Russia's 2020 Strategic Economic Goals and the Role of International Integration

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JULY 2008

EUROPE, RUSSIA, AND THE UNITED STATES
FINDING A NEW BALANCE

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CSIS | CENTER FOR STRATEGIC & INTERNATIONAL STUDIES

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ISBN: 978-0-89206-547-9

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Preface

The joint CSIS/IFRI project "Europe, Russia, and the United States: Finding a New Balance" seeks to reframe this trilateral relationship for the relevant policymaking communities. We are motivated by the possibility that new opportunities may be emerging with leadership changes in Moscow and Washington. In particular, we hope that our analyses and recommendations will be useful as France takes over the chair of the European Union on July 1, 2008.

The title of the project reflects our sense that relations among Europe, Russia, and the United States have somehow lost their balance, their equilibrium. The situations of the key actors have changed a great deal for a variety of reasons, including but not limited to the wars in Afghanistan and Iraq, the expansion of NATO and the European Union, and the unexpectedly rapid economic recovery of Russia. At a deeper level, we find ourselves somewhat perplexed that nearly 20 years after the collapse of the Berlin Wall and the subsequent conclusion of the Cold War relations among Europe, Russia, and the United States seem strained on a multitude of issues. In Berlin in June 2008, President Dmitri Medvedev of Russia invoked the language articulated 15 years earlier by then-Presidents Bill Clinton and Boris Yeltsin about "unity between the whole Euro-Atlantic area from Vancouver to Vladivostok." Despite many achievements over the past 15 years, it is hard not to conclude that collectively we have underachieved in building greater trust and cooperation. We are convinced that, for enhanced European as well as global security, we must increase the level of trust and cooperation among the transatlantic allies and Russia and that this cooperation must rest on a firm economic and political grounding.

We humbly acknowledge that we have no "magic bullet," but we hope that the series of papers to be published in the summer and fall of 2008 as part of this project may contribute to thinking anew about some of the challenging issues that we in Europe, Russia, and the United States collectively face. We are very grateful to the excellent group of American, European, and Russian authors engaged in this task: Pierre Goldschmidt, Thomas Graham, Rainer Lindner, Vladimir Milov, Dmitri Trenin, and Julianne Smith. We also want to thank Keith Crane, Jonathan Elkind, Stephen Flanagan, James Goldgeier, Stephen Larrabee, Robert Nurick, Angela Stent, and Cory Welt, participants in the workshop held on May 16, 2008, in Washington, D.C., for their rich and thoughtful comments about the papers and the project. Finally, we want to thank Amy Beavin, research associate of the Russia and Eurasia Program at CSIS and Catherine Meniane and Dominic Fean of the Russia/NIS Center at IFRI for their indispensable support in making all aspects of the project a reality.

This project is the continuation of the IFRI/CSIS transatlantic cooperation started in 2006. We would like to thank warmly our financial supporters—France Telecom, the Ryan Charitable Trust, and particularly the Daimler **Fonds**.

By publishing some articles in Russian, *Russia in Global Affairs* will also take part in this project.

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RUSSIA'S 2020 STRATEGIC ECONOMIC GOALS AND THE ROLE OF INTERNATIONAL INTEGRATION

Andrew C. Kuchins, Amy Beavin, and Anna Bryndza[1]

In the mind of Vladimir Putin, Russia is destined to be a world leader. Even in 1999, when Western powers—and most Russians themselves—had written the country off as bankrupt and chaotic, Putin envisioned the future Russia as politically stable and economically prosperous. To translate his ideas into a plan of action, then–Prime Minister Putin tasked German Gref, then-director of the Center for Strategic Reform and soon-to-be-named minister of economic development and trade, with drafting a development strategy that was published on the eve of Putin's presidency and came to be known as the "Millennium Statement." Near the end of his presidency in 2007, Putin again tasked Minister Gref to update the strategic plan, and the result was formulated into the "Concept of Long-term Socioeconomic Development of the Russian Federation," which the Ministry of Economic Development and Trade published in September 2007.[2]

The ultimate goal of the Concept is for Russia to become one of the world's top five economies and, along with this, to establish itself as a leader in technological innovation and global energy infrastructure, as well as a major international financial center. By establishing itself as a leading economic power, Russia can also continue to improve domestic living conditions to the level of developed countries and safeguard its national security interests. Much more than a narrow domestic strategy, the Concept places Russia in an international context, where the rest of the world is treated either as a reference point or a vehicle for achieving its goals. Thus, Russia is intrinsically a part of the world community, using international economic integration to achieve domestic goals.

In this paper we seek to assess how efforts to implement the Concept may affect Russia's ongoing integration into the global economy and, in particular, how trade and investment ties with Europe and the United States are envisioned to facilitate modernization and diversification of the Russian

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[2] "Kontseptsiia dolgosrochnovo sotsial'no-ekonomicheskovo razvitiia Rossiiskoi Federatsii" [The Concept of Long-term Socioeconomic Development of the Russian Federation to 2020], Ministry of Economic Development and Trade, Moscow, September 2007, http://www.economy.gov.ru/wps/wcm/myconnect/economylib/mert/welcome/economy/macroeconomy/administmanagementdirect/doc1202863991297.

economy. To highlight the roles of the United States and Europe, we will contrast them with the roles of China and the Commonwealth of Independent States (CIS), the two other key vectors of Russian economic development to 2020.

The 2020 Concept: Dreams or Reality?

As with any vision statement, the question arises as to whether the Concept provides realistic goals that will transform Russia or whether it is more a result of wishful thinking. Prime Minister Putin believes that these goals are the bare minimum of what Russia should strive to achieve, while Minister of Finance Alexei Kudrin is preparing to respond with his own 2023 financial plan. Expected to be much more conservative than the Concept, Kudrin's plan will defy Minister of Economic Development Elvira Nabiullina's 2020 per capita income prediction of $2,700.

During an April meeting in the Ministry of Finance, Kudrin pointed to the fiscal irresponsibility of raising government expenditures while simultaneously reducing taxes.[3] He argued further that it is impossible to continue increasing state expenditures at an average annual rate of 30 percent, which has characterized the last three years. Such growth is unsustainable and needs to be curtailed.[4] Kudrin's insistence on returning to a sensible fiscal policy calls into question the realization of the Concept's ambitious projects.

In evaluating the degree to which the Concept is realistic, one seeks answers to three key questions: Is the projected growth rate of GDP as a primary measure of economic performance attainable? Is the outlined strategy to attain such economic results viable? And, finally, can and how will the aforementioned strategy be financed?

Kudrin's criticism dealt with the latter issue, as he questioned the availability of funds for the ambitious investment projects the Concept called for. The remaining two questions are interrelated and yet are separate as they pertain to two distinct issues: the end result and the path toward it. The Concept projects a compound annual growth rate of slightly more than 6 percent between the present and 2020. Most analysts agree that expectations of up to 7 percent growth are quite reasonable. Moscow-based investment bank Troika Dialog believes such growth to be achievable, while Deutsche Bank argues that Russia is "yet to discover the boundaries of its potential."[5] Goldman Sachs chief economist Jim O'Neill holds a differing opinion, forecasting a dismally low annual growth of 3.3 percent from 2010 to 2015, which is to drop to 2.9 percent from 2015 to 2020.[6] O'Neill bases such a dim outlook for Russia's future on the size of the

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[3] "Aleksei Kudrin gotovit 'kontseptsiu-2023'" [Alexei Kudrin Is Preparing "Concept-2023"], *Kommersant*, no. 59 (3876). April 9, 2008.
[4] Ibid.
[5] Troika Dialog, "Strategy 2020: Dreams and Reality," Moscow, April 2008; Yaroslav Lissovolik, "Russia's Comeback: From Fragmentation to Integration," PRIME-TASS, May 5, 2008, http://www.prime-tass.com/news/show.asp?topicid=65&id=437858.
[6] William Mauldin and Alex Nicholson, "Goldman's O'Neill Says Russia Economic Growth to Slow," Bloomberg, June 8, 2008.

country's workforce and productivity relative to rising economic giants like India and China. Notwithstanding such dissenting views, the general consensus on the viability of the Concept's economic goals is favorable.

There is no such consensus on the proposed strategy of achieving these results. The assumptions underlying the Concept are called into question. Troika Dialog analysts, for example, are highly skeptical of the assumption that the current account deficit predicted by the Concept as early as 2010 can be sustainable.[7] Also questionable is the desirability and ability of reaching the planned level of investment of nearly 40 percent. Such an increase in investment will deliberately change Russia's growth model, currently propelled by domestic consumer demand.

Indeed, Russian industry is focused on meeting domestic consumer market demand rather than export sectors selected for diversification and innovation. The choice of industries to become high-technology exports, as with industrial policies in other countries, is politically driven. Many of them, such as aviation and shipbuilding, are part of the defense sector. Already, trade in the military-industrial complex accounts for the majority of scientific and high-technology exports while comprising a rather small share of total trade. President Putin himself linked technological progress, 2020 goals, and defense in a February 2008 speech, when he pointed out that "new breakthroughs in bio-, nano-, and information technology could lead to revolutionary changes in weapons and defense."[8]

Speaking in defense of the innovative development, Putin expressed strong conviction that it is the only alternative to stagnation and decline, linking it again with national security:

> What choice can there be between the opportunity to become a leader in economic and social development, a leader in ensuring our national security, and the threat of losing our economic standing, losing our security, and ultimately even losing our sovereignty?[9]

Innovation within the military-industrial complex will undoubtedly have an impact on the rest of the economy, but this impact may be much more limited than the Concept predicts.

In general, the importance of Russia's international position and the critical role of trade in innovation and diversification of the Russian economy, are heavily stressed, but should not be overstated. The Concept states that "structural diversification of the economy will become evident in the composition of exports."[10] This is true, but the correlation is not one-to-one. For example, while oil and gas comprise in excess of 60 percent of total exports, they account for only about 25 percent of Russian economic activity, reflecting the fact that much of Russian manufacturing is focused on the domestic market.

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[7] Troika Dialog, "Strategy 2020."
[8] Vladimir Putin, Speech at Expanded Meeting of the State Council on Russia's development strategy through to 2020, Kremlin, Moscow, February 8, 2008, http://www.kremlin.ru/eng/speeches/2008/02/08/1137_type82912type82913_159643.shtml.
[9] Ibid.
[10] Concept, p. 31.

It is evident that the Concept has many shortcomings, and the answers to two out of three questions we posed are not encouraging. While the economic growth goals are potentially attainable, the strategy for reaching them and the underlying assumptions may be misguided. Furthermore, the Concept was conceived under the assumption of virtually unlimited resources, which is already questioned by the Ministry of Finance. Lacking in clear means of achieving its goals as requested by Putin, the Concept does what its name suggests: it conceptualizes a different economic future for Russia. The strategy might change, but the goals have staying power.

Russia's foreign economic policy can either aid or hinder the achievement of the goals set out in the Concept. Membership in the World Trade Organization (WTO) remains an overarching goal for Russia, but the country's geographical position allows for consideration of different vectors and partners for economic integration. While Europe retains its dominant status in the international integration of the Russian economy, the alternative vectors of integration (Asia and the Commonwealth of Independent States) increase their importance, playing very different roles in Russia's economic development.

The Strategic Concept and Three Scenarios of Development

The major thrust of the Concept is that the Russian economy remains overly dependent on energy exports while the global economy is becoming increasingly competitive, driven by a shifting balance of financial power to developing countries, regional economic integration, and technological innovation. Relying predominantly on income from energy resources leaves Russia in an inherently unstable economic position; thus to become a global economic power, Russia must move toward innovation-based development.

The Concept outlines a development strategy using Russia's current competitive advantages in energy, transport, and agriculture; creating a scientific and technological complex to enable specialization in high technology; diversifying the structure of the economy; creating economic and social conditions that support development of the best human capital; and developing democracy and the protection of rights and freedoms.[11] While the Concept assumes identical external economic conditions, it offers three alternative scenarios.

The first and certainly least desirable is the inertia scenario, which is basically a continuation of the resource-export based model of development, even as production of hydrocarbons gradually decreases. Innovation and the competitiveness of Russian goods will decline, while income disparities within Russia will increase and regional economic integration processes stagnate. GDP growth will fall to around 3 to 3.5 percent by 2015, and between 2008 and 2020, GDP will increase by only 1.6 times. As a result of such slow growth, the Russian government will be

[11] Ibid., pp. 8–9.

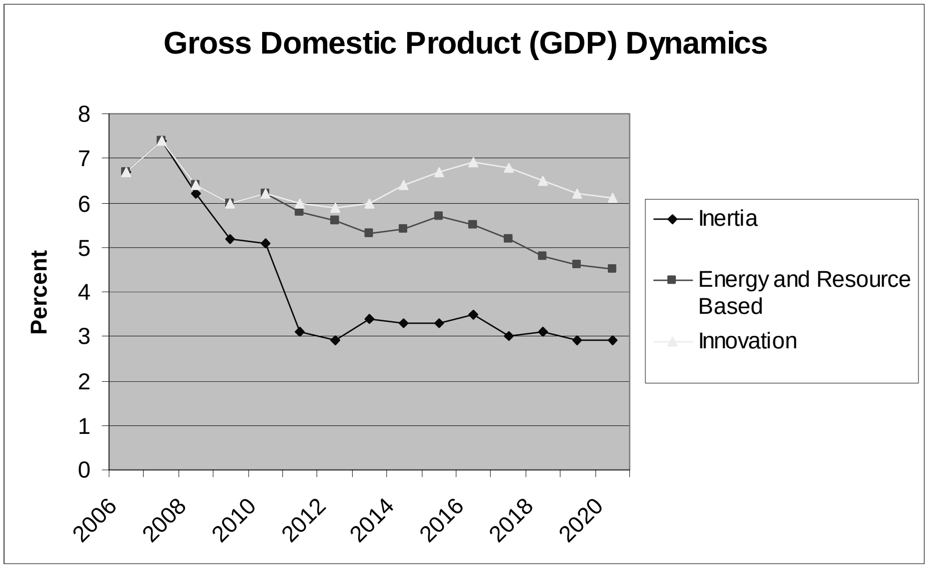
unable to implement its plans for social development, national security, and strengthening Russia's position in the world.[12]

The second scenario offers a moderately better outcome than the first. In this case, Russia succeeds in maximizing productivity and growth in the energy sector, with dramatic improvements in the efficiency of extracting techniques and power generation. Similarly, Russia manages both to diversify its export destinations and modernize transportation infrastructure. Innovation, however, is limited to the energy sector, meaning that the country remains uncompetitive in manufactured goods and below potential in terms of human capital. GDP growth in this scenario is slightly better, falling gradually to 5.5 percent by 2015, then to 4.5 to 5.5 percent by 2020, though this is still too low to meet the government's goals for social development and national security. Likewise, Russia's global leadership is restricted to the energy sphere and the economy remains dependent on imported technology and fluctuating energy prices.

The optimal scenario envisaged in the Concept is that of innovation-based development. Here Russia is able to broaden its comparative advantage beyond the sphere of energy and natural resources and become a leader in technology as well. As a result, it is successful in integrating both into world markets and with its CIS neighbors. In addition, Russia will significantly reduce the gap in living standards between itself and developed nations, with per capita GDP increasing to $21,000 by 2015 and $30,000 by 2020.[13] Russia's portion in global GDP will rise from 2.6 percent in 2006 to 3 percent by 2015 and then to 3.4 percent by 2020.[14]

The innovation-based growth strategy outlined above involves two very distinct processes: *modernization* and *innovation*. The first process, modernization, involves transfer and adoption of the technological advancements of the West through trade and investment policies. The second process, innovation, involves moving beyond simply adopting current technologies to developing new ones.

[12] Ibid., pp. 22–23.
[13] Ibid., p. 26.
[14] Ibid., p. 26.



Role of Trade in Attaining 2020 Goals

The Role of Trade

Trade is the main vehicle to achieve economic goals in the Concept, and the strategic goal of Russia's "transformation into one of the leaders of the world economy" implies not only increasing GDP in absolute and relative terms, but also increasing Russia's trade as a share of world trade. In 2007, Russia accounted for 2.1 percent of world trade turnover. While it was not in the top 10 in terms of either exports or imports, Russia's weight as a trade partner is increasing: in 2007, Russia was the 12th-leading world exporter, up from 13th in 2006; due to a 35 percent increase in imports in 2007, the country also jumped two steps up to become the 16th-largest importer.[15]

Continuation of the status quo by failing to diversify economic output, however, would lead to a reversal of this current trend and a decline in Russia's importance in world trade. This goal of diversification is reflected in the proposed increase of the share of machinery and equipment exported to 21 percent of total exports by 2020 from 5.8 percent in 2006.[16] Simultaneously, the volume of exports will also increase to $564 billion compared to $437 billion in the inertia scenario.[17] All the scenarios have one trend in common: the growth rate of imports will exceed the growth rate of exports, resulting in a trade deficit. While fast import growth is projected in all

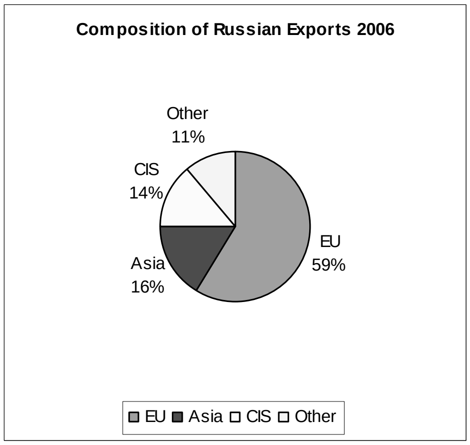
[15] World Trade Organization (WTO), "WTO: Developing, Transition Economies Cushion Trade Slowdown," press release, April 17, 2008, http://www.wto.org/english/news_e/pres08_e/pr520_e.htm.
[16] Concept, p. 31.
[17] Ibid., p. 38.

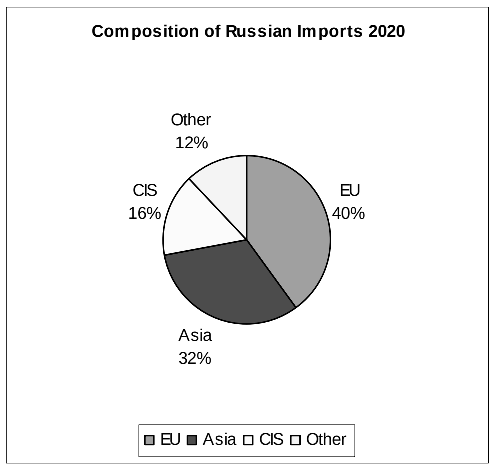
scenarios, the innovation path would increase the trade deficit the most. In spite of the deterioration of the current account balance, the innovation scenario is deemed desirable, because it allows for an increase in Russia's importance as a trade partner. An anticipated benefit of a current account deficit is a halt in the appreciation of the ruble, making competition easier for Russian firms in the global markets.

Both imports and exports play important, but different, roles in helping Russia reach its economic goals. Imports will be increasingly composed of machinery and equipment, which are recognized as necessary to improve and develop production processes in Russia—modernization of the Russian economy. To that extent, in addition to significant growth of imports in absolute terms, the share of investment goods is to increase from 20 percent in 2006 to 35 percent in 2020.[18] Exports will not only reflect diversification of the Russian economy, but they will allow Russia to establish itself as a key player in targeted high-technology industries.

While integration with the West is and has been Russia's primary goal, the projected breakdown of Russia's trade by major partners (the European Union, the Commonwealth of Independent States, and Asia) suggests a shift away from the West toward Asia and the Commonwealth of Independent States. In 2006, 59 percent of Russian exports were destined for the European Union, 16 percent went to Asia, and 14 percent to the Commonwealth of Independent States. In contrast, the EU share of total exports in 2020 is expected to decline by 13 percent and comprise only 46 percent of total exports, while the share of both Asia and the Commonwealth of Independent States is to increase to 20 percent each. CIS and Asian countries are seen as potentially large and increasing markets for Russian exports, especially the high-technology "innovation goods," proving opportunities for growth in these sectors as outlined in the strategy. On the other hand, the decline in imports from the European Union will be more gradual (from 45 percent in 2006 to 40 percent in 2020), while Asia will increase its share to 32 percent from the present 26 percent, displacing some of the European imports.[19] However, as the composition of Russia's imports is to be heavily tilted towards machinery, the European Union will continue to be the primary supplier of such goods and the key to Russian economic modernization.

[18] Ibid., p. 108.
[19] Ibid.





Integration with the West: The European Union and the United States

The European Union

For Russia, integration into the world economy and the West is, first and foremost, integration with Europe, its primary economic partner. In 2006, the EU-27 accounted for 54 percent of total trade, 59 percent of Russian exports, and 45 percent of imports. For the European Union, Russia is the third-largest partner. Economic cooperation between the European Union and Russia is built on converging interests. Western Europe needs new markets for high-value-added products to boost stagnating domestic growth, while Eastern Europe relies on Russia for nearly all of its energy. Russia is interested in acquiring European technology in order to modernize its economy, while still retaining its comparative advantage in the energy sector.

The highest level of integration between the European Union and Russia could be a free-trade area (FTA), an idea that was conceived and incorporated into the Partnership and Cooperation Agreement (PCA) in 1997. The Europeans continue to view an FTA as a means to link rewards with performance, announcing in 2006 and again in 2007 that the new enhanced PCA ought to include a free-trade agreement. This assumes, however, that an FTA is of interest to Russia, which is arguable.

The precondition for the commencement of FTA talks is Russia's accession to the WTO. This has by no means been an easy step for Russia, requiring implementation of numerous commitments made in bilateral negotiations, which will have very real effects on its economy and which will be especially painful in the short term as many industries face increased foreign competition. Any negotiations of Russia's membership in the Organization of Economic Co-operation and Development (OECD) will entail further liberalization and concessions by Russia. Admittedly, adding an FTA to the list of liberalization projects would not be painless, but it is indisputable that competition is a critical condition for industrial development.

"Increasing global competitiveness" is a frequent phrase in the Concept, which acknowledges the fact that, as an integral part of the global economy, Russia's industry is to face competition on the global scale. A free-trade area with the European Union would not only increase competition for Russian industry, which predominantly produces for the domestic market, but allow increasing imports of technology speeding up the rate of modernization of the Russian industrial complex and increasing its efficiency.

This is not to imply that there will be no adverse consequences or that the pains that Russian industry will experience in the short term should be underestimated. The heart of any FTA between the European Union and Russia would be a reduction of tariffs on manufactured goods. Taking into consideration that EU-Russia trade is based on each side's respective comparative advantage (commodities for Russia and manufactured products for the European Union), this would benefit the European Union and to some extent disadvantage Russia.[20] Those who focus on this fact tend to be negatively predisposed to the Russia-EU FTA. Yet this narrow view fails to see that Russia's goals are multifaceted and long term in nature; it fails to consider modernization, efficiency, and competiveness as strategic goals, while focusing on short-term losses. These short-term effects need to be carefully considered by the government so as to provide proper incentives for the domestic industry and alleviate social impacts of increased foreign competition.

To further integration with the European Union, Russia's second-best option is joining the WTO and continuing to be a beneficiary of the European Union's generalized system of preferences—its present course. This option does not require commitments beyond those made in the WTO process and subjects domestic industry to smaller competitive pressures than an FTA would. Yet the difference between this course and pursuing further liberalization is the difference between an inertia and innovation scenario.

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[20] Vladimir Pankov, "Free Trade between Russia and the EU: Pros and Cons," *Russia in Global Affairs*, no. 2 (April-June 2007).

The issue may become more pertinent if the negotiation of a free-trade area between Ukraine and the European Union prove to be successful. After Ukraine signed a WTO protocol, the European Union announced the intention of both states to negotiate an FTA. At the time Ukraine chose the European Union over the proposed Eurasian Common Economic Space (CES), a customs union with Russia; Russia itself moved forward with the process of creating a customs union with Belarus and Kazakhstan by 2011 under the umbrella of the Eurasian Economic Community (EurAsEC).

Progress within EurAsEC virtually precludes the possibility of the EU-Russia FTA. The customs union implies a common external trade policy, which would be incompatible if only one of its members were to enter into a free-trade agreement with another party. At the same time, free-trade agreements between the European Union and the CIS countries put Russia at a disadvantage. In the case of Ukraine, for example, European manufacturers would gain a cost advantage from tariff reduction and/or elimination compared to the most-favored-nation (MFN) tariffs Russian companies will face in Ukraine after Russia accedes to the WTO. At the same time, Russian industry, such as metallurgy, which already competes with countries like Ukraine for European markets, would find itself in a disadvantageous position as well. The possibility of the EU-Ukraine FTA provides an additional incentive to pursue the EU-Russia FTA.

Simultaneously, however, creation of a free-trade area with Ukraine will need to take place, negating Europe's cost advantage. Ukraine has already expressed support for this idea: Prime Minister Yulia Tymoshenko announced during a February cabinet meeting that a key goal of the cabinet is the creation of a free-trade zone between Russia and Ukraine.[21] The Concept looks forward, proposing the creation of a free-trade zone between the European Union and the CIS countries in the long term, but at present this does not seem feasible for quite some time.[22]

The United States

According to the Concept, there appears to be little room for the United States in determining Russia's economic future, most likely because of the limited economic engagement between the two countries in the area of trade. For the U.S. economy, Russia is very much a marginal trade partner, as its share of trade has remained under 1 percent of the U.S. total since 1992. However, this small share has become increasingly important in the last few years, accounting for 0.56 percent in 2003, 0.75 percent in 2005, and 0.86 percent in 2007.[23]

For Russia, U.S.-Russia trade is of more importance because the United States has been one of Russia's primary trading partners. But from the Russian perspective, trade with the United States is becoming less significant in relative terms: it accounted for 5.41 percent of total trade in 1995

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[21] "Creation of Free Trade Zone between Ukraine and Russia Announced Key Target of Tymoshenko's Cabinet," February 22, 2008, Ukrainske Radio, http://www.nrcu.gov.ua/index.php?id=148&listid=61063.
[22] Concept, p. 111.
[23] "Foreign Trade Statistics," U.S. Census Bureau, http://www.census.gov/foreign-trade/balance/c4621.html#2008.

but dropped to 3.47 percent in 2006.[24] While Russia is gaining weight as an economic partner for the United States, the reverse trend is taking place in terms of the U.S role in Russia's trade.

A narrow focus on trade, however, may lead to an erroneous conclusion that the United States is not an important factor for Russia to attain its economic goals. While its role may be different than simply serving as a market for Russian exports or as a source of imports, it nonetheless remains an economic giant that cannot be ignored under any circumstances. Economic conditions in the United States are an essential determining factor for global economic growth. An important assumption in modeling Russia's economic future is strong global economic growth (approximately 4.4 percent annually) with a temporary slowdown in 2011–2012 due to decline in demand for exports during a significant drop in U.S. economic growth. Yet another factor might be turbulence in the financial and currency markets due to existing and worsening financial imbalances in the United States.[25]

The United States is also one of the players whose activity in the Commonwealth of Independent States will influence the speed and depth of regional integration, which will be defined by the "increase in competition between Russia, the EU, the U.S. and China for the economic and political influence in the post-soviet space."[26] Even more important is the U.S. role in international economic institutions such as the WTO, the World Bank, and the International Monetary Fund (IMF). The West exercises disproportionate power in these institutions, and the United States and the European Union will continue to dominate these multilateral organizations in 2020 even if reforms are enacted.

In recognition of the United States' importance, the Concept's innovation scenario is based on a multi-vector model of integration into the global marketplace, emphasizing economic cooperation with the United States, the European Union, China, India, and the Commonwealth of Independent States.[27] There will never be an "American integration vector," but it does not preclude deepening economic cooperation in certain areas, such as civilian nuclear or space cooperation, both of which are targeted sectors for innovation. The U.S.-Russia economic relationship is operating below its potential, and it is not difficult to envision it broadening, especially in the area of investment. Minister of Economic Development Elvira Nabiullina stated that there is a need for "political signals for establishment of advanced comprehensive economic cooperation."[28] Such a signal was sent in Sochi in April 2008 with the inclusion of an agreement to hold bilateral economic dialog. Nabiullina mentioned that metallurgy, paper and pulp, aviation, and machinery could all become areas to be further developed. After all, she summarized, "realization of the

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[24] Ibid.
[25] Concept, p. 13.
[26] Ibid., p. 111.
[27] Ibid., p. 25.
[28] Elvira Nabiullina, Speech at the Round Table, "Strategic Partnership of Russia and the U.S. in the Economic Sphere," 12th St. Petersburg Economic Forum, June 6, 2008.

long-term plans of socioeconomic development of our country is impossible without close cooperation with our main economic partners, among which are the United States of America."[29]

Integration with the Commonwealth of Independent States and China

The Commonwealth of Independent States

One of the goals outlined in the Concept is the desire to breathe new life into Eurasian economic integration processes. Deutsche Bank recently wrote that "economic integration with the CIS may be termed the 'unfinished business' of the past eight years of Putin's presidency."[30] The success of regional integration is, in fact, a key part of the innovation scenario as it envisions functioning economic alliances in the region with Russia as the leading partner. Failure to spur regionalization processes is emphasized in the inertia scenario and presupposes the continuation of regional disintegration. The question is whether such regional orientation could, in fact, hinder Russia's integration with the West by providing an alternative direction for integration. After all, in the last two years Russia has pursued regional integration in earnest, and it has already born fruits such as the breakthrough in negotiations regarding the transformation of the Eurasian Economic Community into a customs union and the establishment of the Eurasian Development Bank (EDB).

Regionalization (referred to as the "Eurasian integration vector" in the Concept) is only one of the two driving forces determining the development of the world economic order described in the strategy, the other being globalization. Though these two global trends might appear to be contradictory, they are in fact complementary. Russian foreign economic strategy mirrors these trends as it simultaneously pursues Eurasian and European integration. The European integration vector implies much more than its name suggests as it includes Russia's future accession to the WTO and the OECD. "Europe" in this context implies "the West," of which Europe is a part and which, in turn, is also seen as synonymous with "globalization." Given the fact that the Concept perceives globalization to be the dominant force, it is no surprise that the European vector dominates the integration agenda. Despite compatibility between the two integration vectors, economic integration with the West ultimately trumps any alternatives.

A major drawback to Russia's pursuing regionalization whole heartedly is the uncertainty of success and the rate of future progress. Regional integration has been on the agenda since 1991, and until recently, the outcome has been disappointing as several CIS countries chose European orientations in their economic policies. Yet another constraining factor is the difference in the level of development and size of the states' economies. It is for this reason that the Concept

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[29] Ibid.
[30] Yaroslav Lissovolik and Irina Lebedeva, "Russia's Comeback: From Fragmentation to Integration," Deutsche Bank Global Markets Research, Frankfurt am Main, April 21, 2008, p. 16.

foresees regional integration truly becoming viable only during the last stage of the innovation scenario (2017–2020).

Despite the secondary role assigned to Eurasian integration, it is nonetheless a vital part of Russian ambitions. The region can prove to be an increasingly important market for Russian exports. The Concept projects that the CIS share in Russian exports by 2020 will be 20 percent, up from 14 percent in 2006. Imports from the Commonwealth of Independent States, on the other hand, are projected to remain at the 2006 level (16 percent).[31] This would reverse the present trend of a relative decline in importance of Russia's trade with the region. While the volume of Russia's trade with the CIS countries has been growing, its share has steadily declined from 23 percent to 15 percent of total trade. This trend is explained primarily by the decline in the share of imports from the Commonwealth of Independent States, while the share of exports has remained stable.

The region possesses markets that would be open to Russian high-technology exports, such as information and communication technologies. The CIS states already constitute the largest market for Russian machinery exports—more than 50 percent.[32] The innovation scenario of the Concept envisages that by 2020 high technology will account for 10 percent of GDP and Russia will emerge as a net exporter of information technologies. The CIS countries could provide the markets, and economic integration would lower or eliminate trade barriers, enabling Russia to compete effectively.

Apart from its role as a market for Russian exports, Eurasia could serve a much higher purpose by providing an area for Russian economic supremacy. The innovation scenario envisions Russia as one of the major global financial centers, which will dominate the financial markets of the CIS countries, as well as the countries of Eastern and Central Europe.[33] Dmitry Medvedev presented this goal in his economic platform, as laid out during the Krasnoyarsk Economic Forum in February 2008: "The future rules of the game are now being defined in the financial world… And we simply must take advantage of this and take a series of actions, directed to achieving the long-term goal announced by the President—to become one of the largest world financial centers."[34] The status of Russia as a world center is to be grounded in the role of the Russian ruble, which is envisioned to become a regional reserve currency. The window of opportunity, however, is narrow and opened up due to the ongoing decline in the value of a dollar, which prompted many central banks to reduce the dollar assets in their foreign exchange reserves. Insisting on payments for commodities (especially energy) exclusively in rubles would also advance this goal.

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[31] Concept, p. 108.
[32] "Naryshkin: v Perspektive Vozmozhno Sozdaniye Obshchei Zony Svobodnoi Torgovli Stran SNG" [Naryshkin: In Perspective of the Possible Creation of a Free Trade Zone for the Countries of the CIS], Regnum New Agency, February 5, 2008, http://www.regnum.ru/news/952528.html?forprint.
[33] Concept, p. 7.
[34] Dmitry Medvedev, Speech at the 5th Krasnoyarsk Economic Forum, February 15, 2008, http://www.medvedev2008.ru/performance_2008_02_15.htm.

Medvedev went further during the St. Petersburg Economic Forum, stating that the plans for development of Moscow as a financial center will be approved in the near future.[35] Such an endeavor would be quite a challenge given the city's current rating as 56th in *The Global Financial Centers Index*.[36] Moscow is slightly behind its two major competitors in the region, Warsaw and Prague, making competition even fiercer. Russian actions in promoting the status of the ruble have also become aggressive with the opening of the St. Petersburg raw materials and commodity exchange, where trade will be conducted in the national currency.

There are reservations regarding the ruble as a reserve currency. Minister of Finance Kudrin said it is possible to envision the ruble as a regional currency for Russia's CIS partners and maybe some key trade partners, such as Germany and Finland, in the future.[37] However, he believes it would take decades of being a stable floating currency before the ruble could make a bid to become a reserve currency. Many in the region also question the viability of the ruble as a regional reserve currency. Kazakhstan is definitely in no rush and is waiting for Russia to achieve promised stability and curb inflation.[38]

China

Rapid growth in Russia's trade with China in recent years elevated the importance of both countries in their respective trade flows. In 2007, China became Russia's third-largest trade partner, trailing only behind Germany and Netherlands. In turn, Russia is China's seventh most important trade partner.

While the overall volume of trade between the two countries is growing and continues to set historic records every year, it is primarily—and overwhelmingly—driven by Russia's imports from China. Growth rates of Russia's exports to China remained relatively stable in the last five years, averaging a little over 20 percent per year. Performance of Chinese imports, on the other hand, has been stellar with the growth rate increasing from 37.82 percent in 2003 to 77.65 percent in 2006.[39] Such growth disparities in trade turned Russia's trade surplus with China into a trade deficit in 2007.

The question of whether China can become a strategic partner for Russia in terms of reaching 2020 economic targets hinges on the composition of trade and not on its volume. The bulk of Russian exports fall into four categories: crude oil and oil products, timber, ferrous metals, and

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[35] Dmitry Medvedev, Speech at the 12th St. Petersburg Economic Forum, June 7, 2008, http://www.kremlin.ru/eng/speeches/2008/06/07/1338_type82914type127286_202288.shtml.
[36] Mark Yeandle et al., *The Global Financial Centers Index 3* (London: City of London, March 2008). http://www.zyen.com/Knowledge/Research/GFCI%203%20March%202008.pdf.
[37] "Perekhod na torgovlyu neftyu i gazom za rubli vozmozhen let cherez 10—Kudrin" [A Transition to Trading Oil and Gas in Rubles Is Possible in 10 Years—Kudrin], RIA Novosti, June 7, 2008, http://www1.minfin.ru/ru/official/index.php?id4=6206.
[38] "Russian Ruble Could Become Stable Currency in 4-5 Years," RIA Novosti, February 15, 2008, http://en.rian.ru/business/20080215/99281946.html.
[39] Federal State Statistics Service of the Russian Federation, http://www.gks.ru/bgd/regl/b08_11/IssWWW.exe/Stg/d03/26-05.htm. Authors' calculations.

chemicals, prompting then-President Putin's comment of the existence of an "increasing raw material bias of Russia's exports to China."[40] In 2006, Putin praised progress in Sino-Russian economic relations while simultaneously stressing the need to address problems in the structure of bilateral trade, especially Russia's exports to China.[41]

The flip side of increasing Russian exports of primary goods with little value added is declining exports of machinery and equipment, which only a decade ago comprised nearly a quarter of total Russian exports to China. In 2006, such products accounted for only 1.4 percent of exports. Simultaneously, however, imports from China in this very category have increased substantially. Though the top Russian imports from China continue to be consumer products—such as textiles, shoes, garments, and agricultural products—China's primary exports to the rest of the world, contrary to popular belief, are electrical machinery and equipment and power generation equipment. China's structure of trade with Russia has been gradually changing over time to reflect this. As Putin summarized Russia's thoughts on such structural changes: "Of course, we are happy for the successes of our Chinese friends, but…."[42]

If such trends were to continue, it would be very difficult for Russia to reach its goals of exporting machinery and equipment totaling $125 billion to $130 billion in volume and accounting for 21 percent of total exports. However, the reverse of this trade pattern is entirely possible if, rather than looking at the entire machinery and equipment sector, we focus on specific industries singled out in the Concept as the future of Russia's global specialization: aircraft, thermoelectric, hydropower, and nuclear plants and equipment, as well as mining equipment. Reclaiming and expanding the share of these products (as is, indeed, envisioned in the Concept) in Russia's exports to China would indeed contribute to reaching the strategic goals. China could provide a large and growing market with an increasing demand for the designated "innovation industries."

WTO

Regardless of the geoeconomic vector(s) of integration chosen by Russia, membership in the WTO remains a precondition for successful integration into the world economy. Throughout the Putin years, Russia has consistently pursued the goal of becoming a card-holding member of the global trade system, only to find the process drawn out far beyond the anticipated time frame.

The extent to which Russia will benefit from accession to the WTO and, consequently, the extent to which membership will aid or hinder reaching the 2020 economic goals, have been subject to debate. The discussion revolves around the welfare gains to the state, their sources, distribution, and time frame.

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[40] "Written Interview Given by President Vladimir Putin to the Chinese News Agency Xinhua," March 20, 2006, http://www.kremlin.ru/eng/text/speeches/2006/03/20/1117_type82916_103264.shtml.
[41] Ibid.
[42] Ibid.

The projections of welfare gains tend to be favorable in the medium and long run, though liberalization in the short run may be accompanied by difficult adjustments. A 2004 study projected gains to the economy, as a whole, of 3.3 percent of the GDP in the medium term.[43] Allowing for improvement in the investment climate in the long run, the gains could reach 11 percent of GDP, triple the medium-term projection.[44] It has been recognized that the degree to which Russia benefits from the WTO will be determined by the internal policies accompanying the accession.[45]

While the WTO is generally associated with a decrease in tariffs, both the 2004 study and 2003 paper, mentioned above, emphasize that it is the reduction and/or elimination of nontariff barriers that will account for most of the benefits of liberalization. Foreign direct investment (FDI) into business services, such as finance and telecommunications is especially important in this regard. As Russia is unwilling to completely liberalize these sectors, it will forgo many of the potential benefits.

Gains from liberalization also stem from resource reallocation and the increasing ability to modernize the economy with imported technology. However, market access is a relatively small source of gains since Russia has already attained MFN status with all of its major trading partners.[46] Thus, in terms of market access, Russia will make larger concessions than it will receive gains due to fact that it has already obtained most of the benefits associated with the WTO from its major partners. The scenarios modeled in the Concept do not include WTO membership, which can be expected only to exacerbate the projected trade deficit.

Analysis of the sector effects predict gains by those industries that are already successful exporters or those that will benefit from decreased prices of inputs. Thus, such thriving export sectors as chemicals, timber, paper products, and metals will be the primary beneficiaries. The losers' side will include much of the manufacturing sector, especially machinery and equipment, making the task of increasing the share of these products in the export mix challenging.

Agriculture is yet another sector that faces potential losses in the case of WTO membership. Dmitry Medvedev has emphasized the necessity to ensure both a needed level of protection for

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[43] Jesper Jensen et al., "Economy-Wide and Sector Effects of Russia's Accession to the WTO," mimeo, May 26, 2004, http://siteresources.worldbank.org/INTRANETTRADE/Resources/Topics/Accession/Jensen-Rutherford-Tarr_effectsaccession.pdf.
[44] Ibid.
[45] Ksenia Yudayeva et al., "Sectoralnyi i Regionalnyi Analiz Posledstvii Vstupleniya Rossii v VTO: Otsenka Izderzhek i Vygod" [Sectoral and Regional Analysis of the Consequences of Russia's Entry into the WTO: An Appraisal of Costs and Benefits] (working paper, no. 3, Carnegie Moscow Center, Moscow, 2003), http://www.carnegie.ru/en/pubs/workpapers/3,2003.pdf.
[46] Thomas Rutherford and David Tarr, "Regional Impacts of Russia's Accession to the WTO," mimeo, June 23, 2006, http://siteresources.worldbank.org/INTRANETTRADE/Resources/Internal-Training/287823-1116536061368/Regional_ImpactsOfRussiasAccessionToTheWTO.pdf.

domestic agriculture and additional opportunities for export of agricultural products.[47] While he pointed to an important role for the national project on agriculture, the success of the project is far from predetermined. In his platform speech on May 8, 2008, Vladimir Putin stressed the significance of having a well-functioning agricultural sector so as to minimize the impact of fluctuations in global food prices on Russian consumers.[48] In addition to the Concept's vision of agriculture as one of the areas of Russia's competitive advantage, the current rise in food prices will prompt debate about food security and protectionism.

The extent and distribution of economic benefits may be debatable, but WTO membership will bring closer the political goals outlined in the Concept. There is no major world economy outside the global trade system, and Russia's continuing exclusion is unbefitting a great economic power. Being a stakeholder in the WTO will also allow Russia to set the tone in negotiations. Being one of the top economies and trade partners in the world, Russia would enjoy the benefits of being "large"—being more than just a price taker in the world markets, but carrying economic weight to be reckoned with.

Role of Investment in Attaining 2020 Goals

Inward Investment

The outcomes of the innovation scenario include diversification and an increase in trade volume. While exports are predicted to increase in these conditions significantly more than in any other scenario, imports are also expected to increase at a faster pace. This increased consumption will need to be financed by borrowing from abroad, and inflows of foreign capital will become increasingly important in supporting the continuation of Russia's growth. The lack of a favorable investment climate, however, has been an impediment to investment into Russia. It is no coincidence that Medvedev dedicated much of his electoral platform to improving the investment climate in Russia, which included strengthening the rule of law, through enforcing contractual obligations and intellectual property rights. This rhetoric about improving Russia's investment climate is on target, but how effective the Medvedev administration will be remains to be seen.

Medvedev understands that Russia must compete for investment and that this requires making the investment environmental more attractive. The inertia scenario paints a picture of Russia's foreign investment future in which the country loses to other emerging economies, including the CIS states.[49]

We should note that in the last three years the level of foreign investment has grown rapidly. In 2006, total foreign investments exceeded $55 billion. This figure was surpassed by investment in

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[47] "WTO Membership Must Open Additional Prospects for Agriculture—Medvedev," Interfax, February 27, 2008, http://www.wto.ru/en/news.asp?msg_id=22664.
[48] Vladimir Putin, Speech to the Russian State Duma, May 8, 2008, http://www.edinros.ru/news.html?id=130604.
[49] Concept, p. 109.

the first half of 2007 alone, when foreign investment amounted to $60 billion and reached $121 billion by the end of the year.[50] One of the principal issues with foreign investment into Russia has been the fact that inward FDI was accompanied by a flight of capital, causing net FDI to remain low. The turning point was in 2006, when capital flight came to a halt, increasing Russia's performance. In 2007, inward FDI reached $28 billion and accounted for 3.7 percent of Russia's GDP.

Developed Western countries remain the major investors in the Russian economy both in terms of accumulated investments and investment flows. Setting aside investment from Cyprus, Luxemburg, and the British Virgin Islands (which have special tax regimes and where investment is difficult to interpret, as a large share is composed of Russian capital reinvestment), the Netherlands, the United Kingdom, Germany, the United States, France, Switzerland, and Japan have the highest investment stakes in the Russian economy.

Europe has and can be expected to play a key role in Russia's inward investment. In the first half of 2007, the largest investment flows were from the United Kingdom and the Netherlands. The U.S. investment position in Russia has been weakening. While the absolute volumes of investment from the United States into Russia have been on the rise, the relative share has been declining. In 2006, the U.S. investments accounted for only 3 percent of total investment into Russia.

One of the major obstacles to increased U.S. investment is the absence of a bilateral investment treaty (BIT). While signed in 1992 and ratified by the United States a year later, the U.S.-Russia BIT was never ratified by the Duma and thus never entered into legal force. The treaty included provisions for national and MFN treatment of investment, protection from expropriation, and dispute resolution specifications. The Yukos affair brought to light the disadvantaged position in which American investors found themselves, compared to many European shareholders who had various avenues for legal action. Fortunately, a decade and a half later, the issue is again commanding top priority on the bilateral agenda. Negotiation of a new BIT has been included in the U.S.-Russia Sochi Declaration.[51] Speedy progress in this regard is in the interest of both parties, given the significance to the United States of safeguarding its investment interests and Russia's need to attract foreign investment.

Almost unnoticeably tucked into the Concept is a surprising comment that in case restrictions on investment into strategic sectors remain in place, other sectors will quickly become saturated with foreign investment, leaving the level of FDI at 2.5 percent in the inertia scenario. While true, this appears to contradict present policies that include a March 21, 2008, adoption of the federal law "Regarding Foreign Access to Strategic Assets."

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[50] Federal State Statistical Service of the Russian Federation, "Foreign Investments in the Economy of Russia by Kinds of Economic Activities," http://www.gks.ru/free_doc/2007/b07_06/3/14-05.htm.
[51] "Fact Sheet: U.S.-Russia Strategic Framework Declaration," news release, White House, Washington, D.C., http://www.whitehouse.gov/news/releases/2008/04/20080406-5.html.

The majority of foreign investment is directed toward wholesale and retail trade (23.7 percent in 2006) and manufacturing sectors (27.5 percent). In 2006, mining and quarrying accounted for only 14.1 percent of investment. This is consistent with the fact that current economic growth in Russia is fueled by consumer demand.[52]

We expect that looking to 2020, the West will continue to play the key role as a source of Russia's foreign investment in general and FDI specifically. Europe will continue to increase its share, while there may be a drop in investment from countries with favorable taxation policies, such as Cyprus and Luxemburg. The future role of Asia remains unclear. Though still remaining in the top 10 countries in terms of accumulated investment in 2006, Japan was not on the list of the top sources of investment flows, preferring investment into the rest of Asia, North America, and Western Europe instead. Chinese outward investment is growing slowly relative to its economic potential and is very concentrated in the government-controlled transnational corporations (TNCs). It is Europe and the United States that most likely will meet Russia's growing needs for investment as its current account deteriorates.

Outward Investment

Since its independence, Russia's outward investment has been to a large degree a measure of capital flight rather than a source of strategic investment. Increased confidence in Russia's economic future has been accompanied by a change in the composition of Russian investment abroad. The share of FDI and portfolio investment has increased as the share of other investments, such as bank deposits, has declined. In 2007, the amount of direct investment tripled compared with 2006, increasing its share of total investment from 6 percent in 2006 to 12 percent in 2007.

The Concept recognizes the future increased role of developing countries' TNCs and touts this as a method of not only exporting capital, but also as a means of becoming a part of global value-added chains and the world economy in general.[53] Russia is a clear leader among the transition economies in terms of outward investment. In 2007, Russia's direct investment outflows surpassed $9 billion, accounting for 12 percent of the total investment made by Russian organizations abroad.

Most of these outflows are a result of the global expansion of Russian TNCs, as well as the regional expansion of Russian banks.[54] Most of the TNC expansion took place in the extractive industries as these firms attempted to gain control over distribution and solidify market share abroad.[55]

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[52] Troika Dialog, "Strategy 2020."
[53] Concept, p. 12.
[54] UN Conference on Trade and Development (UNCTAD), *World Investment Report, 2007: Transnational Corporations, Extractive Industries and Development* (New York: United Nations, 2007), http://www.unctad.org/en/docs/wir2007_en.pdf.
[55] Ibid, p. xix.

The world economy, according to the Concept, will be characterized by two major trends in FDI: acceleration of growth in FDI in general and a shift in capital movement toward direct strategic investment.[56] Much of Russia's outward FDI by energy TNCs is a combination of precisely such strategic investment, however, with the primary goal being securing market access.

Russian companies have not focused very much yet on mergers and acquisitions abroad, but with the growth of the Russian economy and increased access to capital, such an approach will accelerate in the future. Already the expansion of Russian companies abroad has elicited criticism in target countries, as we saw with Gazprom's efforts to purchase the British utility Centrica in 2006.

Conclusion and Recommendations

Further economic integration with the West—especially Europe—will play a major role in facilitating Russia's capacity to achieve the broadly articulated goals of the innovation scenario of the 2020 Strategic Concept, first as a source of high-technology imports to promote Russia's economic modernization and diversification and second as sources of FDI, as well as attractive investment opportunities for Russian capital. However, these markets will be very difficult to penetrate for Russian exports outside natural resources and commodities. In this regard the West is unlikely to be as helpful in the 2020 time frame in promoting diversification as increasing exports to Russia's regional neighbors, especially those states in the Commonwealth of Independent States. Russian industry and manufacturing here may have some comparative advantages, including geographical proximity and existing transport infrastructure, shared industrial base and supply ties, and language and culture that will help these countries modernize their own economies.

Based on this analysis, we offer the following conclusions and recommendations:

- **Liberalization Will Drive Competitiveness.** Increasing its competitiveness in various niches in manufacturing will be imperative for Russia to meet its goals for diversification and innovation. Continue trade liberalization including accession to the WTO and subsequently negotiating an FTA agreement with Europe.
- **Better to Act Sooner rather than Later.** The pain of trade liberalization for uncompetitive Russian industries will be politically and economically more tolerable while Russia continues to enjoy large trade surpluses and a very strong macroeconomic position as it does now, since the Russian government will have more room to provide incentives for adaptation and retraining of workforces in declining industries.
- **Encourage More not Less Foreign Investment.** Increased foreign investment will play a more important role in sustaining the next phase of Russian economic growth than it did in the last decade. The Medvedev-Putin team must act on their promises to strengthen rule of

[56] Concept, p. 13.

law and reduce corruption in order to maintain the growth rate of foreign investment that has taken off in the last three years.

- **Carefully Target and Implement Infrastructure and Human Capital Investments.** Recent policies to accumulate capital will need to be adjusted to allocate more capital for the modernization of antiquated transport and industrial infrastructure and to raise the quality of the workforce, but these policies will have to be carefully balanced with efforts to restrain inflation.
- **Improve Political Ties with Europe and the United States.** The current contradictory trend lines of deepening economic ties amid growing tension on political and security issues are not sustainable and need to be reconciled, as ultimately they will compromise Russian growth goals. Russian capital will be less welcome and thus unlikely to attain the highest returns, and strategic partnerships between large Russian and Western companies will encounter more opposition.