# Russia: a Political and Economic Issue

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## Abstract

*The target of my analysis is to investigate the Expropriation Risk in Russia, and in relation to it, to assess the attractiveness and profitability of Foreign Investment, particularly considering the "strategic" natural resources sector.*
*The analysis starts with a look at the political scenario, when Putin came to power in 2001, to further present, and better understand, two of the most striking cases of Expropriation actions brought by the Government: Yukos and Sakhalin 2. Furthermore, the research singles out hedging strategies to avoid or reduce the Expropriation Risk, among which we see Export Credit Agencies (such as SACE in Italy) playing an important role.*
*The main conclusion is that despite the worsening of the Expropriation Risk over the last few years and months, and the current Financial Crisis, Russia still remains a high-return potential market, which investors should look at, while protecting their projects by implementing successful hedging tools.*

**Keywords: Expropriation Risk, Foreign Investment, Hedging Tools, Export Credit Agencies.**

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## *Introduction*

In Russia, the dire loans for share privatization of the Nineties have not brought up the conditions for a fully capitalist scheme or responsible corporate management. A dozen or so oligarchs have come to own and control much of the Russian economy, some of whom reportedly orchestrated the privatization process. In 1992 Russians first experienced the economic “shock therapy” (sudden removal of pricing and currency controls, withdrawal of state subsidies and immediate trade liberalization) implemented by Yeltsin's first prime minister Egor Gaydar. Within days the life savings of millions of people were wiped out by hyperinflation. Later in 1996, Yeltsin needed political support by the “new Russians”, which he could only buy by giving them the remaining state assets. In return, and to protect their own acquisitions, the oligarchs financed his presidential campaign in the gigantic scam of 1996 known as “loans for shares”. In this second privatization plan, Russia's industrial base and natural resources were dumped at a fraction of their real value. Russia's most profitable strategic resources were taken over by the oligarchy.

Ten years of corrupt capitalism have undermined the consensus in favor of free markets even more than several decades of communist propaganda. By 1999 Russian society was so tired and profoundly disappointed by the political and economic system, that they were ready to welcome any new autocracy or even dictatorship as the only way to get back to order and stability.

As result, it is no wonder that he was democratically elected as President of the Russian Federation in March 2000, since the majority of Russians saw in Putin a strong man capable of rescuing the country.

The Putin administration's measures against some oligarchs, (i.e. some leading business people of oil giant Yukos), showed a clear policy and strategic turnaround. Indeed, soon after his election, Putin disclosed that he would not continue to tolerate the hated clichè of ultra rich tycoons known in Russia as the “oligarchs”, and he wasted no time to revisit the “loans for share” larceny.

The Yukos case is  a good example of such an action, even though the chronicle of penalized oligarchs is extensive. Starting in July 2003, a campaign against Yukos, Russia's biggest private enterprise and one of its best managed has been pursued. The main goal of this campaign was not only the jailing of Mikhail Khodorkovsky and his business partner Platon Lebedev, but a warning to powerful business groups to stay out of politics.

After a lengthy trial, they were both sentenced in 2005 to 9 years in jail and their huge oil empire, Yukos, was dismantled.

However, the issue had negative effects on business development, as the case had shaken any belief in the sanctity of property rights and triggered concerns among foreign investors of confiscation, expropriation, and other similar actions brought about by the Government.

The Sakhalin issue, a PSA (Production Sharing Agreement) project with Royal Dutch Shell, represents a further case, that demonstrates both the government’s lack of understanding when it comes to the idea of the inviolability of contracts, and how the Kremlin was no longer tolerating foreign investors controlling strategic assets.

Foreign investors learned that certain strategic assets, mainly natural resources, would be out of bounds and that any large FDI project would require some form of Kremlin approval under the present administration.

After a first analysis of the most recent Russian Internal Affairs Policy pursued by Vladimir Putin (as a result of a more than a decade of corrupt capitalism), this paper will focus on the study of some important moves against the oligarchs (*Yukos*) and western foreign investors (Royal Dutch Shell) to show to the former to pay their taxes and avoid conflicts with the Kremlin, to the latter how the Kremlin is no longer willing to tolerate foreign actors to hold control on sectors considered strategic for the country. The questions are, what is exactly meant by “strategic”? and is the Russian Government going to act likewise in other FDI projects?

Later, the analysis will focus on the expropriation risk, which again turns out to be of crucial importance, in particular for international actors like foreign investors, banks and credit management institutions (Export Credit Agencies, ECAs, like SACE) and specifically in strategic sectors such as natural resources.

After giving a proper definition of expropriation risk, the paper will try to define a successful strategy in the energy sector.

Finally, considering the latest political and economic events involving Russia, the paper will give some answers and future perspectives on certain posers: how will the country manage the ongoing bank sector crisis and losses of capital? How will the Kremlin be able to restore investors' faith, at a time when the Russian Government is getting growing control on the economy?  What is the best approach that a financial actor should adopt when dealing with projects/partners in Russia?

## *1. A Political Overview*

### *1.1 Putin's Doctrine*

Most of the order-loving Russians have still at present terrible memories of the liberal 'shock therapy' of 1990s, when people's savings were wiped out, gangsters battled in the streets and historic parts of Russia were lost . It is not surprising, therefore, to sense an innate abhorrence towards this period of reforms among the average Russians, which were wearied by unlimited democracy.

To fully understand Putin's accomplishments and his appeal, one has to recall the tumult of the 1990s.

Liberal democracy has already disgraced itself in Russia, and hence, in historic terms, Putin's ruling period may be regarded as the initial stage of the Russian popular reaction against the liberal reforms, which have brought great changes, yet ruined millions of lives along the way. Behind the dazzling lights of Moscow, which has in the last 3 years, become the world's most expensive city; destitution, discontent, corruption, and resignation to iniquity still remain. In *The Russian Doctrine*, authored by a collective of 70 Russian academics and clerics, a national idea and a set of guidelines for the next government was laid out. It contains detailed foreign and domestic policy proposals, including reforms to administration, economy, security system, the military, mass media, education, culture, and a purge of the '*new Russians'* from the state apparatus, mass media and other positions of power. *The Doctrine* was approved at the 2007 World Congress of the Russian People.

*The Russian Doctrine* begins with the premise that the Russian Federation is doomed to extinction because it is unable to cope with the challenges of global competition. In the next decade Russia will start to lag behind China and India, let alone the European Union and the United States. In response, the authors propose a new state structure based on the traditions of both the Russian Empire and the Soviet Union. It would be based on a system of political and economic institutions working along the lines of *The Russian Doctrine*.

### *1.2 Putin's Revanchism*

The idea of Russia being tricked, swindled and humiliated by a well-organized western camp has led Putin to claim that foreign investment is being pumped into Russia to meddle in its internal affairs with the excuse of fostering democracy. After the 2007 meeting with Italian prime minister Romano Prodi in Moscow he said:
"*In the past, in the era of colonialism, colonialist countries talked about their civilizing role. Today, some countries use slogans of spreading democracy for the same purpose, and that is to gain unilateral advantages and ensure their own interests. However, as Russia's economic, political, and military capabilities grow in the world, it is emerging as a competitor — a competitor that has already been written off. The West wants to put Russia in some predefined place, but Russia will find its place in the world all by itself.*
*Therefore, self-reliance is the only practical direction in which Russia can move. 'Russia is a country with a history that spans more than a thousand years and has practically always used the privilege to carry out an independent foreign policy. We are not going to change this tradition today"* [2].
Diverging from the Russian foreign policy of the past 15 years when the Red Army was withdrawing from Eastern Europe and Central Asia, on December 12, 2007 Putin signed a decree to withdraw Russia from the Conventional Armed Forces in the Europe Treaty (CFE-1, signed in 1990 by NATO and the Warsaw Pact and updated in 1999, CFE-2) to reflect a new geopolitical reality in Europe.

[2] A. RASIZADE, *Putin's Place in Russian History*, International Politics , 2008, 45 (531-553)

### *1.3 The Energy Diplomacy*

Another component of Putin's foreign policy is the so-called '*energy diplomacy*' — the use of natural resources to exert power in Europe, which may be described as an implement in compelling the countries dependent on Russian energy supplies to an agreeable demeanor. Putting aside Putin's anger about the anti-Russian 2003 '*Rose Revolution*' in Georgia and the 2004 '*Orange Revolution*' in Ukraine, it should be taken into account that Ukraine alone consumes more natural gas (74 billion cubic meters) than Poland, Hungary, Slovakia and the Czech Republic combined, while Germany consumes only 100 billion cubic meters of gas.

Putin wants to sell his energy for the maximum profit on the world market, and he became exasperated by Ukraine and other 'newly independent states,' which paid in 2005 only $50 per 1000 cubic meters of Russian natural gas, while the European Union countries were paying on average $240. In 2005, both the United States and the European Union granted 'market economy' status to Ukraine, prompting, Russia's defense minister Sergey Ivanov, to wonder: '*If Ukraine has now a market economy, why cannot it pay the market price for our gas*?'[3]

Russia has the largest natural gas reserves in the world; it produces 600 billion cubic meters of gas and 500 million tons of oil a year, half of which is exported. While Russia produces a vast amount of oil and gas relative to other countries, it also has a much greater territory with a colder climate and a larger population. Russia produces only 3 tons of oil per capita, while Norway produces 20 tons. Despite the abundant energy reserves, Russia cannot, therefore, afford to subsidize its neighbors, as Putin stated in January 2006. Russia had been in fact subsidizing the former Soviet republics at the expense of Russian citizens for 15 years.

On January 1, 2006 the Russian state gas monopoly Gazprom stopped pumping natural gas to Ukraine and Georgia in response to their refusal to pay higher prices. This is how the 'energy diplomacy' worked: as soon as Georgia's anti-Russian

[3] See Kommersant, October 21, 2005

president Saakashvili threatened a military solution to the breakaway South Ossetia, Russia shut down its gas pipeline. The Georgian population struggled to endure the record cold temperatures and heavy snowfalls. After a dramatic confrontation, Georgia agreed to pay $235 per 1000 cubic meters of Russian gas. The Georgian energy crisis has proved the fundamental handicap of former Soviet republics in the face of Russian revanchism. Putin has repeatedly professed that the international recognition of Albanian Kosovo’s independence, proclaimed on February 17, 2008, should serve as an analogy for the recognition of independence to Pridnestrovie, Nagorno-Karabakh, Abkhazia and South Ossetia: “*We need common principles to find a fair solution to these problems. If Kosovo can be granted full independence from Serbia, why then should we deny it to Abkhazia?*”

### *1.4 Conclusion*

Enjoying the energy and natural resources sectors *strategic* status, and playing a fundamental role in gaining back international momentum through the “energy diplomacy”, Putin's decisions have been taken with the ultimate goal of getting back control on these assets. In the next sessions, the paper will introduce two important cases, *Yukos* and *Sahkalin*, which we will consider as evidence to understand how the state re-assertion has been and is being brought about by the Putin's Administration.

## *2. The Yukos Case*

The Yukos case can be considered as one of the most clear examples of how the State successfully managed to topple an undesired CEO and dismantle the largest oil company, to eventually get full control on its assets.

### *2.1 The Brief Story of Yukos Group*

The beginning of the twenty first century is well known for its corporate governance and accounting scandals, like the one involving the Russian oil company *Yukos*.
The *Yukos case* can be taken as a striking example of the Russian state's re-assertion of direct control over big business. It started with the arrest in the summer 2003 of Platon Lebedev, the head of the *Menatep* company, and one of *Yukos*'s main shareholders, and escalated with the arrest in October of that year of Mikhail Khodorkovskii, CEO of Yukos and its more important shareholder. The case is also famous because of the largest tax sum claimed in recent Russian history and the largest amount of laundered funds: the embattled oil company was accused of not paying tax amounting to $3.4 billion for 2000, $7 billion for 2000-2001 and there is little doubt that the tax authorities would have made similar demands for 2002-2003.
Besides that, the total number of personal criminal cases, launched against managers, employees or affiliated people on the company has exceeded one hundred. The total number of individuals, charged or prosecuted is more than 60, the number of court cases in several jurisdictions, including Russia, has already exceeded 500, while the number of individuals on the Interpol search list is 15.
*Yukos* oil company was one of the largest Russian "virtually integrated holding companies" established with the Russian large scale privatization and sold to the Menatep Group, in one of the infamous post-soviet "loans for shares" tenders.
The loans for shares programme of 1995 has been widely criticized for its lack of transparency and for fraudulent arrangements. Under this programme, the gems of the

Russian economy, the most promising companies in the industrial and energy sector, were in fact sold out in allegedly rigged auctions,(such as Mikhail Khodorkovsky buying *Yukos)* to businesses in exchange for minimal loans to the Government.

Yukos was no exception. Like most very wealthy Russians, Khodorkovsky founded his fortune on murky privatisations, and his purchase of the company drew much criticism as the auction was arranged by Menatep bank, which he himself owned. For a majority share stake, Mikhail Khodorkovsky paid just $170 million, whilst with 11,4 billion barrels in oil reserves (close in size to British Petroleum) the company's total value was about a $180 billion.

In early October the company merged with *Sibneft Oil.* As a result of the $3 billion deal, the new giant *Yukos-Sibneft*, became the world's leading oil company in terms of proven oil reserves and its assets of $35 billion made it the world's fourth largest publicly-traded oil producer.

Yukos, under Menatep's control, widely used asset-stripping techniques, as did the majority of Russian production companies sold to oligarchy groups. This allowed the controlling shareholders to enjoy the benefits of non-transparency and transfer pricing, which resulted in excessive profit.

However, in 2000, under the leadership of Mikhail Khodorkovsky the Company changed its strategy and began implementing international standards of reporting and accountability. Within several years Yukos, from being an oligarchic structure, evolved into a favourite of the Russian Stock exchange market and rating agencies such as Standard and Poor's. The Company adopted its own ADR programme and published annual and quarterly accounts, audited by PWC.

### *2.2 Yukos dismantlement process*

"*The state is not interested in the bankruptcy of the company,*"[4] President Putin said.

On 15 December 2005, based on a bank deposit of $4M and its American CEO's

[4] See *Yukos scandal triggers major political reforms in Russia* , http://english.pravda.ru, 25.10.2004

Houston home, Yukos asked for bankruptcy protection in the United States. It accused the Russian authorities of "*an unprecedented campaign of illegal, discriminatory, and disproportionate tax claims escalating into raids and confiscations, culminating in intimidation and arrests*". After some months of deliberation, the Houston court declared that under no conceivable theory could Yukos assert domicile in the US.

On 25 July 2006, the creditors of Yukos decided to file for bankruptcy after the bankruptcy manager stated that the company should be liquidated.

### *2.3 Forced Sale of Assets*

On October 31 2003, shortly after the arrest of the company's CEO, the ownership of 44% of the company's shares was frozen by the Russian government. The reason given was to prevent a group of shareholders led by Khodorkovsky from selling a large stake of the company to the US oil firm Exxon.

The Russian Government sold Yukos's main production unit, *Yuganskneftegas*, at auction on December 19 2004, to recover about $28 billion in alleged tax debts, following the loss of an appeal by the firm.

Menatep promised to challenge the sale's legality in a number of countries and sue the buyer and any company helping to fund the deal. The buyer was the 38% Russian state owned company OAO Gazprom. Some European and American oil firms decided not to bid.

On December 19 2004, the Baikalfinansgroup won the auction for Yukos's subsidiary Yuganskneftegas with a 260.75 billion rubles ($9.3 billion) bid.

Proposed lenders to the Baikal Finance Group were Gazprom, Sberbank, the Russian central bank, China National Petroleum Corporation, and ONGC (India). The reason for this arrangement could be that Gazprom feared international legal action against it after a Texas court ruling that barred Gazprom from bidding for the unit. This ruling was subsequently vacated.

Only two bidders applied and were present, during the auction process: Baikalfinansgroup and Gazprom's former oil unit Gazpromneft. Accounts from the auction reported that the first bid of $8.6 billion came from Baikal, which right after made a second one of $9.3 billion, without Gazpromneft placing any or speaking out.

In the course of these events, the value of Yukos shares plunged.

### *2.4 Impact of the Yukos Case on the oil and gas industry: Changes in taxation*

After Mikhail Khodorkovsky was arrested, the Russian authorities started with the demolition of the mechanisms that had helped the former chairman of Yukos achieve excellent results in business. The government started by eliminating the legal amendments that had been lobbied by Yukos and closing the legal loopholes which led to a minimization of taxation.

In November 2003, soon after Khodorkovsky was detained, the State Duma cast an unanimous 371-vote to cancel the so-called “Yukos amendment” to the Law on the Customs Tariff, which limited the export tax rate on refined products to 90% of the export tax on crude oil.

The government also made lawmakers annul privileges enjoyed by quasi-free tax zones in Chukotka, Mordovia and Kalmykia from January 1, 2004. These zones were tax havens for subsidiaries of Yukos, Sibneft, TNK-BP and other Russian companies. Such companies paid effective profit tax at the rate of only 7-13% instead of the officially required 24%.

In May 2004 President Putin approved a number of amendments to the fiscal legislation. The export tax rate on oil became higher for oil prices over $25 per barrel. Since August 1, 2004, Russian oil companies have to pay export taxes according to these new rules, and the new rate ($69.90 per ton) is much higher than the rate valid until two months before that date. The same amendments introduced a new formula for the mineral extraction (severance) tax, to come into effect on January 1, 2005. This implies a larger tax burden on all produced oil.

## *2.5 Impact of the Yukos Case on Business Relations with Authorities*

### *2.5.1 Main Financial-Industrial Groups in Russia*

Before Vladimir Putin was elected President, the Russian political elite was basically influenced by a number of Financial and Industrial Groups (FIGs), the largest of which were: Alfa (with assets in oil industry such as TNK [Tyumen Oil Company]), Menatep (owner of YUKOS), Interros (Sidanco), a group headed by Boris Berezovsky and Roman Abramovich (and holding Sibneft), another group leaded by Vagit Alekperov (Lukoil) and several other smaller organizations.

Once Putin came into power, some FIGs maintained their influence and became even further involved in politics. Those were Alfa, Abramovich's Millhouse, and, during the first years of Putin's term in the office, Menatep. Others kept themselves— or were kept—away from power (this was the fate of Interros, and also of Berezovsky's and Alekperov's FIGs).

A newly formed coterie of the so-called "men from St. Pete" became a critical new factor influencing the political scenario. This byname refers to people born in St. Petersburg who got power because of their personal closeness to the President. After Putin reshuffled all the top echelons of power and positioned his own men at the top of Gazprom, "men from St. Pete" could also be seen as prominent FIGs with their own sizeable energy assets—practically the whole of Russia's gas industry.

Ever since the times of Boris Yeltsin, some groups (especially Alfa and the group of Berezovsky-Abramovich) were named "the Family" because of their strategic relations with members of the Presidential family; they were also nicknamed "men from Moscow" or "people from Old Moscow". This term is now quickly losing its relevance because Berezovsky's former ally Roman Abramovich has alienated himself from the disgraced oligarch.

However, another re-distribution of power among the largest FIGs in Russia was already under way as law enforcement bodies announced the initiation of criminal cases against representatives of Yukos. This process can be partially explained by the fact that both “men from St. Pete” and Alfa saw the merger of Yukos and Sibneft as a threat. They believed the new giant would alter the balance of political and economic power in Russia.

Oil companies are aware that the potential of expanding business on the basis of ongoing fields is not very high. As a matter of fact, in a few years it will be necessary to access new oil and gas provinces in Eastern Siberia, the Barents Sea and Sakhalin. New projects will require huge funds and specific know-how by international oil groups. Companies close to Putin will probably try to persuade him that *Production Sharing Agreements* might be a good solution after all. It will give the government an additional instrument for influencing oil companies by awarding PSAs to the most obedient allies.

Private oil and gas corporations will probably retain a niche in the market but they will have to give up the practice of tax minimization through legal loopholes and start supporting government-sponsored mega-projects. The government is likely to demand a more active backing of pro-Kremlin political movements, charitable financing of cultural and social programs, and so on.

### *2.6 Deterioration of Russian Companies’ Market Performance*

The Russian government’s campaign aimed at raising taxes affected the performance of domestic companies. In the second half of 2004, the new export tax on crude oil and refined products was estimated to increase the overall fiscal burden on Russian oil companies by $1.5-2.0 billion, depending on world prices.

On January 1, 2005 the mineral extraction (severance) tax (MET) was changed. This tax is levied on all oil produced in Russia. The government is considering differentiated MET rates for various types of reserves. It might result in a further decline of the performance of Russia’s most successful oil companies that operate high-quality reserves.

The goal of the government’s fiscal policy is to get as much as possible of additional profits oil companies make because of high international quotations. Before these amendments of tax laws, the state received about 64% of incremental oil revenues for prices exceeding $25 per bbl. Starting on January 1, 2005, the government’s take will reach 86%.

### *2.7 Yukos: Not Simply a Business Issue*

The factors and circumstances leading to the collapse of Yukos are manifold and can be analysed from different angles. Even though the Kremlin has always considered the Yukos' case as a solely economic matter, it is quite clear that it has been a political issue, too.

The Kremlin did not overlook Yukos' rapid expansion, and its involvement in financing opposition politicians before the December parliamentary elections.

Yukos defenders, amongst whom are some prominent politicians, lawyers and analysts, clearly see a political element to the case, arguing that Yukos managers have been prosecuted and the Company is facing liquidation exclusively because of Khodorkovsky’s political and public activities. Others consider Khodorkovsky as a mere criminal who headed Russia’s most powerful and dangerous “corporate criminal group”. Russian businessmen have attempted to change the Russian constitution and influence the parliament according to their liking; they bribed many deputies and even whole parties. Khodorkovsky was one of them.

While he was in jail, Russia held parliamentary elections, which determined a change in the organization of the State Duma, and the presidential election, which confirmed Putin stay in the office for another term. New variants of the laws about referendums, meetings and demonstrations were approved and Russian ministers were allowed to become party leaders.

Russian politicians, experts and even some members of President Putin's team define Khodorkovsky's arrest as the starting point for significant changes in Russia since the beginning of the 1990s. The most important political result of those years was as follows: *“business is pulling out from politics, and politics is coming into the world of business.”*

In addition to that, the Yukos case is also known as a complex and ambiguous composition of fraud, tax evasion, and other criminal cases, launched against several Yukos shareholders, managers and employees. The backbone of the case is the money laundering charges brought against the organized criminal group, which was allegedly composed of the Company’s top managers and headed by Mikhail Khodorkovsky. He and his allies have been charged with the laundering of approximately $ 27 billion, approximately the equivalent of the Company’s profits over a four-year period. Some commentators think that the Yukos case is the by-product of the problems caused by partisan and predatory privatization in Russia: Privatization did create the property owners in the Russian Federation— masses of small shareholders without any power to influence decisions over the enterprises they “own”. It also produced few “new Russians”, who have acquired enormous wealth by skilfully taking advantage of the transition period weaknesses, including the lack of transparent and clear rules and diminished law enforcement abilities of the State. In the absence of appropriate rules or monitoring, the market-oriented changes particularly privatization, stimulated an unprecedented rise in the legalization of criminal assets and property acquired through illegal means.

The moderate analysts see in the Yukos collapse a culmination of Putin’s fight against oligarchs, in his quest to strengthen a weak Russian state, and the clash among different influential Kremlin groups, struggling for oil revenues. These analysts nevertheless recognize the element of selective treatment in the Yukos/ Khodorkovsky case.

## *2.8 Conclusion*

In light of this case, the core question is how a company with audited accounts listed on international stock exchanges, considered a symbol of the Russian corporate governance and transparency, has become involved in a money laundering scandal of unprecedented magnitude ($27 billion)

The conclusion is that the Yukos case has clearly showed the Russian government intentions: increasing its control over the industry indirectly, that is, without re-nationalising the oil industry on a grand scale. It did so on different ways: stricter control over hydrocarbon reserves, and increased control over export networks (and therefore limit the construction of private pipelines). Finally, it has put back in the saddle the main state-owned companies in which it is the main shareholder, namely Rosneft for oil and Gazprom for gas, thus indicating a real willingness to bring the hydrocarbon industry under the umbrella of Russian economic development. This suggestion is borne out by the foreign policy of restoring Russia's place on the world scene through its oil power *"Energy Diplomacy"*. To do this, the government needs to gain control of oil production and reserves as well as export strategies, at the same time avoiding to contribute to the reduction in international prices through an excessive supply. These protectionism practices are clearly not in line with capitalism principles; a conclusion to be drawn is, therefore, that the Russian government goals could hinder real wealth and economic growth in the other industrial sectors. Further, the analysis will introduce another case of State expropriation and violation of contracts, namely the Sakhalin case. This time, the State by using the environmental issue tool, put pressure on the Dutch Gas Company Royal-Shell, to sell the majority of its shares in an uneven asset swap. Once it got full control on the project, the Russian Government said all the environmental problems were solved.

### *3 The Sakhalin 2 Case*

The Sakhalin deal was struck in the early 1990s when the oil price was around $20 a barrel and Russia's healing economy needed foreign capital. But with oil touching $60, Russia decided to claim a greater share of earnings and it successfully managed to take control on the project by threatening the leader and majority shareholder of the project, Royal Dutch Shell, by revoking environmental permits and licenses.

#### *3.1 A brief Introduction on Sakhalin*

In the 1976-1982 period, under the Sakhalin-1 project, two fields were discovered. Chaivo and Odoptu, the prevailing oil price was quite low and neither field was deemed profitable. Later on, more offshore fields were discovered, and in 1988, the Russian government authorized the Ministry of Oil and Gas to develop the first two of them. Being the domestic oil sector unexperienced in the sub-Arctic offshore, drilling foreign cooperation was required.

In May 1991, Russia invited competitive international bidders for a feasibility study on two large deposits in northeastern Sakhalin, *Lunsky and Piltun-Astokhsky*. A consortium, which included Marathon Oil, McDermott, and Mitsui was chosen to undertake the exploration process, and a holding company, *Sakhalin Energy Development Company* was established. Later, Royal Dutch Shell and Mitsubishi joined the consortium and, subsequently, McDermott withdrew.

The Russian government then decided to tender exploration and development rights on several potential sites on the Sakhalin shelf; sites were offered separately in order to increase competition among potential investors; with the exception of Sakhalin-2, *Rosneft*, a state-owned holding company, was involved in all potential projects.


### *3.2 Sakhalin Energy Investment Company*

The Sakhalin-2 consortium, which was the only one being foreign-owned, was successful in discovering commercial volumes of oil. In July 1999, oil production began under a *Production Sharing Agreement*. The operating company, *Sakhalin Energy Investment Company* (SEIC) brought together *Marathon* (37.5%), *Mitsui* (25%), *Mitsubishi* (12.5%), and *Shell* (25%) in developing the Piltun-Astokhsky and Lunsky fields. In 2000, the British-Dutch multinational company, *Shell*, bought *Marathon* out and raised its share to 62.5%. In 2001, 2 million tons of oil were produced; most of which delivered to South Korea.

Infrastructure development for Sakhalin-2 was supposed to include roads, a trans-island pipeline and a Liquefied Natural Gas (LNG) and oil terminals at the southern tip of the island. The total investment in the region was projected at $8 billion. The main issue constraining this development was when (or whether) renewed Japanese economic growth would start creating enough demand for additional LNG.

### *3.3 Problems in the Production Sharing Agreement System*

In 2000, the status of Sakhalin remaining potential projects under the *Production Sharing Legislation*, in general, turned out to be highly uncertain.

In September 2000, President Putin attended a PSA conference in Yuzhno-Sakhalinsk, declaring that “PSAs are for Russia” and he appointed German Gref and the Ministry of Trade and Economic Development as coordinators for the regulation of PSA activity (Pacific Russia Oil and Gas, Summer 2001). Since then, the clarification of existing PSA legislation and legislative approval of its implementation have stalled because of bureaucratic rivalries.

The government was considering this investment as a state expenditure, even though not one kopeck of budget money went into the project.

Total revenues for the Russian side within the framework of the project, according to estimates by Sakhalin Energy, was about \$40 – \$30 billion per year until the project’s development costs would have been covered and \$2 billion per year after construction expenditures would have been recouped.

Projects developed jointly on the basis of PSAs are operating successfully in over 60 countries and they are used by net importers, exporters, Third World countries and those aspiring to great power status.

Natural Resources Minister Yuri Trutnev’s comment that “*PSAs are for countries that are in bad shape and don’t have the money*”[5] shows Russia's extreme sensitiveness on the issue.

PSAs are a good solution for any project and both the investor and host country: the state can earn significant revenues from rich fields and lower amounts from less

[5] See *Sakhalin Energy: Cooperation Commitment with Russian Ministry of Natural Resources* Oct 23rd, 2006, Friday, October 20, 2006, http://royaldutchshellplc.com

important ones, without limiting the relative attractiveness of investment in the development of fields with significantly different characteristics.

In 2003, PSAs were marginalized and the idea was that they are only needed when dealing with the most difficult projects - and Sakhalin was not one of them.

### *3.4 Rise in Costs and the Kremlin Block*

Serious troubles threatening Sakhalin-2 only began to arise after Sakhalin Energy reported that cost estimates for the project had risen from $12 to $21.9 billion, in particular due to an increase in the cost of the *Nord-Stream* pipeline (due to run along the bottom of the Baltic Sea to transport gas to Germany).

This substantially delayed the profitability of the project for Russia as the original deal struck with Shell gave it the priority to recover all its costs before sharing any profits.

On the other hand it has to be emphasized that investors were purchasing Russian and foreign equipment and materials, and after their investment had been recovered, everything would have become Russian property. That included offshore drilling platforms, on-shore oil and gas refineries, 1,600 kilometers of pipelines and a giant LNG terminal, along with the modernization of the island's infrastructure.

There was no possibility that the state could lose in the end. Those facilities would have not only provided the foundation for future oil and gas projects, but also strengthened the fishing, lodging, tourism and recreation sectors.

The rise in investors' costs also meant an increase in the value of orders for Russian contractors, who had already made $8 billion from the two projects and these orders activated a multiplier effect with an increase in revenues in several economic sectors. The increased capital expenditure contributed to the diversification of the economy — one of the government's main goals.

The industrial production index for Sakhalin grew at a rate 50% higher than the one for the country as a whole in the period 2004 - 2005. Even before the two projects became fully operative, they had already contributed to the development on the island. This happened without any sort of additional outlays from the federal budget.

As for the higher expenditure, the threat it posed to final profits was inevitably an issue for investors as well. The idea of investors craftily inflating costs assumes that they were interested in incurring losses as well. The company's board of directors would not have tolerated unnecessary increases in costs if they would have reduced their dividends.

PSAs also allow the state to exercise significant control over projects. As the state has representatives on the boards of directors of the projects' companies, they have a say in controlling costs, as well. Moreover, the government can order audits: in 2006 three different examinations of expenditure for the Sakhalin-2 project were conducted.

In addition, the foreign partners in a PSA get outside financing for the projects, meaning their creditors can also monitor costs since their reputation is on the line.

As soon as the environmental complaints on Sakhalin-2 surfaced, the European Bank for Reconstruction and Development postponed a decision about whether to grant credits for the project.

### *3.5 The Environmental Issue*

A further threat to the project development has been the Ministry of Natural Resources decision of revoking a 2003 environmental permit for Sakhalin-2, which was still under construction, due to the concerns about disturbing the gray whale population. The move could have frozen the development by creating a huge cost over-run. A month-long environmental investigation was brought through to determine how Shell could have amended for alleged damage.

Shell denied mismanagement and western governments protested, against what seemed to be a ploy to persuade Shell to hand Russia's state gas monopoly Gazprom a generous slice of the project in an uneven asset swap.

Other foreign energy groups were also accused of ignoring rules to protect nature, raising suspicions that the Kremlin had decided to use environmental permits as a new mechanism for putting pressure on uncooperative foreign partners.
Many analysts predicted a cash payoff for Shell would have been the "worst-case scenario", and because of that Shell was eventually obliged to hand over the project's control to the state-owned company Gazprom.

### *3.6 Gazprom Enters Sakhalin-2 Project*

Just after the state-controlled Gazprom took control of the $22 billion operation from Shell in a deal mired in controversy, Vladimir Putin declared that the environmental issues surrounding Sakhalin-2 had been settled.
*"As far as I've been informed, the fundamental issues can be considered resolved,"* the President was quoted as saying by the Interfax news agency. *"Russia is satisfied by a serious and businesslike approach of the partners."*[6] His comments came after he met officials from Gazprom and Sakhalin 2 shareholders, Shell, Mitsui and Mitsubishi. He played down the Kremlin's role in negotiations, insisting on Gazprom's *"decision to participate ... was a corporate decision"*[7].
The move by the Kremlin was seen as a sign that Russia would no longer tolerate foreign investors controlling strategic assets.
Shell owned 55% of Sakhalin 2, with Mitsui of Japan owning 25% and Mitsubishi 20%. At first, it was thought that Shell would have given up about 30% - 35%, and the other two companies about 10% each. Gazprom had originally offered Shell a share of its Zapolyarnoye field as a swap for 25% of Sakhalin-2, but Shell's announcement of spiraling costs and substantial additional investments the Sakhalin-2 project strengthened Gazprom's hand, prompting the monopoly gas group to demand a much higher share.

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[6] S. BOWERS, *Sakhalin issues 'settled' - as Russia takes 50% stake - Environmental problems vanish with handover Putin gives backing minutes after deal,* December 22 2006 , http://www.guardian.co.uk
[7] *ibidem*

In December 2006, Shell and its Japanese partners accepted a $7.5 billion cash payment for a stake of 50% plus one share in the project.

Despite its majority of shares, Gazprom left substantial management and technical advisory roles to Shell, which is the global leader in liquefied natural gas, an important component of the Sakhalin 2 project.

Shell definitely lost control over the project, but, given Sakhalin's great revenue potential, it will still benefit from being part of it.

### *3.7 Sahkalin-2 Project's Figures*

Sakhalin 2 is the world's largest integrated oil and gas project with oil reserves estimates of about 1 - 1,2 billion barrels of oil. Daily production capacity was originally about 80,000 barrels, but the next phase of development for 2009 at the site can increase the current production to up to 340,000 barrels, including 26,000 tonnes of liquefied natural gas.

Under Gazprom ownership, Sakhalin 2 has pledged to honor contracts to sell liquefied natural gas to Japan, South Korea and the United States according to an agreed schedule.

Separately, Gazprom, which is the world's largest gas producer, reported more than doubled profits from 154 billion to 332 billion rubles, well in excess of expectations.

The Sakhalin 2 project is still being developed under a PSA that includes Gazprom, Shell, Mitsubishi, and Mitsui. The project’s costs of more than $20 billion have made it the largest single foreign investment in Russia.

Due to environmental concerns on the impact on the gray whales, the consortium announced in 2005 that it would be rerouting some of the pipelines which go from the platforms to the shore-based processing facilities. For these reasons, LNG production has been delayed, and year-round oil production, too.

### *3.8 Conclusion*

The scandal surrounding Sakhalin once again proved not only the government's lack of understanding when it comes to the idea of the inviolability of contracts, but also in the area of direct investment in resource development in general.
Complaints about increasing costs within a production sharing agreement are, in the best case, an attempt to shift profits from the investors into the federal budget or, in the worst one, an unscrupulous approach to competition.

## *4. The Expropriation Risk*

The State intervention in the Russian industry, with special regard to the natural resources sector, is very intensive. Due to cultural and political reasons, Russian authorities - and partly also Russians themselves - still believe that the State's interests come first and that to the State ultimate benefit anything has to be done. On such a basis, it is not difficult to understand why certain anti-capitalist practices, such as private assets expropriation, are still common in Russia.
It is, therefore, of great interest to focus on one of the main risk an investor could face when committing financial resources in the country: the expropriation risk.

### *4.1 Defining the Expropriation Risk*

Investors by themselves could easily explain the reluctance to commit resources in Russia, and they identify the high level of political and economic risk, high taxes, corruption, illegal activity, fuzzy property rights, weak rule of law, and weak corporate governance as some of the major deterrents to investment.
In the sector of natural resources, there are particular difficulties in defining and enforcing access rights, access to the world market, and a stable tax and regulatory framework. Foreign investors sometimes saw their ownership rights threatened by

the activities of large domestic energy firms, trying to gain control of the same assets, as in the Yukos and Sakhalin cases, mentioned in the previous sections.

Without a clear and enforceable framework, there is a high expropriation risk for potential foreign investors, either by administrative fiat or by "creeping" expropriation through unpredictable changes in laws, taxation, and administrative regulation.

The risk of expropriation has changed remarkably since the 1970s, when it was not unusual to seize assets without giving a proper compensation.

### *4.2 The Expropriation Risk: Outright and "Creeping" Expropriation*

There is a large economic literature which analyzes the impacts of expropriation risk on the behavior of the investing company and the behavior of a host country in the absence of a credible commitment to not expropriate. This section considers to what implicit extent, self-enforcing agreements can provide a framework for cooperation. The problem with self-enforcing agreements is that each party must be provided with tools to punish a partner in the case of breach of the *ex ante* contract.

Holdup problems arise when one or more partners invest in assets that are specific to a project. The specificity of an asset is measured as the share of the return to investment that would be lost if the asset were used outside of the specific project.

When a company invests in an energy project in a host country, most of the investment committed to the project becomes a sunk cost, while the return is a quasi-rent, which must be shared between the investors and the host country.

The inability or unwillingness to commit to not expropriate penalizes the host country as well as the company. Unless the structure of the agreement between a host country and the company provides safeguards against expropriation, the foreign investor will not have any interests in financing potential projects.

Expropriation of an investor's asset can be of different types. Early theories of expropriation, such as the works of Eaton and Gersovitz (1981,1983,1984) and

Fernandez and Rosental (1990) consider cases of sovereign default. This literature demonstrates that a host country will repay its debts only if the costs reneging exceed the benefits from defaults.

In the case of foreign direct investment, expropriation or "Wealth Deprivation", may take the form of outright nationalization of a project without paying adequate compensation or it may take the form of "creeping" expropriation. In case of formal expropriation, the investor loses the control rights over the project. In "creeping" expropriation, instead, the State interferes by capturing the quasi-rents of a project by increasing taxes, transport charges, export duties or by other administrative measures. The State uses that property or enjoys its benefits, even when the property is not confiscated and the legal title of the property is not affected.

In Russia, producers frequently report that they are required to deliver a share of their production to the state at zero or nominal prices. Although outright expropriation occurred frequently in the 1970s, "creeping" expropriation is more common today.

While the former is a clear violation of international law, the latter is hard to prove and punish. Outright expropriation transfers control rights to the host country, while "creeping" expropriation leaves those rights in investors' hands. By retaining control rights, the company may take actions to reduce the cost of expropriation on its profitability.

The economic literature on expropriation focuses on the ability of each party either to provide an alternative pay-off that is more attractive than expropriation for each period or to provide a credible punishment in the case of deviation from the *ex ante* contract, so that the partner forgoes the short run benefit of expropriation for the long run gain of a continued relationship.

The reasons why the Sakhalin project moved forward at a time when other investment lagged behind were due to the lack of experience of Russian producers to deal with offshore environments, the main risks posed to the valuable Pacific fishery, and the significantly higher technical productivity of foreign-assisted energy projects. These elements reduce the risk of expropriation as does easy access to the world market. The fact that foreign investors have good outside options, providing a credible threat of withdrawal, deters Russia from excessive taxation or other "creeping" actions.

However, later on, Russian authorities threatened Shell, the main shareholder of Sakhalin 2, by revoking environmental permits, pushing it to give the state-owned Gazprom a big stake of its assets, which gained eventually full control over the project.

A formal framework for natural gas users in Japan, China, South Korea, and Taiwan will be required before large-scale production of pipeline gas or LNG will become feasible. The existence of potential users of oil and natural gas in Khabarovsk and Primorye regions actually increases the expropriation risks for foreign investors, since these regions contain powerful political constituencies, they have historically received energy from Sakhalin on highly subsidized terms.

### *4.3 The Expropriation Risk Theories and Models to Mitigate It*

#### *4.3.1 Eaton and Gersovitz Theory*

The theoretical literature proposes many different mechanisms to enforce agreements. Eaton and Gersovitz[8] provide a reputation model of foreign direct investment in which expropriation or excessive taxation of existing investors deters potential future investors, imposing costs on the host country.

In their study, foreign investment provides both international management skills such as technology, known-how and capital. In deciding on expropriation, a host country ponders the benefits of obtaining income from foreign capital against the cost of losing access to foreign managerial services. In response, when the expropriation risk is binding, the foreign company chooses to deviate from otherwise optimal factor

[8] Eaton, Jonathan & Gersovitz, Mark, 1984 *A Theory of Expropriation and Deviations from Perfect Capital Mobility*, Economic Journal Royal Economic Society, vol. 94 (373), pages 16-40, March

combination and pricing decisions in order to deter expropriation. In the simplest case, the investor reduces the investment size, assuring that the expected income from expropriation is lower than the host country's tax revenue from continued operations.

These alternatives are manifold. In the case of debt finance, the foreign investor, M, licenses technology to a domestic company and extends credit to finance investment. Under the contract, M provides investment, I, in period 0 and B, a domestic company, contracts to return D = or > I to be paid in period 1 to compensate M for its initial capital outlay and for granting a license. In such a deterministic model B invests I, receiving the return RB > I. After receiving the return, B chooses whether or not to honor its debt. If it reneges, an exogenously given punishment ensues, such as loss of access to capital markets, which yields a utility loss, -L. Thus, the payoffs are:

$$U_M = \begin{cases} D - I \\ -I \end{cases}$$

$$U_B = \begin{cases} R_B - D + I - I \\ R_B - L + I - I \end{cases}$$

M receives $D\text{-}I$ if B pays or *-I* if B reneges and B receives $R_B\text{-}D\text{+}I\text{-}I$if it pays and $R_B$ - $L\text{+}I\text{-}I$ if it reneges. Thus, B will repay only if $D \leq L$. It follows that M will be unwilling to invest unless the penalty that B faces for reneging exceeds the cost of investment.

### *4.3.2 Thomas and Worrall Theory*

Thomas and Worrall[9] consider an investor's strategy in a dynamic context. The investor anticipates the host country's short-run incentive to expropriate by committing a small investment amount at the start, thus, choosing a time path for investment offsetting the short-run incentive of expropriation with a long-term

[9] THOMAS JONATHAN, WORRAL TIM, *Foreign Direct Investment and the Risk of Expropriation*, Review of Economic Studies, Blackwell Publishing, vol. 61(1), pages 81-108, January

incentive to gain access to future investment's flow. In this variant, M commits a small investment, $I^o$, in the initial period, yielding $R^1 B$ .

If it honors its commitment to repay, then it receives $R_B - D + I^0 - I^0 + I^1$.

### *4.3.3 The Cross-Ownership Theory*

Perotti[10] focuses on the ability of each party to penalize deviations from the agreement through cross-ownership. In Perotti's model, cross-ownership works as an exchange of hostages by creating incentives for stockholders to give the manager of the company that violates informal arrangements, a large penalty.

In the case of FDI, M is assumed to carry out the investment project itself. After investment costs are sunk, B has the option of nationalizing the project. (B is cash constrained and doesn't compensate M for the expropriation). After the nationalization B controls the project, making the return, R*B*. Again, nationalization triggers the penalty, -L. Thus, if M invests and B nationalizes, M receives –I and B receives R*B*-L.

Instead of nationalizing outright, B can attempt to capture a share of the returns on investment by imposing taxes on M's income. As long as M controls the project, B may (partially) withdraw her resources from the host country. If M decides to stay, the project will then generate a return equal to R*M*. If M shifts production out of the host country, the project produces a lower return $R_{MX}$ $(0 \leq R_{MX} < R_M)$ while an additional profit *r* is received abroad. Since B can guarantee itself an income of at least R*MX*, it will never choose $T < R_{MX}$. Further, he will never choose $T \geq R_M - r$, since this would induce M to withdraw.

The payoffs, therefore, are given by:

[10] PERROTTI ENRICO, *Cross-Ownership as a Hostage Exchange to Support Cooperation, Managerial and Decision Economics*, 1992, Vol. 13, pp. 45-54

$$U_M = \begin{cases} R_M - T - I \\ r - I \end{cases}$$

$$U_B = \begin{cases} T \\ R_{MX} \end{cases}$$

The foreign company receives $R_M$-T-I if it does not withdraw and *r-I* if it withdraws. The host country receives T if the foreign firm does not withdraw and R*MX* if M withdraws.

Schnitzer[11] introduces further extensions of the model to show that a profit-sharing joint-venture with B can create incentives to lower T. Introducing an uncertain probability of success into the model generates information problems if the domestic firm controls the project, since a foreign lender cannot distinguish from a strategic default from a genuine bad completion. However, if returns are shared between the foreign investor and the host country, as under the Production Sharing Agreements, the host country will trade off tax revenues against a share of return.

Moreover, if the effort by M can increase the probability of success at a cost, K, the host country will have a further incentive to reduce T.

### *4.4 Export Credit Agencies (ECAs)*

Other hedging tools aimed at mitigating, or better transferring risks from the investor to another subject, are provided by International Export Credit Agencies. International ECAs (such as *SACE* in Italy) insure financial institutions and banks by providing a hedge facility in relation to a project finance loan, including also an overseas resource or mining investment/project. ECAs insurance covers financial losses incurred as a result of the counterpart's non-payment due under the hedge facility where the sole and direct cause of non-payment arises from any of the insured

[11] SCHNITZER MONICA, *Debt vs. Foreign Direct Investment: The Impact of Sovereign Risk on the Structure of International Capital Flows*, 2000

political or commercial events.

### *4.4.1 Insured Political Events*

ECAs provide insurance against the counterpart defaulting on its obligations under a hedge facility where the sole and direct cause of the default is one of the following political events: *expropriation,* war damage; political violence; or currency inconvertibility and exchange transfer blockage. The cover is provided against the payment of a premium, which varies depending on factors including the country for which cover is sought, the region where the investment or project is located, the transaction tenor, the political risks being insured and the type of investment or project requiring the hedge facility.

### *4.4.2 Features of ECA Financing*

Many ECAs also have specific project finance programs which are tailored to suit the requirements of project companies and commercial lenders. These programs combine the basic forms of financing which meet specific requirements of a limited recourse project finance. The repayment schedule will be tailored to the expected cash flow of the project and should not, in most cases, require repayments before the end of the construction period. Note that there are limitations on the maximum average tenor which are usually determined based on the project location. (*The Berne Agreement and the OECD Consensus*).

Direct finance to the project company, credit support and guarantee to the commercial lenders of up to 100% of the outstanding principal and interest are some of the facilities provided by some ECAs.

When applying for finance under an ECA project finance program, the ECA undertakes a due diligence process similar to that of commercial lenders, but on more favorable financial terms.

ECA financing can also be used to support trade finance and attract finance that would otherwise be unavailable. In effect, the commercial lenders rely on the sovereign guarantees provided by the ECAs to support the borrowing of the project company. For example, political risk insurance provided by an ECA often forms a crucial part of the credit support package provided to commercial lenders. As a result, if a project is *expropriated* prior to the loan being repaid, the ECA will pay up to 100% of the outstanding principal and interest.

Difficulties may arise if financing is sought from two or more ECAs because they often have conflicting rules. For example, USEXIM, the Export-Import Bank of the United States, requires all lending documents to be ruled by the New York Law whereas ECGD, UK's official Export Credit Agency, (as well as many of the commercial lenders) is likely to prefer English Law.

As a result of the strict rules about what does and does not qualify for ECA financing, it is vital that sponsors and project companies who wish to utilize ECA financing are aware of those rules from the outset. In addition, a project company may be willing to accept a higher contract price if as a result of contracting with a certain party or by stipulating certain items of plant and equipment the overall financing will be cheaper.

It is common for EPC (*Engineering, Procurement and Construction*) contracts to contain local content requirements that oblige the contractor to source materials from the country where the project is being developed. Similar provisions will be required if ECA financing is used to ensure the project company continues to qualify under the rules of the relevant ECA.

ECA financing is often used in collaboration with other non commercial lenders, for example, the Asian Development Bank and European Bank for Reconstruction and Redevelopment which further decreases the financing costs but can increase complexity, particularly taking into consideration the differing requirements between ECAs and banks.

### *4.5 Political and Environmental Considerations*

Increasingly, ECAs have been targeted by environment activists and other organizations concerned with debt burdens of developing countries. ECAs have been accused of lending money or issuing covers without having taken careful consideration for environmental or social issues in the countries where the projects are located. Therefore, many ECAs, like *SACE* , have now dedicated divisions undertaking environmental analysis of large scale projects before they agree to lend.

### *4.6 Conclusion*

When committing financial resources and managerial skills aimed at developing projects in countries such as Russia, particularly in strategic sectors like energy and natural resources, investors have to take decisions in a very careful way. Projects need to be structured in agreements, to deter as much as possible the host country from expropriating, or be insured in case of default.

## *5. The Russian Economic Miracle*

Russia continues to be one of the most successful emerging markets. Indeed, the Russian economy has performed astoundingly well over the last eight years. Under Putin, Russia's GDP rose from $200 billion in 1999 to $1.3 trillion in 2007. International reserves rose from $ 12.7 billion in 1999 to $ 500 billion in 2007
The Stabilization Fund reserves have reached $ 170 billion. The Russian economy is now the twelfth largest in the world.
Although economic growth has been slowing down (from 10% in 2000 to 7,8 % in 2007), the country is still nonetheless growing at a fast rate. The economy is not only booming in the extractive sector, but also in the construction, trade, service and banking sectors. Russian business has proved itself able to organize large-scale

production and compete successfully against international corporations. Russia has repaid its debt to the Paris Club ahead of schedule and government external debt is now below 5% of GDP. Foreign Direct Investment stood at $ 121 billion in 2007, up 120% compared with 2006.

Activity in Russia already showed signs of slowing before fall 2008, when the financial crisis entered a more intense phase, compared to the last 5 years. We can observe a decline in the growth rate of the tradable sector, in contrast to a slight increase in the non-tradable one (see below table 1.1). Industrial production over the first eight months of 2008 declined by 2.3 points to 4.9%, compared with the same period in 2007, and growth in fixed capital investment almost halved. Gross capital inflows did halve to $74 billion in the January–August period, compared with $150 billion for all of 2007. Moreover, the credit crunch appeared to be draining domestic liquidity from the economy either directly (given that Russia is Europe's third largest bank borrower) or indirectly through the interbank and corporate sectors.

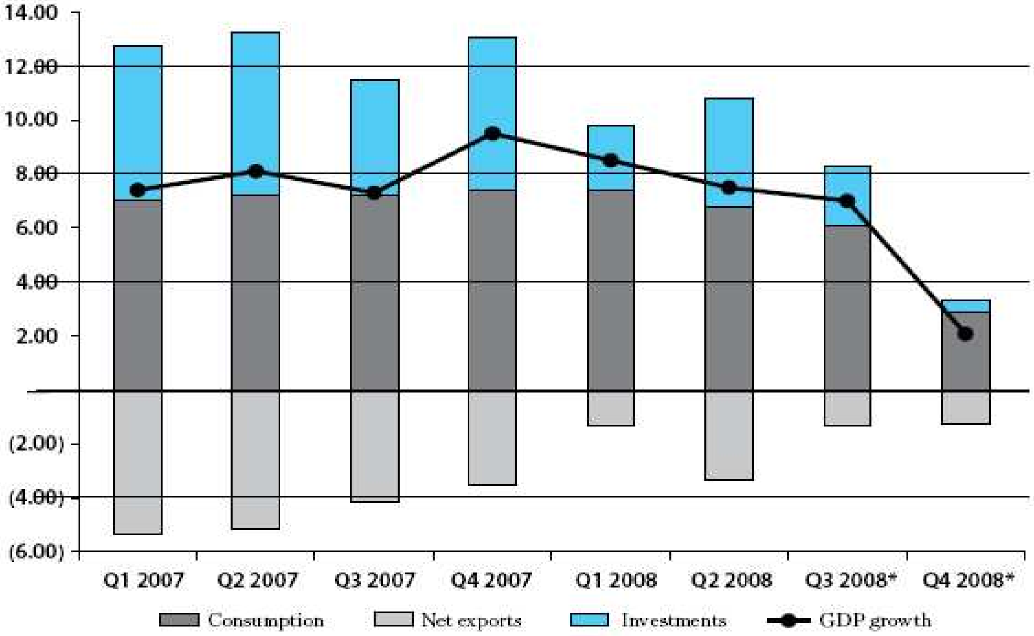
**Table 1.1. GDP growth by main sectors, 2003–08 (value added)**

| GDP growth | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 Q1 | 2008 Q2 |
|---|---|---|---|---|---|---|---|
| **Total GDP growth** | **7.3** | **7.2** | **6.4** | **7.4** | **8.1** | **8.5** | **7.5** |
| **Tradable sectors** | **8.9** | **6.3** | **3.5** | **2.6** | **4.6** | **5.2** | **3.4** |
| Agriculture, forestry | 5.5 | 3.0 | 1.1 | 3.6 | 3.1 | 3.2 | 3.2 |
| Extraction industries | 10.8 | 7.9 | 0.5 | 1.6 | 0.3 | 1.5 | -1.0 |
| Manufacturing | 9.5 | 6.7 | 6.0 | 2.9 | 7.4 | 7.6 | 5.6 |
| **Nontradable sectors** | **7.2** | **7.3** | **7.3** | **9.8** | **9.8** | **9.9** | **9.1** |
| Electricity, gas, water production and distribution | 1.6 | 2.0 | 1.2 | 4.7 | -1.9 | 5.3 | 1.7 |
| Construction | 13.0 | 10.3 | 10.5 | 11.6 | 16.4 | 28.3 | 18.7 |
| Wholesale and retail trade | 13.2 | 9.2 | 9.4 | 14.6 | 12.9 | 11.9 | 11.7 |
| Financial services | 9.6 | 9.9 | 11.9 | 10.3 | 11.4 | 9.7 | 9.7 |
| Transport and communication | 7.2 | 10.9 | 6.2 | 9.6 | 7.7 | 9.8 | 9.4 |

*Source:* Rosstat; World Bank staff calculations.

Since the Q4 of 2007 the consumption, net exports, investments and overall GDP growth has recorded a substantial drop as can be seen in figure 1.1.

**Figure 1.1. Demand sources of Russia's real GDP growth by quarter, 2007–2008 (percentage change)**

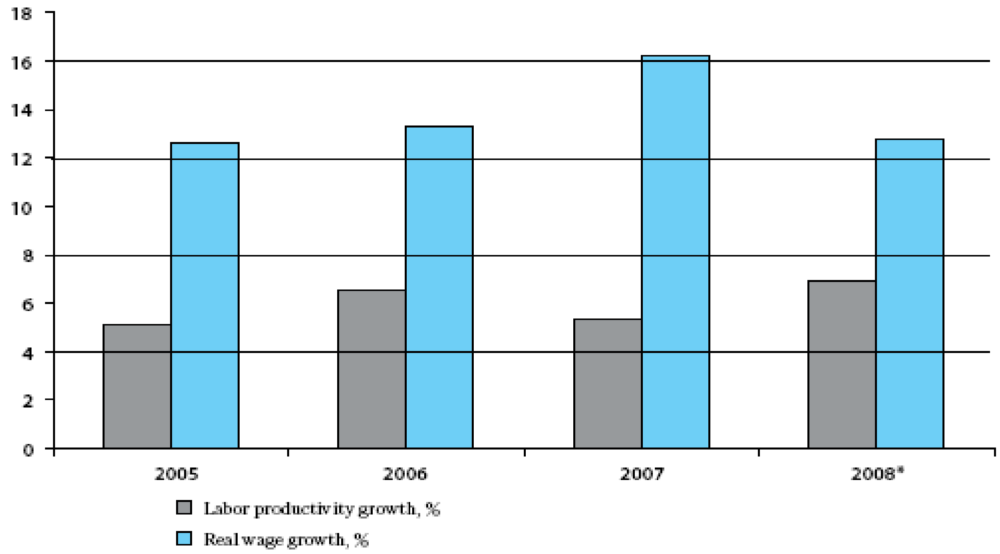



*Source:* World Bank decomposition and estimates based on Rosstat data.
* World Bank staff projected estimate.

## *5.1 Capitalism default and Destabilizing Factors*

However, there are factors that could undermine sustainability of the Russian economic growth. The main cause of the economy's success is high oil price, as well as protection from foreign competition. A collapse of the oil price could throw the Russian economy into recession. Wages and incomes in Russia have been growing more quickly than productivity (see figure 1.2).

Figure 1.2. Labor productivity and real wage growth, 2005-2008 (in percentages)




*Source:* Rosstat and World Bank staff estimates.
* Labor productivity growth Jan-June 2008, the real wage growth Jan-September 2008.
*Note:* Labor productivity calculated as output (GDP) per employed person.

As a result, consumption as a share of the GDP has increased at the expense of investment (gross investment is lower than 20% of GDP - as can be seen above in figure 1.1 in the data on Q4 2008). The government cannot lower inflation which, at the end of 2007, reached 10% and in April 2008 13%. The banking system is not fulfilling its role as a monetary policy transmission channel : the financial flows directed to the raw materials sector are not being transmitted to other ones. The government had no idea about what to do on the negative impact of petrodollars inflow - namely, the strengthening of the ruble, which stimulates imports and hurts Russian industry competitiveness (note that nowadays Russia is going through the opposite financial scenario: namely the devaluation of the ruble). The Corporate debt rose from $ 30 billion in 1998 to $ 500 billion in 2008. Russia's foreign trade accounts for 45% of GDP, which is a warning that Russian products are not competitive. Russian investors prefer to invest abroad, a trend called "*export of capital*". In 2007 Russian imports grew by 37% and exports only by 6 - 7%. These are signs that bureaucratic capitalism has serious faults.

### 5.2 The State Re-Assertion and Intervention as a Deterrent of FDI and General Economic Growth

The key problem with the Russian economy is the role of the government. There has been a clear increase in direct state intervention in the economy since 2003 when the state nationalized one of the most effective oil companies, Yukos (*See Section 2*). This event became a watershed in the development of bureaucratic capitalism in Russia. This sort of intervention has been most frequent in the natural resources sectors, to exert the so called *energy diplomacy*, particularly on Europe. In other sectors the state expansion has increased uncertainty and damaged the business environment. The state is the economic regulator, but does not respect the supremacy of law and operates on the basis of slippery, unofficial rules that even the state does not observe consistently. The expansion of a state that rejects the rule of law makes corruption inevitable and drives business into gray markets. Bureaucratic corporation has indeed privatized the state, leaving no room for the respect of property rights or any economic laws. No economic reform can stimulate business activity while the state is the servant of bureaucratic corporations and refuses to operate in a competitive environment. The World Bank has ranked Russia 106th out of 178 countries, 10 places lower than in 2007, in terms of ease of doing business. According to Transparency International Russia has slipped from 126th to 143rd out of 180 countries in its annual Corruption Perception Index, tied with Indonesia, Gambia and Tongo. In analyzing the Russian economic performance, The Financial Times observer Martin Wolf admits: “Putin is a failure, not a success”. Wolf reminds us that the economies of 11 of the 15 former Soviet Union republics have grown far more than Russia's.

### *5.3 Russia's Economic Model as a Petro-State*

The bureaucratic component of Russian capitalism is not the whole story. Russia's economic model is slowly evolving into that of a *petro-state*. The Russian Oil and Gas sector's share of GDP was 44,5% in 2007, and commodities accounted for 63,3% of exports. True, oil, gas and metals have not been driving Russian growth directly, that is, the rise in value added, in real terms, in these sectors has not been a major component of the increase in real GDP. In fact, output of gas has been almost stagnant (over 2002-2007 it increased 1%); oil production increased 2% in 2007. What has been driving growth is the rise in revenues from these industries, chiefly derived from sales to Europe at rapidly rising prices. Besides these points, a petro-state has certain characteristics: the appearance of a rentier class which lives on the dividends from the sale of natural resources; an alliance between the bureaucracy and business sector; systemic corruption; the domination of large monopolies controlled by the bureaucracy; an economy susceptible to external shocks; the risk of "Dutch disease", whereby a large increase in revenues from natural resources undermines the manufacturing sector of the nation's economy; state intervention in the economy; and a gap between rich and poor. The petro-state has an interest not in modernization but in preserving the natural-resources economy. All of these characteristics are increasingly typical of Russia.

### *5.4 Main Stumbling Factors to Economic Growth and Post-Industrial Modernization*

As the state is busy in a re-assertion process in the economy, there is no scope for reform. This demonstrates that a regime characterized by personalized power is incapable of creating a dynamic post-industrial economy; its primary concern is to safeguard its own interests. Anything threatening those interests must be restricted - competition, property rights, open courts, transparency in decision-making, business ethics, and press freedom. High oil prices tend to lull everyone into complacency. Bureaucratic capitalism in Russia can produce economic growth but this growth does not mean economic development: the share of high technology in the Russian exports amounts to a mere 0,3%. According to the Russian government, the share of companies that uses new technology in Russia is 9,7% (in Italy it is 36,3%, in Germany 60,9%).

Moreover, economic growth driven by consumption, high oil prices and foreign borrowing is hardly sustainable. One could expect that for some time, 5 to 7 years, Russia could still record further economic growth if the Kremlin maintains prudent macroeconomic policy and keeps up with consumer demand; if oil prices continue to be high (*which is not the case, see next section*) and the foreign capital and technology inflow go on.

However, other negative factors will matter, as well, including a decline in labor force, lack of competitiveness, the emergence of huge-mega corporations linked to the state, and insufficient new investments. Government economists have pointed at four systemic bottlenecks that will soon halt further economic growth in Russia: growing deficit of electric power; dilapidated road infrastructure; limited labor force and deficit of high skilled labor. The most negative element in this picture is the statism, the fusion of power and business that will not allow Russia to enter the next stage of post-industrial modernization.

### *5.5 Are Russians Ready for Liberal Modernization?*

We should not overstate the maturity of ordinary Russians or their ability to live in a State ruled by law. The Russian people are still politically inactive and seem unable of petitioning the regime which will address their interests. The Russian public has no experience in forming civil associations, and of life in a country where power is divided among executive, legislative, and judicial branches. Russians are, however, increasingly ready to move towards European cultural and legal standards, and they already consider themselves European. The world has become globalized, and Russia is now a reasonably developed country with a relatively well educated and well informed population.

However, two further problems remain: how to enable people to recognize the link between economic aspirations and freedom, and how will Russian people re-gain faith in democratic principles, after the shocks of the 1990s.

In Russia there are far more people who want to live in freedom, and fight for their rights, than one might suppose.  This is a breakthrough in the thinking of people who for centuries have been used to revere the state and their leader.

Yet we have to consider the growing disappointment related to the ideas of freedom and democracy in people's thinking in recent years. This is the result of several factors: Kremlin propaganda seeking to convince people that the current democracy coupled with the traditional one is the only form for Russia's survival; Russia's assertiveness abroad as a compensation for society's complexities and misfortunes.

In a March 2008 poll, 63% of respondents said that Russia is moving on “the right path”. It is a picture of a quite stable society.

### *5.6 Scenario for the Medvedev-Putin Russia*

What will be the short and longer term paths for Russia under its new format of rule? Will Russia move forward along the liberal democratic path and modernize itself, will it stagnate, or will it face some sort of crisis? For the first time in its history, Russia is enjoying an extraordinarily favorable domestic and international atmosphere for change: it has no serious international threats or enemies; it has domestic stability and both its leaders - Dimitry Medvedev and Vladimir Putin - have the popular support.

However, one dilemma remains: is the Russian elite ready for a new round of modernization? This is a crucial point, as in order to succeed, the ruling class has to restructure the traditional state. While the new rule is still on the process of settling down, total disarray could be felt among the political class and business. There are those who understand that the centralized power and extensive model of economic development are unlikely to lead to further economic expansion. The dissent is heard even inside official economic circles close to the government. Medvedev himself indirectly supports these concerns by talking about the need to fight corruption and judicial nihilism and offering an agenda of innovations. At the same time the majority within the elite and society at large is silent, watching the events unfold and trying to guess who the next ruler will be and what direction will he choose. The winners of the Putin years are those most vocal in defending the status quo – the mega corporations, the petro-state and the combination of power and property. Meanwhile, Russia continues to move along the route known since Soviet times, spending the oil windfall on imports, just as the Soviet Union did during the Brezhnev stagnation. The elite has not forgotten the Gorbachev period, which is considered as proof that weakening control leads to collapse. Society has not forgotten Yeltsin's years of chaos either.

### *5.7 The Medvedev-Putin Tandem is unlikely to Bring About Significant Changes*

In a stagnation environment it is difficult for a liberal democratic modernist to upsurge. Real change can only be provoked by a crisis, or the imminent threat of one. There is no guarantee, however, that a crisis in Russia would result in freedom, pluralism or reform. A crisis may be dealt with a mere change in rhetoric, by minor policy changes or personnel reshuffles in the Kremlin, while the old system would remain unchanged, as it happened in the past. It may be that before Russia has another opportunity to turn to liberal democracy, it will have to free itself from the temptation to approach its problems with a nationalistic totalitarian regime. Much depends on when the next crisis will occur and what conditions will prevail in Russia at the time.

So far Russian autocracy, under the disguise of “managed democracy”, has brought only frustration for genuine democracy and the desire for order not to change.

For Russia to achieve a breakthrough, *the Law of Failure* governing its system must be accomplished. In order to demonstrate that the path was wrong, the leader has to spectacularly fail. Gorbachev’s failure to reform the Soviet Union showed that it could not be reformed. Yeltsin’ failure to create a functioning capitalism with the aid of technocrats and oligarchs demonstrated its unsuitability. Putin’s failure to modernize the country from the top could force society to look for another pattern of modernization. So far, in the people’s eyes and in the eyes of the West, Vladimir Putin is not a failure, which means that true modernization may be a long way off. Besides, Putin’s presence on the political scene symbolizing continuity will hardly help Medvedev and the elite to think about the new round of reforms – this usually demands that successors bury the past.

Thus, the very model of the new Russian rule – the tandem – becomes one of the systemic obstacles on the path to Russia’s transformation. There are several other factors: continuing economic growth; renewed social optimism among part of society; increased super power ambitions of both the political class and the ordinary citizenry; fragmentation of the opposition.

Russians have yet to decide how much freedom and pluralism they can handle given the nationalistic ambitions of some groups. How can a lawless state be restructured without plunging Russia back into chaos? This is the eternal quandary and stumbling block of Russian reformers.

### *5.8 Options for Future Paths Alternatives*

In the immediate future, there seem to be three ways for Russia: continued political stagnation; a systemic crisis; or a breakthrough to liberal democracy. The most plausible option is the continuation of stagnation, despite economic growth. Some optimists believe that the Medvedev-Putin status quo scenario will push Russia towards liberal reforms. I do not see how a regime intent on continuity and the limits of the traditional state to competitiveness can lead to reform. It is more likely that, if it continues, in the longer run it will end either with crisis and an subsequent authoritarian response or with gradual decay. Both outcomes carry the threat of national collapse. What matters the most for Russian society and the elite is to find the means to bring about the liberal transformation of Russia before it relapses into the old ways and the most dynamic part of the society loses its drive and ambitions. Each year Russia remains politically steady reduces the probability of a liberal democratic breakthrough. The opportunity is still there, but for how longer? In this context the Medvedev political cycle appears to be crucial because it can either lay out the agenda for a new dynamism or squash any hope for revival.

### *5.9 The Challenges if the Path will be the Liberal One*

Should Russia try its liberal project once more, it would face new challenges. Russia is unlikely to change its enormous territory without the cooperation and assistance of the developed democracies – especially in developing Siberia and the Far East, as well as modernizing the North Caucasus. Russia would need to abandon its stubborn desire for self-sufficiency and its pathological sensitivity over sovereignty, especially as it becomes increasingly dependent on importers of Russian natural resources. Inviting foreign countries to cooperate on managerial and economic tasks is not new for Russia, but the developed democracies - to be willing to take part in the new Russian Project - would have to be persuaded that the goal is a law-ruled state.

Moreover, Western cooperation is unlikely to be unconditionally accepted by Russia. The West also needs to bear in mind how difficult it may prove to develop joint initiatives on the territory of Eurasia, and how painful it would be for Russia (more specifically, for its elite) to find a way to maintain the national identity while integrating itself into the Western world. If Western politicians indulge in displays of petty egoism, or fail to recognize the magnitude of the challenge, they may give Russia an additional push in the direction of a restoration.

### *5.10 Conclusion*

The West should not expect the new liberal Russia to prove an easy and agreeable partner. Shared values do not necessarily lead to shared national interest or common views on global governance.

There is no doubt Russia will stand with the West in trying times, if only because Russian society is exposed to many of the same threats as the West – primarily, Islamic extremism, nuclear proliferation, and China's transformation into a super power.

For the time being, Russia continues to drift and it is difficult to guess when the new window of opportunity for structural reform will emerge or what its trigger will be. In any case, even according to the government economists' forecasts, the truth may come in 2010-2011, when the resources of the extensive petro economy may be exhausted. The Russian political class will be forced to seek an exit solution. The question remains: will Russian society keep waiting patiently for the elite to wake up and understand the challenges Russia is facing?

## *6 The Financial Crisis*

### *6.1 Global Investors Put a Price on Putinism*

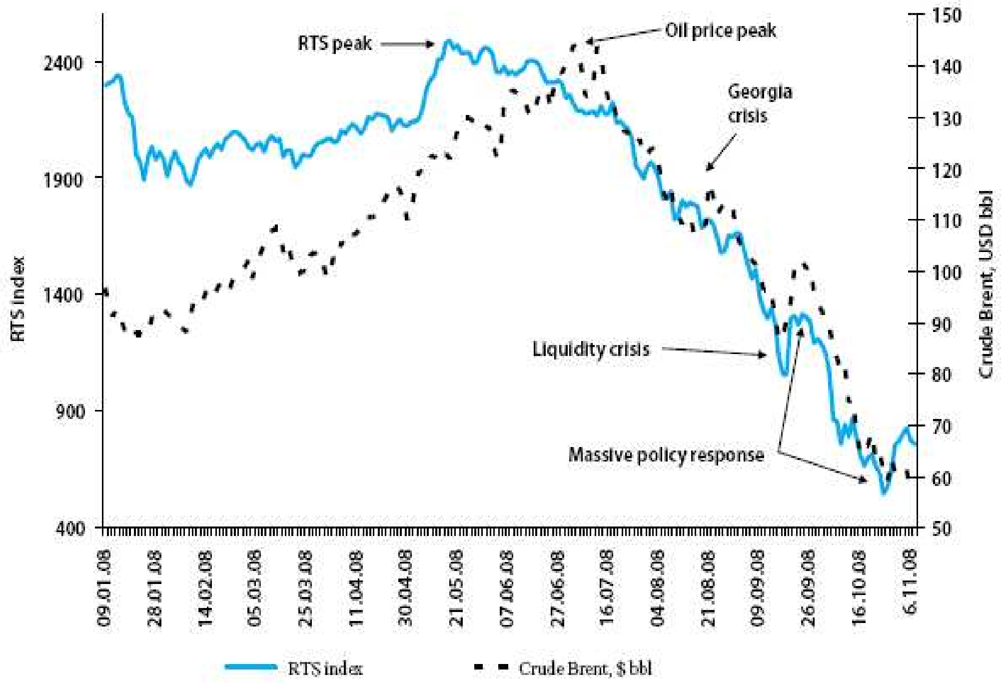
The current slump on Russian markets is taking place amid global markets turmoil. Equity indexes fell 70% from their 2008 mid-May peak through early October to a level last seen in 2004. The steepest drop was recorded by banks: 75% since the year start; and oil, gas and metals companies: 60-65% over the same period. Sovereign external debt spreads tripled over the same period to 450 basis points, a level similar to that of countries with lower credit ratings such as Turkey or Brazil. Spreads for corporate issuers increased even more, to 800-900 basis points for major state-owned companies such as *Gazprom, Rosneft and VTB*, the country's second-largest bank, and well above 1000 basis points for other prominent private sector borrowers. CDS spreads widened in line with those for external debt but the trouble in Moscow began before the Lehman's default, and its chief causes are homegrown. The bill for eight years of Putinism is coming due.

### *6.2 Triggered Mainly by Domestic Factors*

Several factors have combined to bring about chaos in Russia's financial markets. They include a sharply deteriorating external environment, with oil prices at less than one third their $147/barrel July peak, deepening global credit difficulties and a much weaker generalized growth outlook. The triggers behind the collapse of stock prices, however, are mainly domestic. Trouble appeared first in late July when Prime Minister Vladimir Putin lashed out at a Russian mining and steel company, *Mechel*, for alleged price gouging and appeared to threaten personally its chief executive. Mechel stocks fell by a third, and the incident chilled the market. Investors woke up to the systemic risk to property rights and the lack of any rule of law in Russia. This was taken as a signal that another successful private company would be taken over by the government or interests connected to it. The attempted or successful expropriation of Yukos, BP and Shell assets and the blatant use of state resources to menace private business were belatedly considered.

Another element was the 2008 summer *Caucasus war*. Russians routed the Georgian army in four days and annexed, in all but name, its provinces of South Ossetia and Abkhazia. Then Russia got routed by the global economy. The Putin regime looked rash and untrustworthy. Equity prices took another dive in the wake of the conflict, as can be observed by the RTS index performance (see figure 1.3 axis y), which prompted foreign investors to reassess perceptions about political risk in the country. Since the beginning of the war, investors have pulled more than $56 billion out of Russian markets, triggering a liquidity crisis, and Russian businesses are having trouble getting access to international financial markets, as foreign lenders see a higher credit risk and look to other emerging markets instead.

**Figure 1.3. Russian stock market and oil price dynamics during crisis**




*Source*: RTS; Thomson Datastream.

### 6.3 *Liquidity Crunch for Domestic Banks*

About $45 billion in foreign debt had to be refinanced by the end of 2008, and the cost of doing so was rising. The situation has deteriorated sharply since September 15, when forced selling by over-leveraged investment companies and banks to cover margin calls accelerated the share prices fall. With access to foreign markets severely

constrained, many investors were unable to repay called debt, which effectively triggered the interbank market turbulence. The collapse of the stock and interbank markets has had a profound effect on Russia’s financial system. Highly leveraged investment funds have suffered, with several being taken over by other domestic banks, often with government support. At least one large investment bank sold a controlling stake at a high discount to a domestic investor.
Due to the oil and gas windfall of the past few years, Russia has built up reserves for $573 billion that can keep tide the financial system over for a while and avoid a re-run of the 1998 crisis. Not too long, especially if oil prices continue their free fall. In good time the Kremlin pocketed the money and did not have to worry about pushing economic reforms, particularly in the second Putin presidential term on 2004-2008. The foreign investment needed to diversify the economy was discouraged by the Kremlin's backsliding on the rule of law. Now the drop in crude prices is squeezing the country and the Kremlin is struggling, considering also, the fact that on the current budget the Russian state will break even with oil prices at $70 per barrel.

### *6.4 The Macroeconomic Outlook Keeps Deteriorating*

Intensified financial difficulties will have significant negative effects for the broader economy. Bank lending and investment will be affected the most because an exodus of foreign capital is forcing Russian banks to squeeze lending. Although recently, Russia spoke out its intention to broker more foreign direct investment deals to restore confidence, investors fear Russian companies will be hard hit by the global financial crisis. Russia is facing its worst crisis since the August 1998 default. The Russian Stock market has plummeted more than 40% since May. According to bankers and analysts, the real estate and retail sectors will be the hardest hit by a slowdown in lending. The country has a great amount of cash but the banking system and capital markets are not particularly efficient at allocating it. Domestic borrowing costs for Russian companies have soared because of greater refinancing risks.

Foreign investors have shunned the Russian ruble and stock market. Moreover, there are doubts over Russian companies' earnings potential after Mr Putin broadside at Mechel, increasing economic dependence on oil and potential damage to Russia's ability to attract foreign investment. Household spending looks set to decrease as flagging cash-flows due to lower commodity export prices and higher debt servicing costs prompt corporations to lay off workers. To what extent the current financial difficulties affect the economy will depend on the size of the commodity price correction and the depth and duration of the global credit stresses. Even when assuming oil prices for Brent crude at an average of $80/barrel and global credit conditions start improving by the end of 2009, real GDP growth, as forecasted by the IMF, looks likely to be negative in 2009, -0.7%, down from 6.2% in 2008 as the current account balance shifts to a deficit and the federal government to balance, after recording sizable surpluses. Metals, energy, and food account for 80% of Russian exports. It is clear that the commodity boom peaked in June-July 2008 and is now in sharp re-verse. Since July, the commodity price index has dropped by more than 50%, limiting Russia's consumer economy as this has been built on commodities. The great oligarchic fortunes are based in oil and metals. Although domestic consumption has contributed significantly to growth in recent years, diversification away from commodities has barely started since the high price of oil strengthened the exchange rate and sucked imports into the retail sector, while oil revenues made it easier to posture as a great power. The downturn in the commodity economy will thus have a multiplied effect on the consumer economy and the Russian standard of living.

### *6.5 Lagging Restructuring Limits Market Recovery*

The gradual recovery of global financial markets would help revive Russia’s strongly oversold equity market. Share prices are unlikely to regain the peaks reached earlier in 2008, however, due to the weaker (and less well-funded) risk appetite and dimmer earnings prospects many Russian corporations now face. It remains to be seen, moreover, how quickly companies, after years of easy access to markets at negative real interest rates, will be able to adjust to much harder budget constraints and higher funding costs. Sectors heavily dependent on credit, such as construction, retail trade and real estate, are likely to be hardest hit. Bankruptcies and consolidation are growing.

### *Conclusion and Recommendations*

Despite a heavier political risk burden, the Caucasus war and the financial crisis, Russia remains a very attractive market for investors. As the Russian economy is not diversified enough, but otherwise developed in the natural resources sector (oil price at about $ 40 per barrel) and commodities sector (whose prices dropped by more than 20% since July), investors could turn to different types of investment: particularly manufacturing tradable industries.  Being highly competitive, the manufacturing sector still has a minor role in Russia, and offers, therefore, interesting return margins. There are, however, still quite a few obstacles such as: inward FDI policy and approach, labor regulation, corruption, skills and education of workers, functioning of the judiciary, business licensing and permits, and cost of financing.

One of the most important goal to be achieved is the creation of a decent business environment were local and foreign companies can operate in an honest and efficient way.

More generally, to switch to a more modern policy approach to FDI, Russia's government will have to carry out reforms on three main pillars of the current FDI policy: (i) elimination of the relatively extensive non-tariff protection given to the domestic market, (ii) elimination of existing tax preferences for foreign investors, and (iii) significant reduction on restrictions on FDI to a limited number of activities.

The following reforms should be given the highest priority to improve Russia’s FDI policy:

1. Prohibit the imposition of new and eliminate the existing investment measures related to trade (TRIMs), e.g., local content measures, export performance requirements, restrictions on use of foreign exchange, trade balance measures, including those prohibited by the WTO, among others, on foreign direct investment; (ii) the federal law "On Foreign Investment" should be improved to assure that it will grant non-discriminatory, "national treatment" to foreign investors for both right of establishment and post establishment operations; (iii) guarantee freedom to foreign direct investment projects regarding all investment-related transfers, (e.g., profits, royalties, the right of compensation for confiscation, requisition, and other guarantees); (iv) accept binding international arbitration for investor-State disputes; and (v) abide by the international law for expropriation, (i.e., expropriation only for a public purpose and with prompt, adequate and effective compensation).

2. Reduction on the number of sectors where FDI is currently prohibited over a certain period and on the number and incidence of existing limitations on FDI in sectors where it is permitted but restricted. Such measures should address not only manufacturing sectors but also the infrastructure monopolies and service sectors.

3. The Government should desist from creating, and discouraging legislative proposals for establishing, new preferential measures, including policies in the areas of taxation and custom duties, among other instruments, for FDI.

4. Enforcement of property rights should be implemented and strengthened.

5. Registration procedures of foreign investors should be simplified, rule-based, and transparent.

Considering the latest political and financial events, Russia and the world have started to witness the effects on the real economy, triggered by the deep financial crisis, which has caused a recession which will very likely last until 2010.

Up to now Russia has been considered in a world context that does not exist anymore. Since Putin came to power in 2000, Russia has benefited of a great world economy momentum: abundant liquidity, foreign funding, inward FDI of international oil giants in the natural resources sector and also in other industries, high oil prices, which have allowed to pile up international reserves.

As the world scenario is changing deeply, it would be of great interest to update this research on the expropriation risk, to asses the impact on the Russian economy, and to consider Russian reactions/strategies to the new challenges in the new economic/financial, geopolitical equilibrium.

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