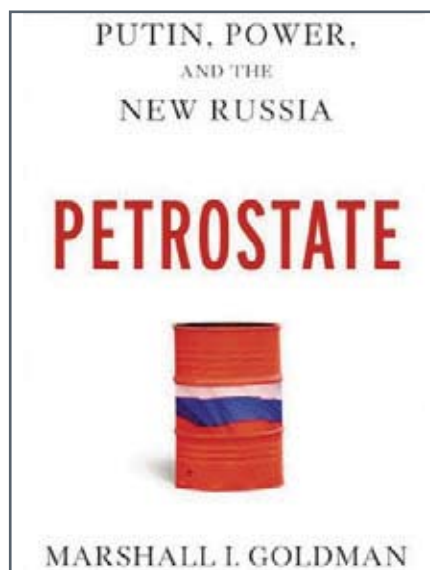


# Beyond the Reset, the Trend toward a New Russian Investment Climate

Art Franczek

In *Petrostate*, Marshall Goldman tells the story of the oil industry in Russia and how the country became an energy superpower. In 1898 Russia was the world's leading producer of oil. Throughout the Soviet period, oil exports were the primary source of the hard currency that was so vital to the Soviet state. Goldman even speculates that in the 1980s the CIA conspired with Saudi Arabia to reduce the price of oil to sabotage the Soviet Union. Coincidentally, the price of oil, which was \$35 per barrel in 1980, fell to \$15 by the late 1980s. The 1998 financial crash was precipitated by a decline to \$10 per barrel. The most recent Russian crisis was largely the result of the fall in the price of oil from \$147 to \$35 per barrel. Russia's economy has always been dependent on oil exports and this is its core problem.

In the 1990s, control of many of Russia's natural resource enterprises was handed over to a group of oligarchs in the Loans for Shares program, under which ownership of Yukos, Sibneft, Norlisk and other companies was given for loans provided to the government. In addition, Profit Sharing Agreements were entered into with Exxon, Shell and other Western oil companies. In many



instances these agreements were not favourable to Russia.

Putin's accession to the presidency coincided with the rise of oil prices and a subsequent economic boom that saw Russian GDP grow annually by 7%. Putin's governing philosophy was largely based on his 1997 PhD thesis "Strategic Planning of the Renewal of Mineral Raw Materials in the Growth Strategy of the Russian Economy". During the next 8 years the share of oil production controlled by the government increased from 16% to

50% reflecting the re-nationalization of such companies as Yukos and Sibneft. State control of oil companies is normal practice in such countries as Mexico, Saudi Arabia, Venezuela, particularly when the price is rising.

While Russia was on the ascendency as an Oil Power, the United States was encouraging democratic movements in Georgia and the Ukraine, and inviting these countries to join NATO. Also, the US announced that it would build Missile Defence Systems in Poland and the Czech Republic; these systems seemed to be directed at Russia. These US actions were perceived as a threat to Russia and provoked what has been called the "Chilly War". During this period trade relations between the US and Russia were tense and the "neo-cons" in the Bush Administration disregarded Russia's interests.

The Obama administration's "Reset" policy quickly transformed the Russian/US relationship. In March of 2009 the US determined that the missile systems were expensive and did not provide real security. Georgia and Ukraine's membership of NATO was no longer considered a priority. Russia responded by providing the US with some assistance in Afghanistan, signing the SALT renewal and supporting the US in enforcing sanctions against Iran. The fact that the Reset Strategy is working on the diplomatic front set the stage for enhanced economic relations between the US and Russia.

Russia's 17-year WTO (World Trade Organisation) accession process has been beset with vicissitudes. In the early years of this century WTO entry was a priority and many reforms such as the Customs Code and IPR reform were enacted. In 2006 the accession process was almost completed in time for Putin's G8 Summit in St. Petersburg.

In 2008 the chances for WTO accession suddenly looked much worse because of the Georgia conflict. In 2009 the accession process seemed to die when it was announced that Russia would apply to the WTO as part of a customs union with Kazakhstan and Belarus. After the July Summit, Medvedev announced that Russia would apply to WTO as a separate country (not with the customs union) and he thought the process could be completed by September 30, 2010.

The World Bank estimates that Russia's accession to the WTO could increase GDP by 3% in the medium term and as much as 11% in the long term. Russian businesses



An aerial view of the Skolkovo development area

will have improved access to services of multinational service providers in telecommunications, banking, insurance, transportation and other business services. This should lower the cost of doing business and increase productivity. In addition the investment climate for foreign investment will be greatly enhanced.

Once in the WTO Russian industries will have to modernize quickly or face the consequences. Overall, tariffs will come down from 10.1% on average to 7.1% seven years after joining. Liberals on Medvedev's team see WTO membership as critical to economic modernization. Statists like Sakhem, along with Deripaska and other oligarchs who benefit from lack of foreign competition, generally oppose Russia's global integration.

Russia is very close to completing the WTO accession process but a number of issues must be completed before it becomes a WTO member some of the open issues are:

**Protectionist Tariffs:** Russia must reduce its tariffs on automobiles and heavy equipment

**Agree on Sanitary and Phytosanitary Standards:** this is important for US exporters of chicken and pork

**Protecting Pharmaceutical Test Data:** legislation must protect this data for 6 years

**State Run Companies:** Russia must guarantee that they will be treated the same as commercial firms

**Pass ex-officio legislation:** this will provide customs official with the power to stop fake goods

On January 1 2010, the first stage of

the customs union between Kazakhstan, Belarus and Russia came into effect, establishing an area in which free movement is provided for goods either originating from its territory or imported from third countries that have entered into free circulation. The first stage of the customs union harmonizes tariffs on over 11500 goods among the participating countries. The Customs Union Customs Code was implemented on July 1, 2010.

This is the first stage what will become a Common Economic Space by 2012. The CES will be comparable to the European Union and will allow for free movement of goods, services, capital and labour. The process of economic integration will be complex and has already resulted in delays of goods at the new borders.

However, after 5 years the GDP of this region is expected to increase by 15% and many investment opportunities in manufacturing, assembly and other areas will emerge for multinational companies. It is likely that other countries such as Ukraine may be invited to join what has been referred to as the "Soviet Reunion".

Innovation and Modernization have become buzzwords for the Medvedev/Putin administration. This is no surprise because Russia spends about 1.5% of its GDP on Information Technology while the US spends about 3% of its much larger GDP. In March, Arkady Dvorkovich and other leading Russians attended a seminar at MIT on innovation. In June, President Medvedev and his entourage visited Silicon Valley and met Steve Jobs

of Apple, John Chambers of Cisco, Sergey Brin of Google and others to experience innovation for himself.

These activities set the stage for the big announcement of Russia's Silicon Valley. Over the next three years, the government will build offices, apartments and laboratories at the Skolkovo Innovation Centre. Victor Vekselsberg the Centre's Director invites innovators to "Come, live, create and do good for yourself, Russia and the whole of civilization."

So far Cisco Systems is planning to invest a billion dollars there, and Nokia has promised to invest in this project.

Businesses that set up at Skolkovo will receive cheap rents, a 10-year exemption from income tax, lower social security payments, reduced customs duties and minimal bureaucracy. In exchange, tenants will be expected to develop new technologies for the country and to sell to the rest of the world.

It is hoped that the Skolkovo innovators takes a look at India and its development of techno-austerity. They have developed the Nano, a car that sells for \$2,200, and a \$70 fridge among other innovations aimed at the frugal. It is my hope that Skolkovo understands the wisdom: "Frugality is the mother of Invention."

Recently, Russia announced it would sell non-controlling shares in some state companies to raise \$29 billion. Aleksei Kudrin strongly emphasized that these asset sales would be transparent and at fair value, in contrast to the Loans for Shares giveaway in the mid-1990s. Companies such as Rosneft, Sberbank, VTB and others will offer shares to foreign investors.

This "re-privatization" reverses the trend toward state ownership that occurred in the first part of this century. These asset sales may provide an incentive for the Russian government to improve property rights and corporate governance so that these assets can be sold to investors.

Doing business in Russia is not easy. Russia ranks 120th out of 180 countries in the World Bank Survey for ease of commercial operation and many critics claim that it will never improve. I have just described a few of the concrete steps Russia is taking to integrate itself into the world economy and move away from its dependence on oil. Medvedev referred to recent events between Russia, US as a "paradigm shift" in which common goals could be pursued and Russia could fulfil its need for "modernization alliances". **P**