

The Russian Bear Grows

Putin's defiant, nationalistic Russia is inviting comparisons to the former Soviet Union. But it's still open for business.

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Is Russia reverting to Cold War form? No. Even though some troubling developments may give that impression: President Vladimir Putin clearly plans to remain the puppet master for years to come, whether or not he gives up his office in March, as the Russian constitution requires. The state continues to meddle in strategic sectors of the economy, ensuring that regime loyalists hold dominant stakes in sectors ranging from oil and gas to civil aviation. The country also regularly bullies its former Soviet neighbors through the use of energy extortion and other means. Russia is even embarking on a major military build-up.

But the country's leaders recognize that wealth, not weaponry, is their key to power and influence in a globalized economy. Transforming the state into a reborn Soviet Union isn't in Russia's interests, nor is it in the interests of decision makers in Moscow.

Russia won't abandon capitalism. State interference chiefly affects energy and natural resource and defense-related industries -- the so-called crown jewels of the Russian economy. Kremlin leaders recognize that going much beyond these areas would be counterproductive. "The group around Putin has learned enough about the way the economy functions and why the Soviet Union collapsed [to] not overindulge this penchant for renewal of state control," says Leon Aron, director of Russian studies at the American Enterprise Institute.

U.S. and other foreign business interests seem to share Aron's interpretation, remaining upbeat even as Russia's parliament, or Duma, prepares to pass a law that will restrict opportunities for foreign direct investment in various sectors of the Russian economy. Despite this move, foreign companies will welcome any law that at least creates more certainty about the rules for investing and doing business in the country.

"Doing something like this -- actually codifying what the strategic sectors are and what the restrictions on those sectors may be -- [will create a business climate] in Russia that is much more transparent and predictable," says Michael Considine, director of Eurasia and intellectual property affairs at the U.S. Chamber of Commerce, "That's what everybody wants."

All this will enhance Russia's attractiveness to foreign investors. The country's average annual growth rate of 6%-7%, fueled by sky-high prices for oil, natural gas and other natural resource exports, presents a powerful lure. According to the Central Bank of Russia, foreign direct investment (FDI) into Russia amounted to \$28.7 billion for 2006. For the first half of 2007 alone, it was \$27.9 billion. In terms of the number of FDI projects, as opposed to dollar value, Russia now ranks fifth in the world after China, India, the U.S. and the UK.

Plenty of sectors are still hungry for foreign investment. The country's infrastructure is in advanced state of decay. Rail networks, the electricity grid, power plants, roads, airports, the health care system, schools, housing and agriculture all will require billions of dollars worth in upgrades in order to maintain the country's economic growth. The government itself will fund some of this through oil and gas revenues. But corruption remains a serious problem in Russia, and Kremlin leaders are reluctant to pour too much money into any one project for fear of it being siphoned away. They're hoping foreign investors will share the risk as well as provide the benefit of their expertise.

Russia's energy wealth is also creating a tremendous market for consumer goods and services. For the first time in generations, perhaps ever, ordinary Russians have both the money and opportunity to spend on themselves. The country's retail sector is exploding, with demand particularly strong for home furnishings, consumer electronics, apparel and food. There's also a strong demand for franchising operations. U.S. chains such as Subway, Gold's Gym, Alphagraphics and Chem-Dry have already established strong presences.

There's also a loud call for high-tech goods, both for consumers and for industrial use: IT products, medical equipment, drugs and pharmaceuticals, telecommunications equipment and, naturally, oil and gas field equipment. Firms looking to invest in these operations there, however, should be aware that intellectual property crime remains almost as serious a problem in Russia as in neighboring China. The country's weak response to counterfeiting remains one of the chief stumbling blocks to its efforts to join the World Trade Organization.

Still, the situation is far from being all roses from the U.S. perspective. Politically, U.S.-Russian relations will remain tense. Putin has openly acknowledged that a nuclear-armed Iran is not in Russia's interests, but that doesn't mean he'll back significantly tougher sanctions, let alone military action, against Tehran in the United Nations Security Council. He remains staunchly opposed to Bush administration plans to install radar facilities in the Czech Republic and missile batteries in Poland as part of a U.S. missile shield. And Moscow supports Belgrade in Serbia's opposition to independence for Kosovo. That situation will come to a head by December, when the province's Albanian-dominated government has said it will declare independence, regardless of the outcomes of its talks with Serbia or whether it can secure international support. The U.S. and its NATO allies have been effective defenders of Kosovo's autonomy since the 1999 war, an intervention Russia opposed at the time. Putin has long regarded Russia's inability to make the West take its interests seriously on that occasion as a national humiliation.

Russia will also continue to throw its weight around in the immediate vicinity -- neighboring ex-Soviet Republics. For the most part, this will mean economic pressure, particularly cutoffs of Russia's natural gas exports, or threats to do so. And the Kremlin has other ways to lean on its neighbors. When NATO-member Estonia decided to move a Soviet-era war memorial, Russian hackers unleashed a massive assault on Estonian government Web sites. Tensions between Russia and Georgia are running even higher, with Moscow supporting pro-independence forces in Tbilisi's rogue provinces of Abkhazia and South Ossetia. A Russo-Georgian war would pose real problems for the U.S., as U.S. military advisors training Georgian troops could get caught in the middle.

In all these cases, Russia's wealth and renewed confidence give it a strong diplomatic hand and leave the U.S. with little leverage over its actions.

But the last thing Russia needs is a fresh, long-term struggle with the West. A second Cold War would be disastrous for its economy. For one thing, thanks to the Kremlin's heavy-handed management of the oil and gas sectors, exploration and development of new fields has slowed dramatically, while production from existing fields has peaked. Crude oil exports at over \$80 per barrel are bolstering the Russian economy, but they won't be enough to sustain economic growth if production goes into a decline. That will hurt all the more if the country's foreign policy were to scare off investors in the country's non-energy sectors and put the brakes on efforts to diversify the economy.

The country is also facing a serious demographic crisis. Russia's population peaked at 149 million in 1995 and has already dropped to less than 144 million. The economy is already suffering a shortage of engineers and skilled laborers, particularly in its metal-processing industries, agriculture and housing and labor productivity is suffering across the board. And the crunch is likely to get worse, as Russia's population is expected to keep falling at a rate of about 700,000 per year for decades to come -- thanks to a combination of the country's collapsing health care system, HIV/AIDS, rampant alcoholism and drug-resistant strains of tuberculosis and other contagious diseases.

Finally, while Russia's military is more than a match for its ex-Soviet neighbors, and while it retains the largest stockpile of nuclear weapons on the planet, its conventional forces are in no condition to challenge the U.S. The same public health threats behind its demographic crisis have badly damaged the quality of its conscripts. Transforming Russia's military to a professional force will take years. And although Russia is ramping up spending on weapons systems, the country is starting from a very low level of sophistication and readiness.

"Russia has been on a fifteen-year procurement holiday," says John Pike, director of GlobalSecurity.org. "Their stuff is not hopelessly obsolete and hopelessly worn out, but that moment is surely approaching." Russian defense spending for 2007 is estimated to be about \$31 billion, barely 5% of U.S. expenditures. The U.S. figure doesn't even include supplemental spending on the wars in Iraq and Afghanistan.