

RUSSIA: PROSPECTS FOR ECONOMIC RENEWAL

A U.S.–Russian Business Dialogue on New Forms of Economic Partnership



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A Policy Forum presented by the Committee for Economic Development and The EastWest Institute

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The United States has a critical interest in Russia's stability, in its economic success, and its eventual transition into a market-oriented democracy. The circumstances in which the Russian economy finds itself today should only heighten this interest.

Russia faces enormous challenges, but its economy is rebounding and continues to move in a market-oriented direction. New political leadership offers real opportunities as well as uncertainties.

Much of what happens in the Russian economy in the coming years will be determined by business — Russian and international — far more than by government policies. In light of the growing importance of business investment in shaping the Russian economy, CED and The EastWest Institute conducted this in-depth and inside look at the state of emerging capitalism in Russia and on future directions in U.S.-Russian relations.

This publication contains highlights of the remarks by the Forum's participants:

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CHARLES KOLB

President

**Committee for Economic
Development**

The Committee for Economic Development is an organization of American business leaders. For over 50 years, CED has been a vehicle for American business to have a voice in guiding U.S. public policy — not only on trade and international issues, but on the broader economic and social policies that shape the environment in which we work and the communities in which we live.

CED Trustees have always believed that it is important for the business perspective to be heard when governments determine their international economic and trade policies. Through CED's policy statements and through the network of counterpart organizations we have in Europe, Japan, and Australia, CED has been especially effective in bringing a business voice to bear when critical policy decisions are

being made and when the United States needs to stake out its position on key international agreements.

This Forum is an effort to focus on the role of the business community in ensuring Russia's economic success. Rather than debate "Who Lost Russia?," our focus is on the role that the American and Russian business communities can play in fostering stability, economic growth, and the rule of law in Russia.

We are pleased to be working with the EastWest Institute on this effort. The mission of the EastWest Institute is to help defuse tensions and conflicts that threaten world stability while building democracy, free enterprise, and prosperity in Central and Eastern Europe, Russia, and the states of Eurasia.

We are especially grateful to CED Trustee George F. Russell, Jr., Chairman of the Frank Russell Company and a Board member of the EastWest Institute, for bringing our two organizations together.

Vladimir Putin and his cabinet face an economy that has severely struggled since the end of communism. Their "free market" system is wrestling with corruption and crime and challenges to the rule of law.

A great deal will be riding on Russia's new administration and whether they have the political muscle to implement reforms and attract for-

eign investment. There is enormous potential in Russia, and investors need to know there is stability. That is why CED has co-sponsored today's panel discussion.

ROBERT LEGVOLD

*Professor of Political
Science*

Columbia University

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There are enormous historical changes taking place in Russia and the other post-Soviet states on a scale that we have not seen in the modern age.

That leads to two basic propositions. The first one is that the challenges that Russia faces today are larger than the capacities of their leadership. They are challenges that no leader or group of leaders, however skilled, however talented, will be able to resolve in short order. Therefore, while "Putinology" is fascinating, it really is quite secondary.

The second proposition is that Russia's underlying problems are an enormously tangled knot. They have been accumulating in an incremental fashion over more than ten years now, going back to the Soviet period.

That means that if Russia is to succeed, almost certainly it will be as a result of incremental progress, not as a result of a grand dénouement produced by a successful macroeconomic and political strategy that Putin may lay out in the first hundred days of his administration.

The challenges he faces at home, and particularly in the economic realm, are deep and structural.

The first obstacle is sustainable growth. Sustainable growth is very different from the growth we are seeing at the moment in Russia. The second obstacle and challenge on the internal side in Russia is to achieve economic reform that sticks, that becomes institutionalized, and that makes a difference.

When we speak of our expectations for Putin, we talk about things like reducing the tax burden and rationalizing the tax code, strengthening property rights, carrying out land reform, redoing the pension system within the country. If the challenge is reduced to this level — rationalizing a tax system, pursuing land reform and the like — and these are then addressed with the partial and the half measures that most certainly will be the product of the current political milieu, then I think little will have been done to meet the underlying challenges. There is a danger that one will grow comfortable with half measures because of what

I call premature optimism about Russia having already turned the corner.

Much rhetoric lately has been focused on 3½ percent growth over the past year, last year's 8 percent industrial growth, and 12 percent industrial growth in the first quarter of this year, with a prospect now that even exports will begin to grow after having been flat last year.

This is not sustainable growth. It doesn't yet demonstrate that Russia has tackled the underlying problems. Nor has it achieved an economic miracle the way its escape from the August 1998 financial crisis is sometimes characterized, because this was due to \$30-a-barrel oil, which was a happy fortuity, together with the benefit of a six-fold devaluation of the ruble that created a powerful impulse to domestic manufacturing. Everyone who deals with Russia knows what is behind the 3½ percent growth.

What many don't know, is that this was growth that was achieved through continuing important subsidization and production within Russia. In 1998, domestic producers paid 80 percent of world-market prices for oil. In 1999, they paid 20 percent of world prices for oil. There were comparable subsidies built into what producers paid in 1999 for electricity. The same thing was true with regard to their labor costs. The decrease was two times the

amount the previous year. Now, labor prices are rising within Russia.

The problem is that as one grows comfortable with subsidization, it will further rationalize the half measures that are taken.

One of the themes of Putin's reform agenda is that the state is too large and should be cut back. Last year, 93,000 new employees went to work for the Russian state. Rather than getting smaller, the Russian state is something like 35 to 40 percent larger today than it was when the Soviet Union collapsed. Nothing good will happen until that is cut back in some fashion.

There are two risks when talking about cutting the state back. The first is that it will be driven largely by a single economic theory — that we need to cut costs. We have seen the result of mechanical theories applied to political and economic reform in Russia and they have played a large role in the fix Russia finds itself in today.

The problem of dealing with the state in Russia today may be parallel to the problem of dealing with the Russian military. One of the reasons why military reform in Russia has failed is precisely because they haven't had the money to carry it out. Reforming the state is also something that is going to require a certain amount of money, not merely cost cutting.

Second, there needs to be a point to scaling back the state. It is fine to deregulate the economy by reducing state interference. But if the tax reforms are simply taken in terms of reducing the tax burden, then a reduction really only affects the taxes that are not being paid— that is, it will be a reduction in what might be called virtual taxes. And if the cuts in state spending are cuts in those benefits that have never been paid, which is the other portion of the virtual social economy in this context, then you are going to get very little effect. Arkadiy Drakhovich, who is in charge of this part of the plan has confessed that the real reduction in the tax burden is likely to be 3 percent of GDP rather than a more substantial cut of the 40 percent the tax burden currently represents, a portion of which is in virtual taxes.

Internally, Putin has to focus on three areas. First, he has to attack the core of what some have called the virtual economy. That is, the industrial core, which is not salvageable – the industrial core which is value-destroying. That can only be done with meaningful bankruptcy procedures, which in turn, can only be done if the regime is prepared to see an important portion of the economy transformed by going under. And as the IMF has emphasized, it is critical to ensure that there is an adequate social safety net

or provisions made if, in fact, the Russians do become serious about allowing nonviable industry to go under.

The second part is meaningful banking reform — reform that will produce a viable commercial banking sector. Direct foreign investment is not soon going to return to Russia. This is a country that, after ten years of independence, has a level of direct foreign investment which is the equal of Peru. That is not going to change in the near term. Direct foreign investment went up last year from \$2.8 billion in 1998 to \$2.9 billion in 1999. But this will not be the solution. In fact, you will sooner see the domestic capital flight to Cyprus and the coast of Spain and elsewhere return when things are done properly in Russia than you will other direct foreign investment.

Therefore, I see a viable commercial banking system as absolutely essential for tapping what internal capital resources there are, and getting them to potentially productive enterprises. Foreign banks must be allowed to come in and create a much more competitive and efficient modernized banking sector.

The third item is introducing competition into the state monopolies. It is unlikely that the three great state monopolies — Gazrom, RAO UES, and the state railway system — will be broken up. It isn't going to happen.

But I think the leadership is weighing the idea of trying to introduce some competition into these sectors. I think it is likely to happen with Gazprom soonest. It may be to allow the oil companies to use the Gazprom-owned pipe system. That would be useful. But this is only the beginning of a process of transforming what is the value-destroying segment of the economy, and that is to begin trimming the effects of the state monopolies by introducing competition.

The most important task that Putin faces, however, is not *strengthening* the Russian state, but *normalizing* the Russian state. That is, reacquiring sufficient control over all levels of government so that the state can perform for the public good or for the common good the critical tasks that states need to perform.

It is not clear that Putin and the people around him think in these terms. He has spoken a good deal about strengthening the Russian state. It often appears that when he talks about it he means the power of the Russian state, even in some ways the prestige of the Soviet state, certainly in terms of the credibility of the Russian state with its citizens and foreign governments. And he has spoken often in terms of law and order. That is a very different thing from speaking about a state strengthened by strengthening constitutionalism; a state that operates under

the rule of law. Putin has an enormous commitment to law-abiding behavior, but I think his commitment to law-abiding behavior is that of a middle-level bureaucrat who understands the way in which people are supposed to obey and abide by existing rules. But the extent to which you would normalize the state by undoing the privatization by creating a genuine rule of law — that we would recognize as congenial to the effective operation of a state — it is not clear that he understands it in those terms.

Whether he understands that strengthening, that is, normalizing the Russian state means “de-privatizing” it is another matter. For the Russian state has, indeed, been privatized — that is, every level of government, from the cop on the beat to senior levels of ministries has been subordinated to the private interests of the officials who occupy these posts.

He does, however, mean to strengthen the state. The first and most important step he has taken to this point is to create seven regional administrations. It may be a step forward if Putin understands that, for government to work, for the state to work, you have to have a rationalized relationship between the center and the regions. That doesn't mean necessarily centralizing it, putting it back in the control of Moscow, but it does mean an effective division of labor among different levels of government.

He is not wrong to say that the situation is untenable if, according to his figures, 20,000 laws have been instituted by government at a lower level that are inconsistent with the federal constitution. Something has to be done to rationalize the relationship between procedures in local fiefdoms, as they are now often called, and the operation of the federal government.

Alas, I suspect the reason most of the governors, including those who have operated their own fiefdoms appear not to be upset with this new measure is that they see it as a chance to get the local presidential representatives, who until now have been overseeing their work, off their backs and out of their locales.

Turning to the external dimension, Russia has to let its foreign policy agenda be driven by its domestic agenda. That domestic agenda is overwhelmingly economic, which means that Russia's focus has to be on a new and changed international environment that is overwhelmingly economic, including the globalized international economic and political order. This will not lead Russia to embrace liberal internationalism or a new economic Wilsonianism. Russia will continue in all likelihood to pursue a hard-headed, carrot-and-stick policy, especially with their immediate neighbors.

The U.S.-Russian relationship has deteriorated to the point where it will be extraordinarily difficult for the United States to exercise leadership in developing a constructive relationship with Russia even if Russia's domestic picture does turn around. I think the United States is in the process of disengaging from Russia, not of engaging Russia. It is in fact walking away from the problem. Most of the U.S. leadership whether in Congress or in a new American administration will not revive a serious or ambitious approach to the Russian challenge. We will continue to look for reasons to ignore or downplay the significance of Russian events and Russian concerns.

The outstanding illustration of that will be the way in which we handle key arms-control issues like the national missile defense and the potential threat that it represents to the ABM regime. Such is only the tip of the iceberg. It is symptomatic of what is a general approach at this point: Namely that we alone will decide unilaterally what serves our security. If that is not compatible with enhancing some level of cooperation with Russia, so be it. The presumption behind that is that we can afford it because what happens in Russia or, for that matter, in this part of the world, even if it is for ill, is tolerable. I think this is an enormous mistake.

PANEL 1 — RUSSIA

*Challenges to Economic
Development
and Integration in
the World Economy
after Yeltsin*

MODERATOR:

GEORGE F. RUSSELL, JR.

Chairman

Frank Russell Company

I think Professor Legvold's talk was fascinating. I for one have been proposing that Russia join NATO as a means to further engage that country.

Our first panel is focused on investment in Russia's private sector. I notice that President Putin's six points, delivered on December 28, 1999, were as follows:

1. *A multipolar world*
2. *Global security*
3. *Nonproliferation and control of nuclear and conventional weapons*
4. *Prevention of regional conflicts*
5. *International peace keeping*
6. *Integration into the global economy*

If you accept this list, the world will be a safer place, and Russia will become a competitive player on the world's economic stage.

PETER CHAROW

Executive Vice President

The EastWest Institute

Russia has taken on the appearance of a market economy, especially when you look at it from the outside. Much of the reform effort, however, has been focused on stabilizing the domestic economy and attracting domestic and inbound foreign investment. This means that Russia's integration into the global economy is at best at a somewhat early stage, characterized primarily by the trading of commodities coming out of Russia for finished goods coming into Russia, capital outflows (including flight capital) and foreign direct investment.

There has been very little in terms of real foreign capital investment in Russian enterprises. There has been almost no Russian capital investment from outside Russia. In terms of cooperation between Russian enterprises or corporations and multinational corporations outside of Russia, we also have

seen very little activity. So the question of Russia's integration into the global economy is still very much unanswered.

For serious foreign investors trying to operate in a Western investment environment, Russia is an extremely difficult operating environment at this time. Although it appears to have a capitalistic system, it doesn't really function the way Western capitalism functions. This is because the whole process has been a revolution from above, rather than an organic development.

Russia has always been ruled by individuals rather than governed by laws. As a result, although there are laws in place which look clear and seem to be implemented and supported by the legal system, that is not always the case.

We have this view in the United States, which is supported by our legislative system, that corporations function for the benefit of shareholders. In Russia, you often run into a situation — even though this is changing — where managers look at you as a shareholder and say, "This is my factory, this is my enterprise. Don't tell me what to do. I have been running this place for 20 years or for 25 years. I know what is best for the company, I know what is best for my workers, I know what is best for my community."

There is also lack of distinction between the state and the private

sector. One element of this is private property. In Russia there is a very hazy distinction between what is private property and what is state property, or maybe, more accurately, there is property which is private, but which the state can use whenever it decides that it wants to do so.

An example is when BP Amoco went through a very difficult bankruptcy battle. Admittedly, there were people in BP who were not familiar with the Russian legal system. Yet we brought between 75 and 100 legal actions in Russian courts, both in the outlying regions and in Moscow itself. And all but one were decided against us.

The one decision that was taken in our favor was taken on a Friday afternoon by the Supreme Court in Moscow. Over the weekend, two Russian officials flew in and met with the judge. On Monday, he overturned his decision without any comment.

This hazy distinction between the state and private sectors leads to a lot of insider dealings. It also leads inevitably to corruption, because everyone is working very hard to try to influence the decisions before they are made. When you have a huge bureaucracy which is very eager to intervene in the markets, then it creates untold opportunities for corruption, and in some respects it serves to validate the corruption.

Markets, like democracies, are based on the ability of participants to reach compromise. In Russia, historically, the phrase has usually been not “win-win,” but “who-whom.” This means, who will be the winner and who will be the loser.

There is a very deeply rooted lack of trust in Russia. By trust, I mean individuals distrust the government, the government distrusts individuals, and individuals distrust one another, other than members of their own clan. I don’t know exactly what it takes to get over all these years of deeply rooted suspicion in the society, but without a fundamental level of trust between actors in the economy, it becomes very difficult to conclude transactions and certainly complicates them. Trade deals are not so difficult because they are one-shot types of transactions which can be concluded simply, but long-term investment, and long-term cooperation, are very difficult if you have this deeply-rooted suspicion and lack of trust in the society.

In terms of values, what I ran into quite consistently over the past few years in Russia is the question: Should there be one set of rules in Russia and another set of rules outside of Russia? Obviously, Western companies coming into Russia and trying to do business there are at a huge competitive disadvantage. You simply don’t have the level of connections, you don’t under-

stand the system, you don’t understand the culture, and often you don’t speak the language. That is a normal competitive disadvantage with which you have to deal.

The West, however is not entirely blameless in dealing with this. Many Western business executives have said to me, “If you are going to succeed in Russia, you have to play by the Russian rules.” People have come to me and said, “I’ve been dealing in emerging markets all around the world, and if you are trying to apply Western standards in emerging markets, you might as well give up and walk away.”

If that is the position you come in with, then you have already lost the game. In the long run you can’t use one set of rules inside Russia and another set of rules outside it. Another conclusion we might draw from this is that maybe it is time to think about redirecting some of our resources from pushing structural reform to addressing some of the issues of cultural values in Russia. If Russia views itself as transforming into a market economy and integrating itself into a global economy, then this dissonance of values has to be addressed somehow. It can be done in a positive and constructive manner, without challenging the cultural heritage of what has obviously been a very successful and great nation over the years.

Lastly, we need to stop standing on the outside and preaching to Russians about what they should do to their country. What we need to try to do instead is to help develop domestic coalitions for reform, based on a set of values which will support the type of market system that the Russians themselves want to achieve.

There is a new breed of Russian managers and business owners who are very interested in running their businesses the way businesses are run in the West, who are very interested in cooperating with multinational corporations and small to medium enterprises in the West, and who are very interested in spreading beyond the borders of Russia and are willing to accept the consequences that all of this entails.

We need to be reaching out to and embracing these elements of society in Russia. We need to be supporting them in what they are trying to do. We need to help them understand how to form associations, nonprofit organizations, groupings, and affiliations that can have an influence on the political process. In one word, we need to help them pursue their own agenda.

SCOTT BLACKLIN

President

**American Chamber of
Commerce in Russia**

It is an exciting time for us, as businessmen and women, on what we like to consider to be the front lines in Russia. It has not been an enviable place to be for the last two years or more. Russia has been recovering from the implosion of its economy from August of 1998 and, arguably, the period of paralysis extended even further back in time.

Part of conducting a business is having a global strategy. If you are to have a global strategy, it cannot ignore Russia. For the last two years, many companies have been able to ignore Russia. Russia is paralyzed. They think nothing good is happening, therefore we don't have to look at it. Effective December 31, 1999, that formula changed. It began to change slowly at first and now it is suddenly picking up momentum.

One of the things that we are seeing is the access to the decision-makers. We have never experienced this, where the Russian government, the think-tanks around the new government, are so open to the new ideas of reform. But, moreover, these are not our ideas. The striking difference is that these are their ideas. No longer do we have to talk to the Russians about the building blocks of lawmaking or a pluralistic economy. Many of these people know and believe it. So the significant change that we have seen is that the Russians are taking ownership of their own agenda. They are not waiting for tips, hints, pushes, shoves, other types of incentives or disincentives from us.

They do look for engagement, they do look for understanding, they do look for support, as they continue to unravel a very complicated organizational revolution. So, point number one is that the change is real.

Russians themselves are redefining things. Traditionally, the Russians have always looked at power in terms of political and military muscle and the kind of bully potential that it has associated with it. But increasingly we are seeing Russians who understand that Russian power is the creation of wealth. Russian power depends on the ability of that government to create and capture cash flows.

We have to be very careful. The Chamber has always been very aware of the fact that we know we are foreigners, and in the final analysis it will be the Russians who make the changes for themselves. We do however have a window in time through which we have an opportunity to redefine our relationships and, of course, influence events. We must continue to engage the Russian Federation. There are many, particularly on Capitol Hill, who do not embrace this idea of engagement, who would like to sit back and say, "You Russians have A, B, C, D, E, F, G to do; after you do it, then we will begin to talk and we will begin to feel you are real."

That view misses the point entirely. Because we all have a stake in these issues, the quality and the level of our engagement will play a key role in the success of Russia's reforms.

So I would say, from the business community, in the Russian Federation in this time of uncertain flux and uncertain duration, one thing is clear: it is imperative to maintain and even accelerate American cooperation and engagement with the Russian Federation.

BERNARD SUCHER

Troika Dialog

In the beginning of October 1998, I stood up in front of some of the world's most powerful investors to talk about Russian capital markets. What I told them was that, as bad as all this seemed to be — and it really did seem pretty bad — that things still seemed to be working. Unlike the banking system, the Russian capital markets still had a price mechanism. We were conducting business; we had experienced very few, if any, serious failures. Maybe nobody cared, but the thing still worked. To the extent that markets go through periods of extraordinary exuberance and panic, we could at least look forward to some adjustment, some swing back of the pendulum.

And now, two years later, obviously that is exactly what happened. So, by holding on by the skin of our teeth, when a lot of other folks were running away, that prediction proved to be pretty well made.

Russian capital markets came through a crisis that few people in business ever really have to endure — a 90 percent drop in prices, a 90 percent fall in people involved.

Over the last couple of years there has been a quiet, but definite upsurge of investment by Russians in their own markets. They have precious little to invest in regulated commercial instruments, and there is probably more going on in unregulated commercial paper than anything else in fixed income. But whether it is in equity or whether it is an investment by Russian companies in other Russian companies, that is daily bread for guys like us.

Russian capital responded to the crisis in Russian markets and the Russian economy by looking for opportunity. We are talking about small numbers, but in the almost complete absence of Western interest, Russians detected opportunity. Equity markets jumped up six times from the bottom in that short period of time, enabling some people to make a lot of money.

We have seen Russian companies focusing and developing their businesses with an eye to capital markets. Russian managers are keenly aware of the opportunities and the rewards of realizing standards set by the world.

That focus by Russian managers in building their businesses and looking for opportunities to grow with the help

of outside investors is one of the key driving forces that makes us optimistic about doing business in Russian capital markets.

In this time of crisis, we have made big improvements in the actual mechanics of business. Now that volumes are rapidly growing again, we are handling it. We have a marketplace that looks much more like the 21st century than the one we had a couple of years ago.

Our new corporate governance bogie is creative uses of accounting, people figuring out how to make their income statement and their balance sheet look good, but not necessarily serving your interests as an outside shareholder. That may not be everybody's dream of an ideal corporate governance environment, but it looks like progress. We care about dividend collection now. We are talking about small signs that we are moving somewhere.

On a lot of levels we have come up to the standards, not of the world, but of a normal emerging market. Russian capital markets or emerging markets a few years ago were a pre-market, a proto-market. I think we are in the emerging-market category now.

On the equity side, there is a lot of attention about rapidly developing markets for new technology shares. It is possible that with a lot of work, we

can have a new issues market for promising young Russian companies.

I question how many promising young Russian companies there are at that stage of development and whether they ought to have access to capital markets and whether investors are going to risk their money on another bubble. But the fact that we are able to focus on our new issues is startling.

Finally, electronic commerce technology and innovation in stock markets in the West are impacting Russia. All across Europe, in particular, we see the emergence of pan-national exchanges. These people are interested in trying to embrace Russia as part of these exchanges.

People want to include Russian shares in their international exchanges. We will be there; probably as a small participant. But folks will be trading, from their offices in London, Russian shares just as there is trading for European shares. Those kinds of alliances are going to make us move much faster.

ALEKSANDR V. SURIKOV

Economic Senior Counselor

**Embassy of the Russian
Federation**

I agree with my colleagues that the challenges which Russia faces now are quite big. And it is clear that the changes that have taken place in this year as well as in previous years have not been sufficient to guarantee the sustainable growth of the economy.

But please do not miss the basic condition that for years, Russia has been functioning in the same way as the United States or Europe. It was a period of radical transformation.

Now the situation is different. Maybe it is premature to say that Russia has turned the corner, but in some respects it has. We have turned enormous corners to change the former Soviet communist regime toward a democratic market society.

I cannot agree that the rule of law does not exist in Russia. Now we do have courts that really play an impor-

tant role in economic life. Hundreds of court decisions were taken in these years preserving the rights of the shareholders. Russian courts, step by step, are implementing new laws, laws of a market economy. In Russia, we have completely changed the laws regarding the functioning of the market infrastructure. During the past ten years of Russian history, we have compressed the history of centuries in other countries.

It is natural that in these years of change, the young market economy in my country has not always pleased foreign businessmen. It is understandable that the legal and moral basis of the society we are aiming for is not yet stable and is not what you in the West would want it to be.

Our society's poverty still doesn't permit us to guarantee sustainable growth. All that is clear. But it is obvious too that in the last year, we have dramatically changed the situation, achieved real economic growth. Maybe it is not sufficient, but still 3.5 percent growth in our GDP in 1999 is something. Twelve percent industrial growth in the first quarter of this year; 8 percent in the first quarter of last year. It is real industrial growth.

The growth was supported by oil prices, but oil companies only give 10 percent of Russian tax revenues. At the same time, when prices for oil were high, the prices for other raw materials

were down substantially. And Russia is dependent not only on oil, but other raw materials and other productions. Not every one of them is in a good position just now.

There was devaluation of the ruble, and it contributed to growth as well. But the most important change is that after so many years of dramatic reforms, for the first time we are facing real economic growth. The dramatic change is that the people, for the first time, see hope and are feeling the changes of the previous years improving their life.

We have entered a new period of political stability in Russia. Both the President and the government are unanimous on future economic and political development of the country. Some people say that Mr. Putin is not enacting quick economic reform, but do you want such kind of fast actions immediately after he came to power? For so many years, many of you have spoken to us, saying "Your society is unstable, everything is changing, we do not understand what is happening."

I would think that we need no dramatic changes just now. Let them think twice or several times before doing something. The actions of President Putin show the Russian government quite well understands the necessary measures, the structural measures, the moral changes which we have to introduce to our political life,

to our society. Step by step, these changes will be introduced.

The government understands the necessity of improving the investment climate of the country, improving the shareholders' rights, improving the functioning of the laws and the laws' execution, commercial laws, and execution of the decisions. There are plans for reform in the banking system, in the system of the execution of the law of the country, in the collection of tax, and in the land reform.

Many people have spoken of the need to strengthen the authority of the government. I can assure you the Russian government understands it.

As to the proposal to reduce Russian political ambitions to the level of the present GDP level, I will disagree with it. The geographic, historical, and intellectual potential in my country, all the history, will not permit us to abstain from the idea of being an equal international player in the political arena with other major players. Now nobody is speaking just now about renewing the empire era, but in the future who will think that Russia only has to focus on its own problems, on its own necessities, on its own situation? We are and will be one of the big powers in the world. I think it is these factors which should encourage business people to come, to invest, and to participate more actively in the new Russian history.

PANEL 2 — THE U.S. ROLE

What can U.S. business and the U.S. government do to help Russia rebuild?

MODERATOR:

JOHN R. PRICE

Managing Director

Chase Manhattan Corporation

I have recently come back from two weeks in China and I have been thinking about ways in which China and Russia relate and differ in their approaches to development. From past trips to Russia, I have picked up from many people that there is envy, in a way, about how China has approached its move to a market economy. I am not sure that the envy and the nostalgia that some Russians feel in looking at China is merited.

True, China has attracted \$35 billion in direct foreign investment in the last five years, in Shanghai alone. And the rate of flows into China of FDI averaged between \$35 and \$40 billion a year, compared to what we heard today of about \$2.8 to \$2.9 billion into Russia. However, the Russians do not have vast numbers of overseas expatriate investors as does China. They don't have the Taiwanese investors. They don't have those from Singapore and

Southeast Asia, and they don't have the Vancouver Chinese. So you start with a very different template in looking at foreign direct investment in Russia.

We often talk about flight capital with respect to Russia. But few people realize that there is flight capital from China as well. In fact, it was estimated to be about \$20 billion last year going out of China. Not all Chinese nationals are convinced that the road will be smooth enough for them to keep all their assets at home.

Our panelists are knowledgeable about the Russian environment and we look forward to their presentations.

EUGENE LAWSON

President

U.S.-Russia Business Council

There are many developments that make us feel better these days about Russia. First, the results of the Duma election last December indicate that if the executive branch were to promote a reform agenda — and we will see shortly — there is obviously a clear working majority that can produce legislative success for Mr. Putin. The vote

on the Comprehensive Test Ban Treaty is indicative of this.

Second, the Comprehensive Test Ban Treaty was adopted 355 to 55. Those are perfect examples of this. However, as was pointed out, 70 percent of the Duma is new, and that makes for a substantial learning curve in that very important branch.

Yeltsin's resignation ended a period of erratic leadership. One should remember that Russia is a super-presidential power, and without a strong and effective leader in the presidency, there can be no hope of meaningful systemic change.

Thirdly, the Russian economy is certainly improving. It has enjoyed 11 or 12 straight consecutive months of industrial growth.

Fourth, Mr. Putin's win without a runoff, coupled with the results of the Duma elections, may lead to a period of political stability in which business plans can be devised and, we think, executed. That would be certainly a wonderfully nice change from what we have had in the previous four or five or six years or so.

The advisers in the Putin camp also breathe confidence. Some of the legislative priorities that they described are most assuredly on the mark. Part 2 of the tax reform legislation is high up on the priority list.

The Putin team has utilized executive prerogative to institute a five-

fold increase in the deductibility of standard business expenses, such as advertising and training, which is really close to the heart of people doing business in Russia.

Those are some of the positive signs that we see today. However, The American Chamber of Commerce in Russia and the Council have an agenda of several issues on which we would like to see progress.

The first is tax reform and a better record of dealing with American companies to resolve the tax problems; second, strengthen the rule of law and especially investor protections; third, progress in intellectual property rights, which is crucial; fourth, the passage of a land code to help with the agricultural reform agenda; fifth, improving the banking system in Russia.

It is awfully hard to do business in Russia unless you have a credible banking system. The Ex-Im Bank, for all intents and purposes, is closed down. The statement at the bank was that the door is open but the window is closed.

My desire is to see the Ex-Im Bank have an open door to our exporters, clear policies, and a transparent mission for its Russia portfolio. Ex-Im Bank is a lender of last resort, but with Russia's current ratings we can't get a commercial lender to work with us. Russia's credit rating is very tough. Not very many of the big banks are going to lend money to Russia at the present

time. So for U.S. exporters to get the financing they need to do business in Russia, it is absolutely essential that they be able to access the Ex-Im Bank.

The more we work to strengthen commercial ties, the better our relations on all levels would be. In the end, the trade, commercial, economic ties, investment ties, will truly be the ties that will bind us together.

DOUG GARDNER

Partner

Arthur Andersen, Moscow

This year, Arthur Andersen will celebrate our tenth year in Russia. We now have over 600 partners and staff throughout the CIS. Most of those are in Russia, most of those are in Moscow.

It is important to operate properly in Russia from day one. Know the rules, know the laws, know the regulations, and comply with them. You may not like all of them. They may not be consistent with the laws that you are familiar with from the United States. But you are in Russia. If you go in and you try to play by their rules, that is, a lot of the unwritten rules, you will lose,

because you are ultimately an outsider.

Andersen had a large international client who had a tax inspector problem. The tax inspector knew this company made a lot of money and thought they would try to scare the management. And they scared them pretty good. They said that they knew a consulting firm that would make this problem go away for a fairly significant consulting fee. My client was ready to pay that. They did not want to tangle with the Russian tax authorities. But we advised them that it was absolutely the wrong thing to do. A very long story made short, they ultimately paid the consultant. Unfortunately, to this day they still have tax problems, because that tax inspector knows, OK, we got to these guys once, we will get to them again.

If we look at Andersen's experience in representing our clients in Russia, we have been very successful in defending their interests in tax protests.

When you come into Russia, plan properly and be flexible. I think the last few years have demonstrated you have to expect the unexpected in the Russian market. The August crisis, for many, many foreign companies, many American companies, drew a substantial loss. They lost staff, they lost assets, they lost market, they were very confused about what to do. Many

of those companies did not have a plan. Those plans must exist, I think, any time you go into an emerging market, but I think particularly in a market like Russia.

Develop local management and directors, and train, train, train your staff. Shortly after I got to Moscow in '94 and into early '95, we hit our peak of expatriates in our Russian practice. At that peak we were about 60 expatriates. Today we are operating with about 30, with two or three of those due to roll out this summer. None of those will be replaced. We now have six Russian partners in our firm, and essentially every single manager we have, to operate a professional services firm of over 600 staff, is a Russian citizen. We have no expatriate managers.

Get involved in the professional organizations. Use whatever lobbying capabilities you have available through the U.S. Government or through other organizations. That can be very powerful, and it will allow you to focus and get a consistent message through to the responsible individuals in the Russian structures, in the Russian government, in Russian commercial structures.

We do not accept bribes. Because if you do, you are going to corrupt your whole staff, and the only thing in our business, in the professional services business, is our people. They are really our only asset. We own some furniture

and we own some computers. But, at the end of the day, our people are our assets.

If we corrupt that by setting a bad example, I think we would be very sorry.

U.S. businesses should recognize that Russians are intelligent and proud individuals. It is the system that is corrupt. In the proper environment local managers flourish.

Russians core technical skills are world class. You couldn't get better mathematicians and some of the world's top computer programmers are Russian.

With the international community, and that includes Russia herself, we need to work to eliminate opportunities for corruption and capital flight. At the end of the day, the corruption issue is one of the top issues that has to be addressed. The Russian Government is concerned about it and they want their capital to stay at home. This is something where I think there is some common ground.

I would say legal reforms are absolutely the first thing that has to be done. Without legal reforms you can put all the taxation reforms you want in, but if the laws don't support you, if you can't find out who the owner is of a company, at the end of the day it is all a lot of wasted effort. You are not going to know who controls that capital, who controls that organization.

Second on the agenda would be the tax system. I believe most of the capital flight from Russia is largely driven by tax avoidance. We have to agree on a long-term strategy for cooperation with other Western countries and Russia herself. We must all agree on what the issues are and all focus on those. The preaching has got to end. There are very intelligent people on both sides of this question, both from the U.S. side and the Russian side, and I know we will get to the right answer.

JACK BROUGHER

Director

Russia and Independent States, U.S. Department of Commerce

Since Russia's independence, two U.S. administrations have operated under the presumption that one of the most important ways to help Russia is to assist in attracting investment and trade; that this is absolutely necessary for Russia's efforts to create a growing market economy.

I think a truism that has developed among many people working with Russia in the '90s is that one also has

to work at the grassroots, at the working level, and, to the extent one can, with the regions. We have many examples of this. I will mention just two interesting ones:

The first is a project that grew out of a conclusion drawn by business people on the West Coast that delays in Russian customs clearance constituted the single biggest barrier to business with the Russian Far East. After four and a half years of very intense discussion and work, we have reached the point where this project, which is called ClearPac, is clearing U.S. goods into Vladivostok and Sakhalin on a pilot basis and, we hope, will begin operations this year in two more ports, clearing goods in two days instead of the usual seven to ten.

When we are done, we will have a working model system for modern customs clearance that the Russian Government can adopt, if it wishes, to modernize customs clearance operations around Russia.

Many people do not know that U.S. Government officials played a key role in getting the Caspian Pipeline Consortium Project back on track after several years of delays. After simply sitting for several years without moving, this project is now under construction and will transport oil from fields in Kazakhstan through Russia and the Black Sea, and put Russia in a key role as a transit corridor for energy from

the Caspian area along with other corridors. U.S. Government officials played a key role in facilitating that, and I think that there are other constructive things that we could do together in the future if we can find a common approach.

There are also some government-to-government tools that have been successful. We have a U.S.-Russia trade agreement, with specific provisions covering basic intellectual property protection, which is going to be increasingly important as Russia attempts to compete internationally. There is a bilateral investment treaty with Russia signed by the United States and ratified by the U.S. Senate and the President, which is before the Russian Duma. It would provide some basic protections which, as Russia modernizes, would give U.S. investors a little more confidence.

Then there is the World Trade Organization. The WTO, of course, lays out a detailed blueprint by which Russia could prepare itself to participate in the world economy and, really, WTO membership is a necessity if a country wishes to be a major participant. Russia has to do some significant prioritizing in regards to what it thinks is most important for it to do first.

There is a program in the Commerce Department called the Special American Business Internship Program. We have had a thousand

interns from Russia. More than 65 percent of those interns have reported in a survey that they subsequently have established a business relationship with American companies, and 85 percent have reported that they have been able to apply what they learned in their own organizations in Russia.

In conclusion, I would say that time has confirmed, and reinforced, the validity of the concept that Russia will attract trade and investment in large volumes only when it makes more progress in establishing a viable business environment. Thus, this should continue to be a priority for both U.S. Government and private sector cooperation with Russia.

Given President Putin's constructive comments about improving the business climate, it appears that the American business voice may be listened to even more in Russia than before and, hopefully, acted upon.

In today's age of the internet and e-commerce, there may be significant prospects for grassroots work with Russia and direct commercial diplomacy that do not go through the two national governments. Training and exchanges are also likely to be more important than ever.

JOHN H. SCHMIDT

Director

**Russian Cooperation
Program, Boeing**

In spite of the ups and downs in the Russian economy, government, and U.S.-Russian relations, Boeing's presence has continued to grow steadily in Russia for the past eight years. We are proud of our engagement in Russia. The vast majority of our activities there have been successful, and we plan to continue our work with our Russian partners.

During the post-Cold War period, we have witnessed an unprecedented consolidation of the world's aerospace and defense industries. Boeing has not only done the obvious, with mergers and acquisitions; we have also searched the world for the best aerospace talent and infrastructure, and engaged it.

Russia is an important piece of that engagement. It is the only country in the world which combines these four

factors: First-class aerospace resources; A united, semi-private industry; Underutilized capacity; and a large, long-term demand for airplanes.

Boeing has an interest in identifying the best and working with the Russian aerospace industry in ways that are of mutual benefit. We have done just that over the last nine years to the tune of over a billion dollars in investment and turnover in Russia.

Looking first at space, Boeing is the world's leading specialist in aerospace systems integration. That is why we are the prime contractor for the International Space Station, an enormous program with contributors from over 16 countries around the world. The leading partners in these programs are the Americans, Russians, and Europeans.

Part of Boeing's work in Russia was overseeing and integrating the first Space station module, Zarya. That meant managing over \$200 million in investments for NASA. This was a fantastic learning experience for Boeing, NASA, and our Russian partners. Boeing established an office inside the factory of what had been one of the Soviets' most valued military enterprises — the producer of the SS-18 missiles and the Proton rockets. We learned how to work with Russian engineers, executives, and factory workers, and they learned how to work with us — not altogether easy, I can

assure you — and together we produced the first Space Station module, on cost and ahead of schedule.

The Boeing Technical Research Center in Moscow houses a number of joint research, design, engineering, and training activities. We contract directly with selected Russian companies in a way that lets them retain their employees. Boeing does not want to contribute to Russian brain drain — quite the opposite, we have done what we can to prevent it.

In 1993, we began working with Russia's largest titanium company, VSMPO, to assist them in meeting Western aerospace standards. This allowed VSMPO to sell to the world market. We procure about 20 percent of all our commercial products' titanium from Russia, which is worth approximately \$250 million over six years. Boeing is also actively supporting a project of great interest to the Russian, U.S., and other governments: the development of new, transpolar routes — everyone who flies will enjoy shorter routes from North America to Asia. Our airline customers will enjoy increased and more efficient operations. Russian regional and federal governments will enjoy infrastructure enhancement and the associated economic benefits.

Despite the ever-changing political situation, Boeing has maintained relationships with key industrial and gov-

ernment leaders, and the reality is that we can do business successfully in Russia. Boeing is prepared to expand its investment in and engagement with our Russian partners. However, like many other companies we need help from government to create a better business environment.

Some suggestions include:

First, our governments should revive the Vice President-Prime Ministerial commission. This commission proved extremely effective in managing bilateral issues and facilitating U.S.-Russian business.

Second, we encourage the Russian Government to find renewed energy for its own economic reforms. We will not pretend to advise Russia on the best ways to reform its tax, property, investment, and other laws. The healthier Russian industry, the better our ability to work with it.

Third, the Russian and U.S. governments should place increased emphasis on further introducing standard contract law into the Russian system.

Fourth, I'd like to suggest that both governments renew their commitment to joint programs such as the International Science and Technology Corporation and Cooperative Threat Reduction programs. By providing examples, introductions, and seed money, the governments facilitate

collaborative business that proves to be a multiple of their investment.

Fifth, and last, the Russian and U.S. Governments might consider a cooperative effort focused on preparing the way for Russian accession into WTO. We all win through fair trade.

In the end, it is the Russian and American people and businesses who will provide a firm foundation for stable, positive U.S.-Russian relations. Boeing has been working for nearly ten years to contribute to this foundation. These kinds of activities by our governments will increase our ability to do so.



CED *President Charles Kolb* (left) and Forum keynote speaker **Robert Legvold**, *Professor of Political Science*, Columbia University.



Forum panelists, from left, **George F. Russell, Jr.**, *Chairman*, Frank Russell Company; **Scott Blacklin**, *President*, American Chamber of Commerce in Russia; **Bernard Sucher**, Troika Dialog; **Peter Charow**, *Executive Vice President*, EastWest Institute; **Aleksandr V. Surikov**, *Economic Senior Counselor*, Embassy of the Russian Federation.



Forum panelists, from left, **John R. Price**, *Managing Director*, Chase Manhattan Corporation; **Doug Gardner**, *Partner*, Arthur Andersen, Moscow; **Jack Brougher**, *Director*, Russia and Independent States, U.S. Department of Commerce; **John H. Schmidt**, *Director*, Russian Cooperation Program, Boeing; **Eugene Lawson**, *President*, U.S.-Russia Business Council.

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