It is not surprising, because the only source of legitimacy of his authoritarian regime is high economic growth, and it is being halted by the international financial crisis. Putin needs all the conflicts he can provoke to survive.

10. Recommendations for EU-Russia Gas Cooperation

In short, Europe's gas supply from Russia is highly unreliable. First, the EU does not have elementary real-time information about production, storage and transportation of Russian gas. Second, this gas supply is hostage to grand larceny of billions of dollars each year. Third, unlike other major piped gas supplies, this trade is not subject to any long-term agreements or pricing formulas, only annual ad hoc agreements.

This situation is completely unacceptable for Europe's energy security. The most amazing aspect of the current crisis is that the main victims, the European customers, have been utterly passive. Incredibly, they have taken Russian and Ukrainian assurances that gas deliveries would not be harmed at face value. This is not only naïve but irresponsible. Moreover, this conflict is not likely to be resolved without the intervention of a third party, and it can hardly be anybody but the European Union. A large number of measures are urgently needed.

1. Both Putin and Tymoshenko called for independent international monitors of the gas flow, and on January 11, they signed an agreement with EU President and Czech Prime Minister Mirek Topolanek about European monitoring of Russia gas supplies through Ukraine. This monitoring should also include production and storage of gas, so that the EU has proper information about its gas supplies.

2. The EU can no longer accept that a corrupt intermediary such as RUE gambles with its energy security but must demand its elimination.

3. The EU should also demand that Russia and Ukraine conclude long-term supply and transit agreements according to fixed pricing formulas, as the Central European countries have concluded with Russia. The prices are up to Russia and Ukraine, but the EU cannot accept a system that Russia and Ukraine cut off the gas supplies out of a whim once a year. As is most evident from Putin statements about Ukraine as a "criminalized" state, the necessary trust between Russia and Ukraine is missing. To guarantee secure gas supplies is a legitimate EU demand and the EU should act as a mediator.

4. The supply disruption shows how vulnerable the European energy system is. Further energy saving must be part of the solution, and energy supplies need to be more diversified. Most have choices both in the short and long term. Bulgaria and Slovakia have already suggested restarting their closed nuclear power stations, while Lithuania is now unlikely to close the Ignalina nuclear power station. Many will opt for more coal and liquefied natural gas (LNG) or piped gas from Norway and Algeria rather than piped gas from Russia.

5. The countries that have suffered the most from the interrupted supplies are those with dominant or monopolistic gas companies. This conflict has shown how important it is to unbundle such energy companies to enhance energy security.

6. Specifically, the EU should consider measures to encourage gas storage, and it is important that the storage is not under the control by Gazprom that has been guilty of the supply disruptions.

7. Interestingly, Russia has claimed that Ukraine has violated the Energy Charter, which Russia has signed but not ratified. This is a good occasion for the EU to open a general energy negotiation with Russia. A characteristic statement by Prime Minister Puitin (2009) as late as on January 8, 2009, is: "So, it is ridiculous and simply foolish to say that Russia has suspended supplies." But Gazprom's persistent claims to be a reliable supplier have now been empirically disproved. The EU should inform the Russian government in no uncertain terms that the EU will have to radically reduce its dependence on Russian energy if Russia does not ratify the Energy

Charter and signs the Transit Protocol. The EU can do so from a position of strength, as the world is probably facing a few years of abundant energy.

8. Nor is it acceptable that Ukraine’s energy sector remains a black, non-transparent hole of corruption and losses. In its current negotiations with Ukraine on a European Association Agreement, the EU should demand a thorough reform of the Ukrainian energy sector, including the transformation of Naftohaz to an ordinary corporation with fiscal discipline, homogenous wholesale prices, independent and transparent regulators, and unbundling of the energy sector.

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Key Facts

Russia	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
									Projection	*Forecast*
Output and expenditure										
GDP	10,0	5,1	4,7	7,3	7,1	6,4	7,4	8,1	6,0	0,0
Private consumption	7,3	9,5	8,5	7,5	12,1	11,8	11,2	12,8	13,0	
Public consumption	1,9	-0,8	2,6	2,2	2,1	1,3	2,5	5,0	na	
Gross fixed capital formation	21,5	10,2	2,8	12,8	12,6	10,6	17,7	20,8	10,5	-6,0
Exports of goods and services	9,4	4,2	10,3	12,5	11,8	6,5	7,3	6,4	5,5	-5,5
Imports of goods and services	31,5	18,7	14,6	17,7	23,3	16,6	21,9	27,3	22,0	-11,0
Industrial gross output	11,9	4,9	3,7	7,0	7,3	4,0	6,3	6,3	4,5	
Agricultural gross output	7,7	7,5	1,5	5,5	3,0	1,1	3,6	3,1	10,0	
Employment										
Unemployment (end-year)	10,2	8,9	8,5	7,8	7,9	7,1	6,7	5,6	na	
Prices and wages										
Consumer prices (end-year)	20,1	18,6	15,0	12,0	11,7	10,9	9,0	9,0	13,5	
Gross average monthly earnings in economy (annual average)	39,2	47,3	36,7	24,4	24,0	25,3	25,4	25,0	na	
Government sector[1]										
General government balance	3,2	2,7	0,6	1,4	4,9	8,1	8,4	5,1	6,9	-0,8
General government expenditure	33,7	34,6	37,1	35,7	33,6	31,5	31,2	33,0	na	
General government debt	62,5	48,2	41,4	32,4	25,9	16,5	10,6	9,5	3,0	
Monetary sector										
Broad money (M2, end-year)	63,8	39,7	32,4	50,5	35,8	38,5	48,8	47,5	20,0	5,0
External sector										
Current account	46.839,0	33.934,0	29.116,0	35.410,0	59.514,0	84.443,0	94.300,0	78.309,0	104,0	-23,0
Trade balance	60.171,0	48.120,0	46.335,0	60.493,0	85.825,0	118.497,0	139.208,0	132.044,0	238,0	11,0
Merchandise exports	105.033,0	101.884,0	107.301,0	135.929,0	183.207,0	243.800,0	303.900,0	355.465,0	493,0	334,0
Merchandise imports	44.862,0	53.764,0	60.966,0	75.436,0	97.382,0	125.303,0	164.692,0	223.421,0	306,0	321,0
International reserves, excluding gold (end-year)	24.264,3	32.542,4	44.053,6	73.175,0	120.809,0	175.891,0	295.568,0	465.878,0	429,0	326,0
External debt stock	160.027,0	151.122,0	169.900,0	199.400,0	225.000,0	257.200,0	310.600,0	464.000,0	520,0	490,0
Memorandum items										
Population (end-year, million)	145,2	144,4	145,0	144,2	143,5	142,8	142,2	142,2	142,0	142,0
GDP (in billions of roubles)	7.305,6	8.943,6	10.817,5	13.201,1	16.778,8	21.665,0	26.882,9	32.988,6	41.256,1	
GDP per capita (in US dollars)	1.788,7	2.123,4	2.379,6	2.983,0	4.059,0	5.361,4	6.977,6	9.062,0	12.585,0	10.380
Share of industry in GDP (in per cent)	na	na	24,9	24,1	27,5	28,8	27,9	28,0	na	
Share of agriculture in GDP (in per cent)	6,4	6,8	6,0	6,0	5,4	4,8	4,3	4,1	na	
Current account/GDP (in per cent)	18,0	11,1	8,4	8,2	10,2	11,0	9,5	5,9	5,9	-1,5
External debt - reserves (in US$ million)	135.762,7	118.579,6	125.846,4	126.225,0	104.191,0	81.309,0	15.032,0	-1.878,0	na	
External debt/GDP (in per cent)	61,6	49,3	49,2	46,4	38,6	33,6	31,3	36,0	29,6	32,9
External debt/exports of goods and services (in per cent)	139,6	133,4	140,5	131,2	110,6	95,7	92,8	118,5	na	

Source: EBRD, JP Morgan and UBS.