

Economics Group

Special Commentary

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Russia: Always a Step Behind, Still an Outsider

Executive Summary

The Russian economy has come back from the brink of disaster. After suffering through its worst recession in decades, economic growth has rebounded. A rebound in oil prices helped to shore up the trade surplus in 2009, although the surplus has narrowed again as imports have surged. Consumer spending has picked up as unemployment has declined and real wage growth has strengthened. Despite a slight, but noticeable, uptick over the last couple months, inflation remains very low by historical standards, allowing the central bank to keep interest rates at record lows to support the fledgling recovery.

Despite the good news on the rebounding economy, Russia faces significant and numerous challenges. The country must wean itself from oil dependence. While President Dmitry Medvedev favors political reforms and a transition to a knowledge economy, Prime Minister Vladimir Putin believes Russia should remain a global energy powerhouse, and that economic growth and modernization should be driven by energy clout. The coming presidential election in 2012 will go a long way toward determining which direction Russia takes. Although Mr. Medvedev and Mr. Putin are not expected to both run for president, they are both jockeying for position. Russia also needs to address its reputation as a corrupt and inefficient country. To this end, the president has vowed to tackle corruption, cut back on bureaucracy and focus on innovation. In order to attract foreign capital to finance investment, Russia needs to improve and modernize its financial system, in particular protecting shareholder rights and improving the rule of law. Its recent privatization program will do well to attract more investors as well as raise profits to help finance the budget deficit.

Russia also has challenges on the geopolitical front. The fallout from Russia's heavy-handed invasion of Georgia, and the opposite reaction to the ethnic violence in Kyrgyzstan, in which Russia refused to get involved, show that Russia is still struggling to develop an identity on the global stage in the wake of the collapse of the Soviet Union. Russia is still trying to work out an arms treaty with the United States, and it remains outside Western institutions like the European Union (EU), the World Trade Organization (WTO), the Organization for Economic Cooperation and Development (OECD) and the North Atlantic Treaty Organization (NATO). If the country is to become a viable player on the world stage, it needs to make economic as well as political reforms, and alter its stance with its neighbors and current and emerging superpowers.

Economic Overview

After falling 11.0 percent on a year-ago basis in the second quarter of 2009, Russian real GDP has rebounded, growing 2.7 percent year over year in the third quarter. While this is a step back from the 5.2 percent growth in the second quarter, it was the third straight year-over-year increase (Figure 1). The rebound in the trade surplus on the back of rising oil prices, following a dramatic 75 percent plunge in the surplus during the second half of 2008, has been a key driver in the recovery (Figure 2). However, the trade surplus has plunged again in 2010 as the improving economy has led import growth to far outpace export growth, which is starting to weigh on GDP growth. While exports were up 18.1 percent from a year earlier in September, imports were up

Russia's economy has rebounded from the depths of the recession. However, the country must overcome many challenges to become a viable player on the international stage.

Together we'll go far



Figure 1



Figure 2



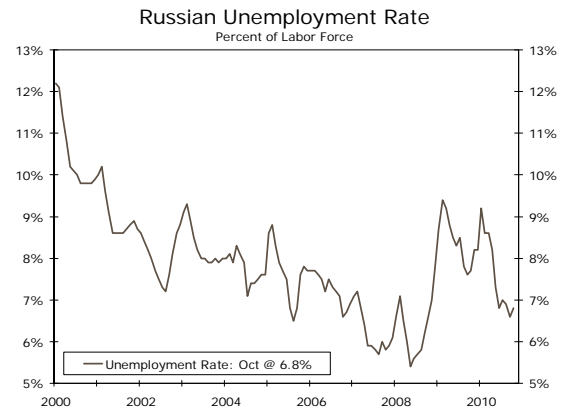
Source: Russian Federal Service of State Statistics, Central Bank of Russia and Wells Fargo Securities, LLC

33.7 percent. In the third quarter, the trade surplus was just \$9.6 billion versus \$13.1 billion in the second quarter and \$11.1 billion in the third quarter of 2009. This decline in the trade surplus comes despite continued strong oil exports. Although oil exports have leveled off over the last few months, they are a bit above levels seen before the oil boom of 2008. Another factor in the smaller surplus in the third quarter was the grain export ban. Wheat exports fell to just \$1.7 million in September from a monthly average of \$238 million in the second quarter, bringing the third quarter monthly average down to just \$203.7 million. While the grain export ban was not a *significant* factor in the slower economic growth in the third quarter, since the ban didn't take effect until mid-August, it will certainly be a big factor in the quarters ahead. The ban, originally set to expire in December of this year, has recently been extended until July 2011.

Figure 3



Figure 4



Source: Russian Federal Service of State Statistics and Wells Fargo Securities, LLC

Many indicators are showing renewed strength throughout the economy.

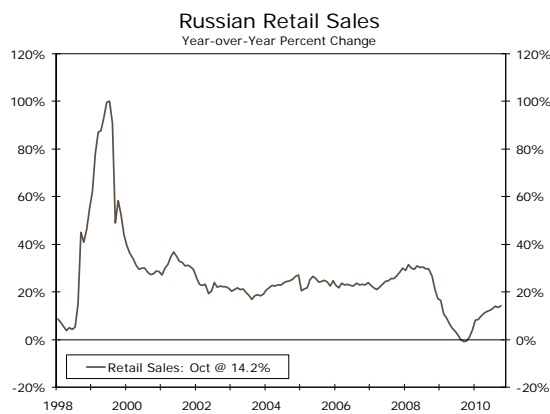
Other indicators are showing strength throughout the economy. After plunging during the recession and bottoming in January 2009, industrial production has bounced back and was up 6.6 percent year over year in October (Figure 3). While production growth has slowed from 12.6 percent year over year in May as the global economy cooled and Russia grappled with drought and fires, production levels and growth are back to pre-crisis levels. As the economy has regained ground, employment growth has come back from a trough of -3.1 percent year over year in May 2009 to 1.0 percent year over year as of September. As a result, after peaking in February 2009 at 9.4 percent, the unemployment rate has come down noticeably to just 6.8 percent as of October (Figure 4). With the increase in employment has come improved real wage growth, which rebounded from -5.4 percent year over year in July 2009 to 6.7 percent in June 2010. However,

real wage growth has since slowed again to 2.0 percent year over year in October and is still weak by historical standards (Figure 5). Even so, rising wages, along with improvement in consumer confidence, has fueled a rebound in nominal retail sales growth from -0.9 percent year over year in September 2009 to 14.2 percent year over year in October of this year (Figure 6). Even the construction industry has gathered momentum, as construction contracts were up 5.4 percent year over year in September after bottoming at -18.3 percent year over year in September of last year. However, the improvement is all due to non-residential construction, as residential construction continues to trend lower. With all the improvement in the economy, one would think inflation would be marching upwards, but that really has not been the case. Although inflation has rebounded a bit over the last couple months, it remains very low by historical standards. This has allowed the central bank to keep interest rates low to support the recovery. Inflation and interest rates will be discussed in a bit more detail later in this report.

Figure 5



Figure 6



Source: Russian Federal Service of State Statistics and Wells Fargo Securities, LLC

Budget Falls into Deficit, Expected to be Balanced Again by 2015

The global economic slowdown led to a plunge in Russian exports, particularly oil exports, in 2009. This, along with slower domestic activity, led to a steep decline in tax revenues, resulting in a government budget deficit of 5.9 percent of GDP for 2009, the first deficit in a decade. However, a rebound in oil exports and the resulting higher tax revenues has helped the budget deficit to improve in the first half of 2010 to 2.1 percent of GDP compared to 4.1 percent in the first half of 2009. In June, the government revised its deficit forecast for 2010 from 6.8 percent of GDP down to 5.4 percent. The previous budget estimated oil revenues based on a price of \$58/barrel. But with the increase in oil prices, the June revision assumed a price of \$68/barrel. Since then, oil prices have risen even further to around \$85/barrel recently. Thus, it looks as though oil revenues are likely to come in even higher than the June revised estimate, suggesting an even smaller budget deficit for 2010 than the government expects.

Recent increases in oil prices suggest the budget deficit for 2010 could be smaller than previously expected.

The government is taking measures to increase revenue from other sources as well. These other sources of revenue include a 61 percent increase in the natural resource utilization tax (NRUT) on natural gas, the reintroduction of the NRUT on Siberian oil production and increases in excise taxes on tobacco, alcohol and petroleum. In addition, the government will increase social security contributions from employees by 3 percent and from employers by 2 percent. Furthermore, the government will reduce the size of future indexations of benefits.¹

On the expenditure side, the first half of 2010 saw a slight decline in expenditures as a percent of GDP. However, going forward, further government spending to support the economy, along with hikes in social outlays, mainly pensions, will push up expenditures in the quarters ahead. In

¹ **Russia: Current Growth Spurt Likely to Fade, Institute of International Finance, July 30, 2010**

addition, an increase in government spending leading up to the 2012 presidential election is expected as the ruling United Russia Party tries to bolster support by placating the masses. However, tax revenue from oil production and exports, as well as the aforementioned increases in revenue from other sources, will likely outweigh expenditure increases. The government is taking these steps, along with increased privatization, which will be discussed later in this report, in the hopes of balancing the budget by 2015.²

Figure 7



Figure 8



Source: Russian Federal Service of State Statistics, HIS Global Insight and Wells Fargo Securities, LLC

Inflation Remains Low, but Ruble Still Vulnerable to External Forces

Inflation in Russia remains extremely low by historical standards. Following the hyperinflation of the early 1990s, brought about by the fall of the U.S.S.R., and again in 1998-1999 after the country defaulted on its debt and the exchange rate crashed, inflation has come down significantly in Russia, largely following global trends.³ Some of the reasons for the decline in inflation worldwide include technological innovation, relocation of production to low-wage economies, a decline in the power of trade unions and greater efforts to control inflation by governments and central banks in an attempt to attract foreign investment in an increasingly globalized financial system.⁴ The average inflation rate in Russia over the past decade has been about 13.5 percent. During the height of the oil boom, inflation reached “only” 15.1 percent year over year in May and June of 2008. Since then, inflation had decelerated sharply to just 5.5 percent in July of this year. However, inflation has rebounded over the last couple months, coming in at 7.5 percent year over year in October, as prices for grains and other food products soared following the country’s worst heat, drought and fires in decades (Figure 7). But the central bank perceived this increase to be temporary and decided to leave the main policy rate at a record-low 7.75 percent at its most recent meeting, citing weak bank lending and continued doubts about the sustainability of the recovery. Looking ahead, while substantial slack in the economy presents a downside risk to inflation, declining unemployment and improving real wage growth present upside risks. These forces will likely offset each other for the near to medium term, which should keep inflation in a relatively limited range. This will allow the central bank to keep interest rates low to support the recovery.

Following the sharp depreciation of the currency during the financial crisis, and the subsequent quick appreciation as the crisis faded, the ruble has traded in a relatively narrow range between 29-32 rubles per dollar over the past year, but trading has remained volatile within this range (Figure 8). As Russia has a much more open capital flows system than other emerging markets, the ruble is extremely vulnerable to changing investor sentiment, whether it is due to oil prices,

Inflation in Russia is low by historical standards. The ruble has recovered from crisis lows, but remains vulnerable to changes in oil prices and investor sentiment.

² “Russia to Sell Rosneft Stock in \$59 Billion Plan to Cut Deficit,” Bloomberg, October 21, 2010

³ In December 1992, inflation soared to over 2,300 percent year-over-year. In July 1999, inflation was over 120 percent year-over-year.

⁴ *The Ascent of Money*, Niall Ferguson, page 117

politics or other factors.⁵ This is one reason the country saw a much bigger capital outflow during the financial crisis than other countries, which ultimately forced the central bank to use a significant amount of foreign exchange reserves to stem the ruble's decline.⁶ The ruble's subsequent recovery from the lows during the crisis has helped to contain inflation by making imported goods cheaper. However, because of this improved affordability, imports have risen much faster than exports. This has resulted in a decline in the trade surplus throughout the year, which is weighing on GDP growth.

In order to spur economic growth during the recession, the central bank pumped billions of rubles into the financial system, amounting to about 8.6 percent of GDP by IMF estimates.⁷ However, instead of lending it out, banks largely held those rubles in reserves at the central bank.⁸ While this helped to keep inflation at bay, it also held back the recovery. Bank lending in Russia is somewhat dependent on oil prices as well, since higher oil prices lead to increased capital inflows. Thus, with oil prices rising lately, banks have become a bit more willing to lend, although credit still remains fairly tight. However, should oil prices fall again or should another economic calamity occur, capital would likely flee the country again, and bank lending could slow. Thus, Russia's economic fate still largely depends on oil and external factors, something that needs to change if Russia is to become a more viable presence in an increasingly globalized economy.

Moving Away from Oil

Oil accounts for nearly a fifth of Russia's GDP, two-thirds of its exports and almost half of its government revenues. During the commodity boom prior to the global slowdown, triple-digit oil prices were a boon for Russia. In July 2008, at the height of the oil boom, the value of oil exports was up 77 percent from the prior year. Since the state takes 90 percent of all earnings of oil exports at prices above \$25/barrel, the country's coffers were brimming.⁹ However, as oil prices plunged in the second half of 2008, the value of oil exports was 46 percent below the prior year by December of 2008. The decline continued into 2009, reaching the nadir in February before finally rebounding. The decline in oil exports led to a dramatic 75 percent plunge in the trade surplus, which ultimately factored heavily in the country's recession. Over the past year and a half, exports of oil have largely mirrored the swift rebound and subsequent leveling of oil prices, helping to pull the economy out of recession (Figure 9).

Oil accounts for a significant portion of GDP, exports and revenues.

Though down significantly from the peak, oil prices at around \$85/barrel are still higher than

Figure 9

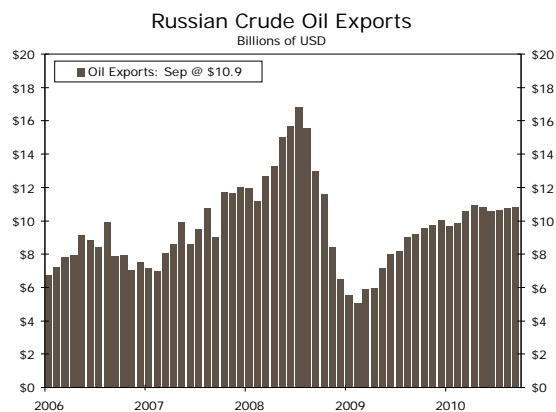
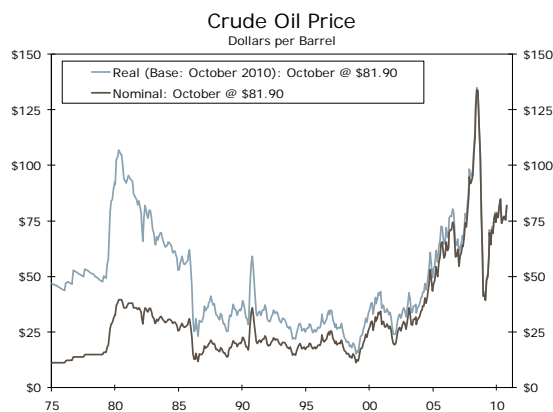


Figure 10



Source: Federal Customs Service of Russia, St. Louis Fed, U.S Department of Labor and Wells Fargo Securities, LLC

⁵ "Russia: Is it 'BICs' After All?" UBS Investment Research, June 1, 2010
⁶ "Sector and Finance Ministry at Odds on Tax," Financial Times, October 1, 2010
⁷ "Russia Unlikely to Remain a Super Saver for Very Long," Capital Economics, October 27, 2010
⁸ "Downside Risks to Oil Mean Ruble Trouble Here to Stay," Capital Economics, September 16, 2010

levels seen during the prior two decades before the boom, on both a real and nominal basis (Figure 10). And with developing markets requiring ever more oil to feed their growing economies, oil prices will likely trend higher over the coming years. This would seem to bode well for an oil giant such as Russia. However, the country's heavy dependence on oil nearly drove the economy into the ground during the bust. Worse, Russia saw a capital exodus, further exacerbating the effects of falling oil prices on the economy.¹⁰ In order to stem the ruble's plunge, the country had to buy up rubles using its foreign exchange reserves. Since these reserves are used to pay future pension payments, it is dangerous to rely so heavily on one single source of revenue, and a volatile one at that, to fulfill these obligations. This unpredictability in revenue streams, along with slowing investment in oil production and declining production in Siberian oil fields, has the country searching for ways to better diversify its economy.¹¹

Russia is trying to reduce its dependence on oil by becoming a more knowledge-based economy.

One such endeavor is a huge, high-technology center in Skolkovo, a suburb of Moscow. The goal is to create a sort of Russian Silicon Valley. The country churns out about 70,000 computer programming graduates every year. However, due to better opportunities outside the country, as well as difficulty starting a business inside the country due to bureaucracy, corruption, inefficient regulations and lack of financing, many graduates simply go elsewhere, or end up working for foreign companies. Thus, the brain power is there, ready to be tapped, but Russia has not benefited from its investment in the education of these students. The Micex Market for Innovation and Investment, a small stock exchange with just five companies listed so far, aims to be Russia's answer to the NASDAQ someday.¹² But with all the optimism, the Skolkovo plan has its critics. Rather than diving headlong into an industry dominated by major players such as China and India, the energy industry advocates improving the investment climate and using the increased capital flows to modernize the rest of the economy. But this would likely keep the country dependent on energy and natural resources much longer, and could even increase such dependence, which is the opposite of what the country is trying to achieve.

Politics Becoming "Interesting" Again

President Medvedev and Prime Minister Putin have opposing views on Russia's future.

The two main political figures in Russia, Prime Minister Vladimir Putin and President Dmitry Medvedev, have differing views on Russia's future. Mr. Putin touts Russia as an energy superpower, which he believes should be Russia's identity. He is not too keen on political reforms. Rather than moving toward more of a democracy, he prefers to keep power centralized, and to keep the masses pacified by raising pensions and entitlements. Along with leaders in the energy sector, he believes the natural resources industry should drive the economy and that modernization will come as a result of being an energy superpower. Mr. Medvedev, on the other hand, believes that Russia's dependence on the energy sector is "primitive."¹³ He favors political reforms and innovation, and thinks Russia should focus on becoming a knowledge economy. The high-tech hub at Skolkovo is central to the president's drive to modernize the economy by focusing more on innovation. The president is also intent on tackling corruption and reducing bureaucracy. To these ends, he has already announced a 20 percent reduction in civil servant jobs and a 15 percent reduction in the police force by 2012. Another possible reform, which is stuck in limbo, would be a reduction in the size of the military.

With two very powerful political leaders having such opposing views, Russian politics is becoming "interesting" again. Over the past decade, with Mr. Putin at the helm, the political landscape was very stable, almost boring to some.¹⁴ But with the 2012 presidential election looming, and with Mr. Medvedev and Mr. Putin diametrically opposed as to how to move the country forward, the country is bracing for a more volatile political landscape. This was borne out by Mr. Medvedev's recent decision to sack the long-standing mayor of Moscow, Yury Luzhkov, in September. Mr. Luzhkov had been critical of Mr. Medvedev and supportive of Mr. Putin returning to power. For his part, Mr. Medvedev justified the action by accusing the mayor of corruption, blaming him for

⁹ "Sector and Finance Ministry at Odds on Tax," *Financial Times*, October 1, 2010

¹⁰ "What Can Nigeria Tell Us About Russia?" UBS Investment Research, September 28, 2010

¹¹ "Sector and Finance Ministry at Odds on Tax," *Financial Times*, October 1, 2010

¹² "High-tech Project Raises Awareness," *Financial Times*, October 1, 2010

¹³ "A Search for New Sources of Growth," *Financial Times*, October 1, 2010

¹⁴ "Two Top Men Lay Markers for 2012 Election," *Financial Times*, October 1, 2010

the city's traffic problems and low quality of life, and admonishing him for failure to protect the city's cultural heritage.¹⁵ All of this was blasted across the state-controlled news channels, suggesting that while Mr. Medvedev is intent on reducing the state's control, he is not wholly averse to using his powers for his own benefit.¹⁶

By sacking the mayor, the president achieved two things. First, he showed that he is in charge. This is very important in a country where, some say, political credibility depends on establishing the chain of command, which usually means ousting dissidents or opponents.¹⁷ This brings to mind Mr. Putin's arrest of oil tycoon Mikhail Khodorkovsky in 2004, which established Mr. Putin as the supreme leader. Mr. Khodorkovsky claims that his conviction was motivated by his opposition to Mr. Putin, while Mr. Putin says Mr. Khodorkovsky "deserved his punishment."¹⁸ Had he not sacked the mayor, Mr. Medvedev would have appeared weak. Second, control of the levers of power in Moscow is essential when an election is approaching. The mayor is a key cog in lining up support for the president. By controlling the unions, the courts and the media, the mayor can bolster support for the president's United Russia Party in the run-up to the election. And sacking the dissident Luzhkov now gives the incoming mayor time to set the wheels in motion. Interestingly, the new mayor will be Sergei Sobyenin, who was deputy prime minister under Mr. Putin in 2008. Thus, he is a Putin man, which, unfortunately for Mr. Medvedev, strengthens Mr. Putin's hand going into the election. It is not certain that Mr. Putin will run for president in 2012. However, it is unlikely the two will run against each other, so actions in the coming months will reveal just how intent he is on returning to power, and who is really the most powerful man in Russia.

In any event, power is increasingly being concentrated in a small circle. Over the last couple years several top officials from the 1990s power circle have been pushed aside. With the Kremlin gaining more and more control over the political sphere, it is more difficult for aspiring politicians to make their way up the political ladder. Generally, politicians need to hold lower offices and prove their mettle before being appointed to governor or higher offices. But with the Kremlin taking more control over who is in power in lower offices, the only way for politicians to move up is to bow to the Kremlin. This is certainly not a sign of moving toward democracy.

Many Changes Needed for Russia to be a Contender

Besides political reform, there are many other changes needed in Russia for it to become a more viable nation in the global economy. Russia remains one of the most corrupt nations in the world. Transparency International recently released its report for 2010, in which Russia's ranking fell from 146 out of 180 countries in 2009 to 154 out of 178 countries in 2010, between Papua New Guinea and Tajikistan. It is estimated that corruption accounts for between a quarter and a half of all economic activity in Russia.¹⁹ President Medvedev is well aware of the corruption problems in the country and has vowed to make tackling corruption a top priority. Eliminating corruption in the courts and firing top officials in the judicial system and the police force are some of his stated intentions.²⁰ To this end, the government is launching a one-week anti-corruption course to be attended by 500 Interior Ministry officials by the end of the year.²¹

Another problem is different interpretations of the law. Certain documents and business practices accepted in one locale may not be accepted in another, making it very difficult to do business in the country. Multinational firms often have to deal with the conflict of either adapting to the way business is done in certain areas—bribery and kickbacks are commonplace—or holding true to

Sacking the mayor of Moscow showed that Medvedev is in charge. It also gave the new mayor time to gain control of the levers of power in Moscow.

Many changes are needed in Russia. Corruption, rule of law, investment regulations, privatization and a free press must all be addressed.

¹⁵ "The Moscow Mayor and the Ruling Caste," Economist Intelligence Unit, October 19, 2010

¹⁶ "Medvedev Asserts Himself Sacking Luzhkov," Economist Intelligence Unit, September 30, 2010

¹⁷ "Two Top Men Lay Markers for 2012 Election," Financial Times, October 1, 2010

¹⁸ "Khodorkovsky Says Prepared to Die in Russian Prison," Bloomberg, November 2, 2010

¹⁹ National Anti-Corruption Committee estimates 25%; Association of Russian Attorneys for Human Rights estimates 50%

²⁰ "A Search for New Sources of Growth," Financial Times, October 1, 2010

²¹ "Russia Perceived as Most Corrupt Major Economy," VOA News, October 26, 2010

their ethics and losing business opportunities as a result.²² The high level of corruption, bureaucracy and the risk of being entangled in court cases involving corruption, taxes or bribery are real risks for multinationals. These risks often turn businesses and investors away from Russia, which prevents the country from competing with the likes of Brazil, India and China in terms of investment and growth.

Besides corruption and various interpretations of the law, other changes are needed to attract investors. In the financial industry, better protection of shareholder rights, stronger laws against insider trading, creation of a central securities depository, harmonization of securities laws, deregulation and improvement in the bankruptcy codes are some things investors would like to see.²³ At the government level, more coordination between different ministries and agencies would improve efficiency and reduce red tape. On a bigger scale, joining the World Trade Organization (WTO) and the Organization for Economic Cooperation and Development (OECD) would make Russia much more attractive to investors.²⁴

Russia has plans to sell stakes in about 900 state-owned companies, which will help to attract more foreign investment.

Another change that would help is increased privatization. Privatizing more companies would boost local market liquidity and attract investors. To this end, the government has recently announced it will sell a 15 percent stake in Rosneft, its biggest oil producer, and use some of the profits to help balance the budget. It also plans to reduce its holdings in Sberbank, Russia's biggest bank. The government is also considering plans to sell stakes in Russian Railways, the state-owned rail monopoly, Sovcomflot, the country's biggest shipper, Aeroflot, the national air carrier, and Rostelecom, a telecom company. However, there are no plans to sell stakes in Transneft, an oil pipeline operator, or Zarubezhneft, an oil producer. In all, the government plans to sell stakes in about 900 companies over the next five years. By privatizing more firms, the country can improve the investment climate and create competition. More competition will help to keep costs down, which will help to control inflation, another big worry for investors.²⁵

Outside the financial sphere, more freedom of the press and visa-free travel are desired. State control of the media is one of the major reasons why many feel true democracy in Russia is a long way off. The recent beating of a journalist, who was covering youth political movements and protest actions, is just the latest in a string of attacks on Russian media personnel, which have become all too common, mainly because the perpetrators are rarely punished.²⁶ Although the state does not appear to be behind the attack, the episode is an example of the risks that Russian journalists face. Freedom of speech and expression is a central tenet of democracy, so until the media is free to express its views, true democracy will never materialize in Russia.

Making these changes will make investing in Russia more attractive, which would strengthen the ruble, which would help keep inflation under control, which would attract more investors, and the virtuous cycle would be set in motion. This is important because Russia's current account surplus could soon turn to deficit, increasing the need to attract foreign investment.²⁷ But until Russia gets serious about fixing some of these problems, the country will always lag behind the other BRICs in investment and growth, as well as international respect.

Never a Dull Moment in Russian Geopolitics

If corruption, political uncertainty, barriers to investment and lack of economic diversity weren't enough for investors to worry about, there is always geopolitics. Probably more than any other country in the world, Russia seems to be constantly in the news. In 2004, Russia was accused of poisoning Ukrainian presidential candidate Viktor Yushchenko, a pro-Western liberal. Its invasion of Georgia, a former Soviet republic, in April 2008 in response to Georgia's attack on South Ossetia, a Georgian province still loyal to the Kremlin, elicited a global outcry against

²² "Multinationals Find New Ways to Tackle Graft," *Financial Times*, October 1, 2010

²³ "Foreign Investors Are Skeptical About Implementation," *Financial Times*, October 1, 2010

²⁴ "Fundamental Problems Deter Inflows," *Financial Times*, October 1, 2010

²⁵ "Russia to Sell Rosneft Stock in \$59 Billion Plan to Cut Deficit," *Bloomberg*, October 21, 2010

²⁶ "Russian Reporter Severely Beaten, Likely for Stories," *New York Times*, November 7, 2010

²⁷ "Russia Unlikely to Remain a Super Saver for Very Long," *Capital Economics*, October 27, 2010

Russia for being too heavy-handed. Amid economic hardship in Kyrgyzstan in 2009, Russia pledged \$2 billion in aid in return for the country's promise to close an American military base. But Russia was furious when Kyrgyz President Kurmanbek Bakiyev took the aid but then allowed the United States to retain use of the base, albeit for a higher rent.²⁸ Russia also continues to struggle with the ongoing strife in Chechnya, which has been mired in violence since 1994. While most of the violence has been concentrated in the war-torn province, the double bombing in March 2010 of subway cars in Moscow was a warning from the militants that the war was coming to the heart of Russia.²⁹ In contrast to the war with Georgia, Russia refused to assist Kyrgyzstan in quelling the breakout of ethnic violence between Kyrgyz and ethnic Uzbeks in the summer of 2010 on the grounds that it was an internal Kyrgyz issue. Consequently, Russia was seen as being timid and non-committal to one of its former territories.³⁰

Then there was the sensational arrest of 11 Russians accused of spying on U.S. soil a month later, an operation which had been ongoing for two decades. The spies were later returned to Russia in exchange for four Russians accused of spying for the CIA, and then summarily given the state's top honor by President Medvedev. But Russia had to wipe egg off its face because the spies really didn't uncover any useful secrets, and the operation was deemed by most outside Russia, as well as some former KGB agents, as a complete failure and a disgrace.³¹ Russia has confirmed that assassins are now on the trail of the man who blew the spies' cover.³²

In November 2010, President Medvedev caused a stir when he visited the Southern Kuril Islands.³³ The islands are claimed by both Japan and Russia, and the president's visit drew Japan's ire. Japan temporarily recalled its ambassador to Russia in protest. The Soviet Union seized the islands from Japan at the end of World War II, and the two countries have still not signed a formal peace treaty because of the dispute. Russia is also in a race to the Arctic Circle in a quest to claim at least a share of the last frontier in fossil fuels.³⁴ Other countries in the race are the United States, Canada and Iceland, and possibly China. With production in many oil fields around the world dwindling, and with the melting of the polar ice cap allowing greater access to arctic sources, Russia is pouring huge amounts of money into reaching the Arctic. However, there is concern that the Arctic rush could eventually turn into a military conflict.

But these events are mere skirmishes in the bigger picture. Nobody can forget the Cuban Missile Crisis or the Cold War. But while Russia is no longer viewed as a global superpower, it does still have one of the biggest arsenals of nuclear weapons in the world, on par with the United States.³⁵ In April 2010, Russia and the United States signed the second iteration of the Strategic Arms Reduction Treaty (START), designed to reduce each country's nuclear stockpile by a third, which would bring both stockpiles to the lowest level in 50 years.³⁶ However, the treaty has yet to be ratified by the U.S. Congress, and the recent increase in the ranks of Republican senators suggests that ratification may be delayed, and possibly blocked entirely.³⁷ Indeed, the Russian State Duma (akin to the U.S. Congress) recently withdrew its recommendation for Russia to ratify the treaty, likely to avoid being spurned by the U.S. Congress should the Republicans block the action in the Senate.³⁸ One bright spot, at least in Russia's eyes, was President Obama's decision to cancel the proposed strategic missile defense system that was to be set up in Poland and the Czech Republic. While this may have given Russia more incentive to work with the United States on nuclear non-

Cross-border conflicts, terrorism, territorial disputes, spies and nuclear weapons – there is never a dull moment in Russian geopolitics.

²⁸ "Russia's Empty Empire," *The Economist*, June 24, 2010

²⁹ "Russia Braces for Terrorism's Return," *The Washington Post*, March, 30, 2010

³⁰ "Trouble Down South," *Foreign Policy*, June 14, 2010

³¹ "Russia Awards Top State Honors to Deported Spies," *Breitbart*, October 18, 2010

³² "A Turncoat in the Russian Spy World," *New York Times*, November 12, 2010

³³ "Japan Temporarily Recalls Russia Envoy Over Dispute," *Bloomberg*, November 2, 2010

³⁴ "Arctic Grab is Mad Fight for Last Oil Frontier," *Bloomberg*, September 27, 2010

³⁵ Source: Center for Defense Information: current world nuclear arsenals

³⁶ *Great Decisions 2010 Fall Updates: Russia and its Neighbors*, Foreign Policy Association

³⁷ "Start Treaty Trapped in Claws of U.S. 'Hawks'," *Pravda*, November 3, 2010

³⁸ "Results Raise Questions About Foreign Policy Goals," *New York Times*, November 5, 2010

proliferation, most notably regarding Iran and North Korea, it infuriated leaders in Poland and the Czech Republic.

While Russia tries to be more Western, it remains outside the bounds of Western institutions like NATO and the WTO.

Not only does Russia see the United States as a constant threat, but it has also been increasingly pushing back against NATO, and rejects the membership aspirations of its former satellites.³⁹ Earlier this year, President Medvedev approved a military doctrine that defined NATO's eastern enlargement as Russia's main military threat, since it would be increasingly surrounded by potentially hostile countries.⁴⁰ As such, it would not be surprising to see more instances of Russia using its natural resources as leverage in enticing, or forcing, Ukraine, Georgia and other former Russian territories to refrain from joining NATO. The fissure with NATO was further deepened by Russia's invasion of Georgia in 2008, which was condemned by many former Russian territories and seen as a lack of respect for territorial integrity and sovereignty. Russia's response to the conflict reflects the difference between the European concept of security and that of Russia. While the European Union and NATO focus on soft security such as good governance, political and social reform, reduction or elimination of corruption, establishment of the rule of law and protection of human rights, Russia focuses solely on hard security (i.e., military force). A platform for security cooperation between the European Union, Russia and North America, The Euro-Atlantic Security Council, which would be independent from NATO, has been proposed but has not yet been implemented. If the council ultimately comes to fruition, it would give Russia a new platform in which it would be included in the decision-making process from the start.

Russia also harbors interest in joining the World Trade Organization (WTO), which it has been trying to do since 1993. Russia has seen how WTO accession has been a springboard for China's economy. However, acceptance into the WTO has been continually delayed by politics, territorial disputes, changing economic conditions and differences in economic philosophies. Georgia, a WTO member, could potentially block Russia's accession. The war with Georgia in 2008 certainly did not help Russia's cause.

On a much smaller scale, Russia formed a customs union in July with Belarus and Kazakhstan that will ease trade barriers, although it will not fully abolish all duties and tariffs.⁴¹ Russia stands to benefit by becoming a hub for regional finance and trade. In addition, the customs union will enhance the mobility of labor and competition in industry, which will lower costs, foster innovation and help Russia to better diversify its economy. But even here there has been controversy. Although Belarus signed the agreement, it did so reluctantly. In June, Russia cut off gas supplies to Belarus, claiming it was owed \$200 million, a result of Belarus' decision to pay last year's much higher price for gas. The three countries vowed to apply to the WTO collectively if their individual applications were denied, but this may be a moot point now that the United States has recently announced that it has resolved all of its issues with Moscow on entry into the WTO and plans to move the process forward quickly. While Tajikistan and Kyrgyzstan have signaled their interest in joining the customs union, Ukraine has so far remained uninterested, despite having a president, Viktor Yanukovich, who is more friendly to the Kremlin than his predecessor.

Conclusion

Russia's economy has bounced back from the abyss on the back of higher oil prices. But the country needs to wean itself from "black gold" and diversify its economy if it is to join other current and emerging superpowers on the global stage. Conquering corruption, slashing bureaucracy, improving investment regulations and allowing for greater freedom of expression are just some of the reforms needed in the world's largest country. These reforms, along with better relations with other major economies as well as its former satellite states, will help Russia

³⁹ "Cooperation with the Kremlin," BertelsmannStiftung, January 2010

⁴⁰ "New Russian Military Doctrine Opposes NATO Enlargement," Georgian Daily Independent Voice, February 10, 2010

⁴¹ "Russia and Two Neighbors Form Economic Union," New York Times, July 5, 2010

to become better aligned with the global economy and to compete with the likes of the United States, Brazil, India, China and the European Union.

From the time when Peter the Great tried to make Russia more Western during the enlightenment, to the transition from an agrarian economy to industrialization to keep up with the West, to the transition from a Tsarist regime to socialism on the heels of such change in Europe, to the transition to a market economy, to the technology revolution in the 21st century and the struggle to establish true democracy, Russia always seems to be one step behind. The 2012 presidential election will go a long way toward determining Russia's future. Will it remain an energy superpower, or will it focus more on diversifying its economy? Will it remain that mysterious country outside the walls of Western civilization, or will it become a true democracy based on Western values? Will it remain an outsider, or will it join the international community in expanding trade and improving security? The Mayans believed that 2012 will be the end of the world. While nobody really believes this to be true, 2012 could be the end of an era of Russian isolationism and the beginning of a new era of innovation, integration and reform. The 2012 election will surely be one of the most important in Russia's history.

Russia always seems to be a step behind. The 2012 election could be a turning point.

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