

U.S.-RUSSIAN RELATIONS: AN ASSESSMENT

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WEDNESDAY, FEBRUARY 27, 2002

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON EUROPE,
COMMITTEE ON INTERNATIONAL RELATIONS,
Washington, DC.

The Subcommittee met, pursuant to call, at 1:45 p.m. in Room 2172, Rayburn House Office Building, Hon. Elton Gallegly [Chairman of the Subcommittee] presiding.

Mr. GALLEGLY. I call this hearing to order.

Just about a year ago, this newly created Subcommittee opened its formal hearings with a look at the U.S.-European relationship. I said at the time I felt that the transatlantic relationship was the most important relationship this nation had. Today, in the aftermath of 9-11, I feel this relationship is even more important and in many respects stronger than ever.

It is fitting today that we open our hearings with what I consider the second most important relationship we have, that with Russia. U.S.-Russian relationships have significantly changed since the terrorist attacks on September 11.

Russian President Putin, in what some have defined as a bold defiance of many in his own population, his bureaucracy and his military, has seized upon the tragedies of the World Trade Center and Pentagon as an opportunity to transform relations with the U.S. from distant and sometimes hostile to one of broad cooperation and new opportunities in many fields.

By identifying terrorism as the common enemy and associating Russia with the common cause of the United States and others to deal with global terrorism, President Putin seems to be attempting to forge a new alliance with the West and with the United States.

Without a doubt, President Putin's motivation is one of advancing Russia's own interests. But his goal, improved relations with the U.S. and a closer alignment of Russia with the West as a whole, now seems to be more desirable from both sides and achievable within the context of the global effort against terrorism.

With President Bush's forthcoming visit to Moscow in May, this new reality provides a valuable opportunity for both Washington and Moscow to prioritize and articulate a new framework for more cooperation and a forward looking bilateral relationship.

Our hearing today is designed to look at the current U.S.-Russian relationship, identify opportunities and challenges in the relationship and determine how U.S.-Russian relations should be carried out. I want to welcome our distinguished panel of experts and look forward to their insights.

Before turning to our witnesses, however, I would recognize my good friend, the Ranking Member, for any opening remarks, and that would be Mr. Hilliard.

[The prepared statement of Mr. Gallegly follows:]

PREPARED STATEMENT OF THE HONORABLE ELTON GALLEGLY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA, AND CHAIRMAN, SUBCOMMITTEE ON EUROPE

The Europe Subcommittee meets today for its first oversight hearing for this second session of the 107th Congress.

Just about one year ago, this newly created Subcommittee opened its formal hearings with a look at the U.S.-European Relationship. I said at the time that I felt the trans-Atlantic relationship was the most important relationship this nation had.

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By identifying terrorism as the common enemy and associating Russia with the common cause of the United States and others to deal with global terrorism, President Putin seems to be attempting to forge a new “alliance” with the West and the United States.

Without a doubt, President Putin’s motivation is one of advancing Russia’s own interests. But his goal—improved relations with the U.S. and a closer alignment of Russia with the West as a whole—now seems to be more desirable from both sides and achievable within the context of the global effort against terrorism.

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Our hearing today is designed to look at the current U.S.-Russia relationship, identify opportunities and challenges in that relationship and determine how future U.S.-Russian relations should be carried out.

I want to welcome our distinguished panel of experts and look forward to their insights.

Mr. HILLIARD. Thank you very much, Mr. Chairman. Mr. Chairman, Members and distinguished guests, I am eagerly awaiting your views and your assessment of the issues surrounding the United States and Russian relationship.

In my view, Russia’s positive relationship with the United States definitely needs to continue to be formulated. The aftermath of the September 11 attack and subsequent volunteerism is evidence that it is time for a reflection on our role and the role of our ally, Russia, in international affairs.

I support the technical assistance which is targeted toward establishing a global marketplace and strengthening democratic institutions for basic humanitarian assistance which is so much needed for the entire population. I am very interested in the assessment of where Russia is now, where it is going and the future role it would take in international affairs.

Mr. Chairman, thank you very much.

Mr. GALLEGLY. I thank the gentleman. Before we turn to the panel, Mrs. Lee, my colleague from California, would you like to be recognized for an opening statement. Ms. Lee?

Ms. LEE. Thank you, Mr. Chairman. I want to thank you and our Ranking Member for calling this hearing today, and I want to thank also the distinguished panel of witnesses for being here. I look forward to hearing from you.

The bipartisan Russia task force chaired by Howard Baker and Lloyd Cutler and commissioned by the Department of Energy has called the dangers posed by Russia's poorly secured weapons of mass destruction the most urgent national security threat to the United States. The events of September 11 have reinforced these dangers rather than displacing them.

We also now have an opportunity, however, to forge a stronger relationship with Russia, a partnership to curtail the proliferation of biological, chemical and nuclear weapons. But, that opportunity really does require a real investment in joint security efforts to safeguard these weapons and the scientists who might be tempted to sell their knowledge to the highest bidder. Of course, we want to work with Russia to build a safer, freer and more democratic world.

I look forward to hearing the testimony from you today and our discussion as we move forward to discuss this important relationship. I hope that you will discuss the whole issue of the proliferation of weapons, nuclear weapons especially, as it relates to Russia.

Thank you very much.

Mr. GALLEGLY. I thank the gentlelady from California.

At this point, our first witness will be a Hoover Fellow and Professor of Political Science from the Hoover Institute and Stanford University, and that is Dr. Michael McFaul. Welcome, Dr. McFaul.

**STATEMENT OF MICHAEL McFAUL, Ph.D., HOOVER FELLOW
AND PROFESSOR OF POLITICAL SCIENCE, HOOVER INSTITUTE,
STANFORD UNIVERSITY**

Mr. McFAUL. Thank you, Mr. Chairman, and thank you for convening this hearing. I think the timing is impeccable. I know we tried to do this earlier. I think, however, the timing now is even more appropriate than it was the last time.

I want to begin my remarks by saying that I do think, as you said in your introduction, September 11 was a turning point for Russia and for Mr. Putin in particular in terms of seeing themselves and him as a leader of that country, seeing and placing themselves in the world.

Before September 11, I think it was clear that Mr. Putin was pro-market. No question about that. Maybe Blake will say more about that in his remarks, and the really remarkable achievements they have done in terms of economic reform since he became President.

Likewise, I think it was pretty clear that Mr. Putin was pro-European before September 11. What was not clear to me before September 11, was whether or not, he was pro-American, and I think September 11 was a real gut check for him. It was a time of decision. It was a kind of polarized moment. Are you with us, or are you against us? Putin decided that he wanted to be with us rather than against us.

People that I know that work for Mr. Putin talked about the several meetings they had subsequently to September 11. Like you

said, Mr. Chairman, against the advice of some of his closest colleagues, he decided he was going to make fortifying and building U.S.-Russia relations a cornerstone of his foreign policy.

As one of his colleagues said to me just last week in the Kremlin, he, now, like our President, has a new historical mission that he believes in, and that is to integrate Russia into the West. Before September 11, he was confused as to what the American role in that might be. I think before September 11 he thought we can do it without the Americans. We will just concentrate on Germany, the European Union, Europe as a whole. I think now that he personally has reconsidered that and understands that working with the United States and building a qualitatively new relationship with the United States is part of that historic mission.

Having said that, I have three serious worries or concerns that I want to share with you. First, his expectations. Expectations about this new relationship are, in my opinion, inflated in this country, but especially in Russia.

I would remind you of the euphoric period and the inflated expectations we had after the collapse of Communism in 1991 when folks in Russia—I was living in Russia at the time—thought well, now that we are part of the West we are all going to have mansions and two car garages and be part of the West. It is going to happen overnight because we have embraced capitalism, democracy, the West.

Obviously that did not happen, and the disappointment with that, a decade of disappointment, has had real long-term repercussions for their attitudes toward the West and the United States in particular.

In Russia, now after September 11, it has become very commonplace to talk about Russia and NATO, Russia and the WTO, Russia and the EU, conversations that did not happen before September 11. I know because I used to write things like this, like Russia should be in NATO. People would respond by saying, "I am not sure what they drink out there in California. We will go on to the next person, right?"

Now in Russia these are conversations, real conversations, and in my opinion, somewhat dangerous conversations because they are ahead of where the processes are in terms of integration, and I think we need to be concerned about that. I would have said the same thing about the United States, although it is less of a problem here because we are, quite frankly, focused on other issues.

My second worry is about opposition in Russia to Putin's pro-America leaning, and I use the word pro-American on purpose, not pro-western. You also said that in your opening remarks; that we should be concerned. But, let me just remind the Committee of all the groups that are either opposed or lukewarm to this new policy.

Number one, the military. That should go without saying. The fact that American troops are now in Central Asia, that American military advisors as we speak are in Georgia, does not make Russian military personnel happy. They have fought for hundreds of years to keep these countries in their sphere of influence, and suddenly we are there. In their opinion, they believe that when American troops show up, they do not go home very fast. They are very concerned.

Two, the intelligence services, KGB or the FSB as it is now called. They again I think share the perspective of the military officers, but what is important to note here is that the KGB is no longer like our CIA. The KGB is in part ruling Russia today, and so we have to be concerned about their anti-American voices.

I would remind you that Sergei Ivanov, the Russian Minister of Defense, is also from the KGB and a close confidant of another KGB alumnus, Mr. Putin. He spoke out openly against supporting the United States immediately after September 11 and then had to retract those statements. They generally do not say this publicly. They are very well trained folks. I get the sense that these anti-American sentiments are shared by a large body of people within the KGB who also happen to be in the Kremlin today.

Third, the military industrial complex. These folks have interests in the very countries that we call the "axis of evil." They fear that they are going to lose those contracts. They are against what we are doing.

Fourth, I would add Russian oil companies, specifically when we are talking about Iraq, are extremely concerned about their future interests in that country, given Bush's State of the Union address.

Fifth, the Duma, your colleagues, who I had the chance to spend a lot of time with last week in Moscow. Basically, there are only two very small factions in the Duma, Yabloko and Union of Right forces, that support Putin openly. The rest, the absolute majority, do not support this pro-American vote.

Just recently, the Chairman of their equivalent of the House Committee on International Affairs, Dimitri Rogozin, said just last week that Russia has two allies in the world, the Russian Army and the Russian Navy. That is a very troubling sign for me that the Duma itself only thinks of those two as their allies and not the United States.

Sixth, the liberals, even those that support pro-western ideas, pro-American ideas, are also divided. Publicly, of course, they support this, and they think it is a good idea. Privately, they are nervous about our neglect of democratization within Russia. That is, they worry that we are so focused on the war on terrorism that we are not paying attention to the development of democracy.

I can tell you, they are horrified by the fact that we are about to give millions of new dollars to a dictatorship in Uzbekistan at a time when we are not giving commensurate new dollars to the democratic forces in Russia.

Finally, society. Society is ambivalent. I think it is only skin deep. My own polling has shown strong support for liberal values and democratic values in Russia. But, on the veneer of that is some real anti-American sentiment, by the way just anecdotally, fueled again by the Olympics and the conspiratorial way that the Russian media has written about the Olympics, as I witnessed last week in Moscow.

My third worry, which I already hinted at, is a worry that my liberal friends in Russia share, and when I say liberal I mean democratic friends, not Democrat-Republican, but liberal in the European sense, if you will. My third worry is about our side and that in our focus on fighting the war on terrorism, and finding allies wherever they may be, we are neglecting internal processes within

Russia. First and foremost, I mean the process of democratization, or I should say rather the lack of democratization.

I think Putin is great for the market. I think Putin's instincts are basically right when it comes to western integration, but I think he is bad news when it comes to democracy. If I had more time, I could articulate all the nasty things he has done, but I think a year ago we could debate whether he was pro-democratic or not. Now I think the evidence is overwhelming that he just does not get it. He may want to be democratic, but first and foremost his policies have been highly anti-democratic, and we as a country are not giving that enough attention.

With that in mind, I outline in my prepared remarks four categories of recommendations for policy changes. I do not have the time to go into all of those, but the four categories were the following:

One, I think we should eliminate as many Cold War legacies as possible. Two, I think we should focus on integrating the Russian state into western international institutions. Three, a neglected issue, we should focus on integrating Russian society independent of the state into western society. Four, we should cooperate on anti-terrorism.

I have a long list of very concrete things I think we should do, but in my last 2 minutes I want to mention three to you because you are really the acting agents for these ideas, not the Bush Administration.

First, regarding eliminating Cold War legacies, I do support the Administration's view that it is time to eliminate or graduate Russia from Jackson-Vanik. And, I think it would be tremendously important for U.S-Russian relations and to our President if that happens before the May summit, and I urge you to do that.

Secondly, however, I want you to know that I consider Jackson-Vanik to be one of the most successful foreign policy initiatives that Congress has ever done in history; at least that is my reading of the twentieth century. I think it would be a shame just to let this thing fade away and forget about it, so I urge you, and in my testimony I spell it out, but I would urge you to consider the establishment of a Jackson-Vanik foundation for the promotion of religious and human rights in Russia.

The legislation basically has already been written by Congressman Lantos. In his bill that he introduced last year, he talks exactly about this. I think you should, A, take action on that bill, but put it under this new name—the Jackson-Vanik Foundation—because that will signal in Russia what this money is for and who it is supporting.

I think these people are embattled now; that is the democrats, the religious activists against the state, and we now, more than ever, should be standing with them, not ignoring them and not pretending that their cause is not important to us today.

Third, I think you need to speak out openly and often about the abuses of human rights. I mean, first and foremost, about Chechnya and the media, and I would urge you to hold more and more hearings where you bring Russians who are embattled and give them an opportunity to speak before you. You cannot imagine the power of having a Russian testify before your Committee has

back home for that Russian. I would urge you to invite them and bring them as often as you can.

Finally, when we go to the summit, when President Bush goes to the summit, you are going to have a state to state meeting, and if you look at the agenda it is going to look like the Cold War agenda. It is going to be about arms control, European security, regional conflicts and human rights. That looks like the 1970s to me. That does not reflect U.S.-Russian relations, in my opinion. It does not reflect the multitude of interactions that we have that are not state to state.

An idea that I will share with the Administration and I want to share with you today as well is that at this summit we should not have just state to state summits, but business to business summits, academic to academic summits, congressional to congressional meetings, NGO to NGO meetings, to demonstrate that this is not the old U.S.-Soviet relationship. And, not all these things that are going on, and that they are not just going on between the state and society.

President Bush will meet with some NGO leaders. President Bush will go and meet with some business leaders, I am sure, but that is just a small fraction of what goes on. I think it would be a tremendously symbolically important event if this next summit is not just a state to state summit, but encompasses all these aspects of U.S.-Russian relations that are there today.

Thank you very much.

[The prepared statement of Mr. McFaul follows:]

PREPARED STATEMENT OF MICHAEL McFAUL, PH.D., HOOVER FELLOW AND
PROFESSOR OF POLITICAL SCIENCE, HOOVER INSTITUTE, STANFORD UNIVERSITY

September 11, 2001 was one of the most tragic days in American history. In devising responses to the attacks of September 11th, American policymakers face difficult choices with uncertain outcomes. The war against extremist elements of Islamic fundamentalism that use terror as their main weapon will be new, protracted, and multi-faceted. The battlefield will appear in the strangest of places—in the mountains of Afghanistan, the mosques of Egypt, and the airwaves of Saudi Arabia. There will never be unconditional surrenders or clear military victories. Above all else, a new level of uncertainty about the tactics of war, the nature of the enemy, and the conditions of peace will haunt American decisionmakers and the American people for an undefined period of time. In almost all realms of international politics, the United States faces a new, more complex set of political, economic, and security, challenges after September 11th.

U.S.-Russian relations offer one bright counter to this otherwise gloomier international picture. Russian President Vladimir Putin was one of the first foreign leaders to speak directly to President Bush. In that phone call, he expressed his condolences to the president and the American people and his unequivocal support for whatever reactions the American president might decide to take. He then followed this rhetorical support with concrete policies. Though American and Russian armed forces had worked together successfully in Bosnia and Serbia in the 1990s, Putin's pledges of support seemed to signal a qualitatively new level of military cooperation between former (old War) enemies. Some have the new relationship a strategic partnership; others have even described the new relationship as an alliance.

The potential to build a new foundation for Russian-American relations is great, similar to the window of opportunity that opened a decade ago in the wake of the Soviet collapse. Ironically, at a time when the United States is struggling to maintain strong relations with traditional allies in Europe, Russia has the potential to become a strategic partner of the United States. Not since World War II have Russian and American foreign policy interests been in closer alignment. To date, however, the expectations about a new future have vastly outpaced the actual concrete steps taken (or even outlined) to build a closer relationship between our two countries. The United States cannot afford to repeat some of the mistakes made when the last window of opportunity opened. We thought the Cold War ended in 1991,

yet it is amazing how many legacies of that earlier era still linger today.¹ (And many of the lingering legacies have impeded our readiness for addressing post-Cold War challenges such as the threat we currently face.) Leaders in both countries must lead. They must act boldly, abandon business as usual, take chances, and take advantage of this moment to map the path to a new future.

RUSSIA'S CONTRIBUTION TO THE WAR ON TERRORISM

On September 11th, Putin did not hesitate to call his new friend, George W. Bush, to communicate his full support for the United States and the American people. Putin did not let a decade of unfulfilled expectations in U.S.-Russian relations color his rhetorical response. While some leaders and people around the world believe that the United States 'got what it deserved' on September 11th, Putin expressed sympathy as a leader of a country that also has suffered from acts of terrorism against civilians in the capital.² Polls conducted immediately after the September 11th attacks demonstrated that the majority of Russian citizens also sympathized with the American people and considered the terrorist attacks on the World Trade Center and the Pentagon to be attacks on the entire civilized world.

Putin, however, did not immediately follow his rhetorical pledge of support with concrete policies of support. On the contrary, in the immediate days after September 11th, several senior Russian officials—including Minister of Defense Sergei Ivanov—spoke openly against military cooperation with the United States to fight terrorism. It appeared that Putin was beginning to embark upon a pattern of decisionmaking that has now become routine in the Putin era. During previous moments of critical policymaking (be it economic policy, military reform, or foreign policy), Putin has allowed open disagreement between his advisors without coming down on one side or the other. At many of these critical junctures, Putin has avoided making the hard choice until a consensus opinion coalesced. If such a consensus did not form, for instance on military reform, then the initial push for policy change quietly stopped.

To help devise a plan of action for Russian foreign policy in the aftermath of September 11th, Putin consulted with many. According to one account, a group of 21 prominent politicians and government officials gathered at one meeting to discuss Russia's options. At this meeting, only two participants supported an overt pro-American position. Putin also retreated to his dacha in Sochi on the Black Sea and invited his top foreign and security policy advisors to come down and consult with him. While Putin was in Sochi, Bush called him from his retreat at Camp David. Some time after their conversation, Putin seems to have made a truly strategic decision to offer concrete support for the new American war effort.

The following Monday, September 24th, Putin announced a five-point plan to support the American war against terrorism. He pledged that his Russian government would (1) share intelligence with their American counterparts, (2) open Russian airspace for flights providing humanitarian assistance (3) cooperate with Russia's Central Asian allies to provide similar kinds of airspace access to American flights, (4) participate in international search and rescue efforts, and (5) increase direct assistance (humanitarian as well as military assistance—to the Northern Alliance in Afghanistan).

Some have interpreted these policies of support as nothing new or extraordinary. Of the five policies, the most dramatic change concerns Putin's acquiescence to American troops in Central Asia. Yet, even this policy might be interpreted as Putin merely reacting to hard facts on the ground. Through the U.S. initiated Partnership-for-Peace program, especially as developed under Secretary of Defense William Perry, the American and Uzbek militaries have cooperated actively and often well before September 11th. While Russian armed forces protect the border between Tajikistan and Afghanistan, Russia has considerably less influence on Uzbek defense policy for several years.

Nonetheless, Putin's pro-American plan was not simply tactical. It was a strategic decision to use September 11th as a stimulus for aligning Russian and American

¹A partial list of Cold War legacies still in place would include the following. Tens of thousands of American troops remain stationed in Germany, Russia's army still deploys thousands of tanks on its Western border to defend against a NATO invasion, and Pentagon war plans still aims nuclear warheads on hair trigger alert at thousands of targets inside Russia. The main topic of discussion at meetings between American and Russian heads of state is still arms control. Perhaps most eerily, ten years after the end of Soviet communism and the birth of Russian democracy, Russia and "communist" China signed a friendship treaty and North Korea's communist leader, Kim Jong Il, visited Moscow to reaffirm old ties and lay flowers at Lenin's tomb on Red Square.

²It has never been proven who carried out the terrorist attacks that killed hundreds of Russians in Moscow and elsewhere in September 1999. Putin has stated repeatedly that Chechens carried out these attacks. The majority of Russian people believe him.

interests. Before September 11th, Putin had moving slowly in this strategic direction, though his focus beforehand had been on European integration and not the U.S.-Russian bilateral relationship. September 11th pushed him further in the pro-American direction.

Russian policy subsequently reflected this strategic shift. Russian military advisors and Russian trained soldiers actively participated in the Northern Alliance campaign to liberate Afghanistan. To be sure, American air power and U.S. Special Forces provided the pivotal military assets necessary for the defeat of the Taliban. Russia's role, however, was significant if also unnoticed. Russia could have stood on the sidelines, offering rhetoric support and nothing more. Instead, while avoiding the direct use of Russian troops in the war (for obvious historical reasons), Russia's engagement went well beyond words.

Moreover, Putin's agreement to an American military presence in Central Asia represented a historic change in Russian foreign policy. Before September 11th, President Putin has vacillated between pro-Western and anti-Western foreign policy stances.³ In many ways, Putin own personal dual impulses of seeking at times to integrate into the West while at other times seeking to balance against the West reflects Russia's longstanding love-hate relationship with the West. In the wake of September 11th, however, Putin has seemed to lean much further towards the West and the United States in particular. (Before September 11th, Putin had placed relations with Europe as a higher priority than relations with the United States). His acquiescence to NATO troops in Central Asia signaled a reversal of two hundred years of Russian foreign policy. Under Yeltsin, the communists, and the tsars, Russia had always considered Central Asia as its 'sphere of influence.' Putin broke with that tradition.

THE AMERICAN RESPONSE TO RUSSIA'S ASSISTANCE

Bush immediately rewarded Putin's supportive turn by changing the way he spoke about Russia's 'war against terrorism.' On September 26th, White House press spokesperson Ari Fleischer communicated President Bush's appreciation for Putin's statement. The White House press spokesperson also stated that the "Chechnya leadership, like all responsible political leaders in the world, must immediately and conditionally cut all contacts with international terrorist groups, such as Osama bin Laden and the Al Qaeda organization."⁴ The Clinton Administration had previously connected some Chechen fighters to bin Laden's network.⁵ The Bush Administration had not. Subsequent meetings between the Bush administration and the Chechen government in exile have been downgraded.

President Bush's statement did not give Putin a green light to do what he wanted in Chechnya. For the past two years, the Russian armed forces already have done whatever they wanted in Chechnya with little or no reference to American opinions. Before September 11th, the Bush Administration had not made Chechnya a top priority in its policy towards Russia. The statement of support, however, did underscore the notion that the United States and Russia faced a common enemy. Putin had been pushing this theme for two years with his American counterparts. Putin was pleased to hear that President Bush finally recognized publicly their common cause.

More generally, Bush also has praised Putin for his support in the war. During Putin's visit to the United States in November, Bush was especially complimentary of his Russian counterpart. As a symbol of his commitment to foster closer ties to Putin and Russia, Bush hosted the Russian president at his ranch in Texas, a rare invitation coveted by but not offered to many other world leaders.

However, beyond President Bush's statement on Chechnya in September and the words of praise and genuine hospitality for Putin, the Bush administration has offered little to Putin or Russia in response to Russia's support for the American war

³ Putin pushed through the Russian parliament ratification of the Comprehensive Test Ban Treaty and the Strategic Arms Reduction Treaty II, expressed a clear desire for Russia to become a fully integrated member of the G-8, the World Trade Organization (WTO), and, more generally, Europe, and has stressed in his new foreign policy doctrine that "Russia shall actively work to attract foreign investments," and will endeavor "to ensure favorable external conditions for forming a market-oriented economy in our country." At the same time, Putin also has reached out to North Korea, Cuba, and China, and signed a major arms deal with Iran.

⁴ White House Press Secretary Ari Fleischer, White House Briefing, September 26, 2001.

⁵ According to Ambassador-at-Large Stephen Sestanovich, Special Advisor to the Secretary of States for the New Independent States, "Chechen rebels are receiving help from radical groups in other countries, including Usama Bin Laden's network and others who have attacked or threatened Americans and American interests." See his "The Conflict in Chechnya and its Implications for U.S. Relations with Russia," testimony before the Senate Foreign Relations Committee, November 4, 1999, p. 2.

on terrorism in Afghanistan and more generally. To be sure, Putin did not provide a request list of goodies that he wanted from United States in return for Russia's support of the American war effort. It is not his style. Bush officials also have argued that the new U.S.-Russian relationship has grown beyond this "old" approach of zero sum exchange. Nonetheless, within Russia there are real expectations that Russia should receive some tangible benefits from its pro-American policy. To date, these expectations have gone unmet. Rather, in the view of many foreign policy elite in Russia, the Bush administration has ignored Russia's contribution and instead embarrassed Putin by continuing to pursue old policies considered to be against Russia's national interest. Bush's decision in December 2001 to withdraw from the ABM treaty is cited as the most glaring example of business as usual—that is anti-Russian business as usual.

DOMESTIC RESISTANCE TO PUTIN'S PRO-AMERICAN LEAN

In deciding to make concrete policy changes to reflect his rhetorical support for the American war against terrorism, Putin has acted against the preferences of many important constituencies within Russia. In making this decision, Putin was leading elite and public opinion, not following it. To date, open criticism of Putin has been limited. After all, Putin still enjoys tremendous popularity, making it unwise politically to speak out against him. Below the surface, however, there are subtle signs of discontent with Putin's new support for American military action in Russia's own backyard.

Russia's armed forces, first and foremost, are not happy about NATO troops in Central Asia. The recent American deployment of troops in Kyrgyzstan after the war in Afghanistan was over is especially puzzling and alarming for this Russian constituency since they do not understand the American mission there and the Bush administration has not explained the mission. Uzbek President Islam Karimov has hinted that he would like to see the American armed forces stay in Uzbekistan for an indefinite period of time to help protect Uzbekistan from terrorists, and though never stated publicly, the Russians. American troops have demonstrated a pattern of staying in places well after the fighting has ended. Moreover, the recent increases in U.S. aid to the Uzbek dictatorship are cited in Russia as additional evidence of the United States' long-term military intentions in the region. Some Russian military officers as well as defense policy elites have hinted at the possible benefits of the American deployments. The American presence offers Russia help in containing terrorist threats from the region for which the Russian military does not have the capacity to do alone. However, for the vast majority of Russian military officers still fighting the last war—the Cold War—the thought of American troops based permanently in a former Soviet republic must be horrifying, especially in a place as strategic and anti-Russian as Uzbekistan.

Second, the intelligence services, including Putin's own alma mater, the KGB (now called the FSB) do not welcome the new alliance. Putin's Minister of Defense and former KGB general, Sergei Ivanov, has reversed his earlier remarks and pledged support for Putin's position. Nonetheless, many Russian observers believe that Ivanov could become the focal point of opposition to Putin within the government should the pro-American policy adopted by Putin not yield results. Within Putin's presidential administration, several former KGB officers are known to harbor real suspicions of American grand designs.

Third, the military industrial complex does not welcome the new Western orientation. These companies enjoy contracts with American enemies such as Iran and Syria and hope to develop even further relations with other American enemies in the Middle East such as Iraq. For them, therefore, a Russian realignment in the Middle East means fewer hard cash contracts. These military enterprises enjoy strong support within the Duma.

Fourth, Russia's oil industry is a lukewarm supporter at best of Putin's pro-American policy. In the long run, the most forward looking owners of Russia's oil companies see an opportunity for Russia to replace Saudi Arabia as a more reliable supplier of oil to the United States and its allies. In the short term, however, the next phase of the war against terrorism could threaten the investments of companies such as Lukhail and Yukos in Iraq.

Fifth, few within the Russian parliament support Putin's pro-American policy. The Communist Party of the Russian Federation (CPRF) has spoken openly against Russia's new foreign policy orientation, arguing that Putin's new strategy represents a sell out of Russian national security interests. More surprisingly, Dmitry Rogozin, the chairman of the foreign affairs committee a member of a pro-Putin faction in the Duma, stated recently that Russia has only two reliable allies—the Russian army and the Russian navy. Many others in the Duma have called for renewed in-

creases in Russian military spending as the only way to guarantee respect for Russia in international affairs. While reluctant still to speak out publicly, many other Duma deputies support these public statements of Rogozin and the communists. Within the Duma, only two factions the Union of Right Forces and Yabloko have consistently backed Putin's pro-Western orientation.

Sixth, even these pro-Western liberals are divided. Publicly, the Union of Right Forces and its chairman, Boris Nemtsov, as well as Yabloko and its chairman, Grigory Yavlinsky, have endorsed Putin's strategic Western turn. These political groups see this moment as a real opportunity for Russia to finally and fully integrate into the West. At the same time, and less publicly, voices within both of these organizations, as well as human rights activists, worry that Putin will use the camouflage of the war against terrorism to roll back democratic practices within Russia even further. For instance, Putin's pledge to support the United States in no way altered the campaign to close TV-6, Russia's last non-governmental television network with a national reach.

Seventh, and finally, Russian society is divided. While the majority in polls has expressed solidarity with the American cause, this same society is divided about the benefits of engagement with the West. Anti-Americanism in Russia is only skin-deep but pervasive. Many commentators have compared Putin's pro-American leanings to the hapless foreign policy of Mikhail Gorbachev, who also cooperated fully with the United States but received little in return for his country. The perceived injustices against Russian athletes at the Winter Olympics have prompted a new wave of anti-Americanism within Russia. Immediately after September 11th, it was taboo to criticize the United States publicly in Russia. After the Olympics, that taboo has been lifted.

The comparison between Gorbachev and Putin is flawed in one critical respect. Putin is very popular while his opponents are poorly organized, two assets that Gorbachev did not enjoy in his last years in power. How stable and lasting Putin's support will be, however, is not clear. If, for instance, Russia begins to experience economic difficulties in part due to the war against terrorism (oil prices have already fallen dramatically), quiet criticism of Putin's policy may become more public. And then what? Past experience would suggest that Putin would pull away from his forward leaning policy, unless he can show tangible gains from the new orientation.

Perhaps the greatest threat to Putin's new pro-American orientation is Putin himself. Putin made a strategic choice to support the United States after the September 11th that was motivated by intuition and feeling, as much as calculation of tangible interests. As one Russian policymaker close to Putin told this author, Putin has decided that it is his historical mission to integrate Russia into the West. The magnitude of this mission, however, does not mean it is irreversible. If Putin decides that the United States is not serious in helping him realize his mission, he could abandon his new pro-American policy as quickly as he embraced it. He can always return to his focus on Europe as a way to continue his pursuit of Russian integration into the West.

LOCKING IN RUSSIA'S PRO-WESTERN ORIENTATION: RECOMMENDATIONS FOR NEW U.S. POLICY INITIATIVES TOWARDS RUSSIA

It is both natural and appropriate that the Bush administration is focused primarily on the next stage of the war on terrorism and homeland defense. Russian policy must be subordinated to these new priorities. At the same time, Russia cannot be neglected. U.S. policymakers must take advantage of the window of opportunity opened by September 11th. American decision makers cannot assume that relations between the United States and Russia will improve organically simply because we in the United States have determined that the "post-Cold War era" ended on September 11th. American foreign policy leaders in both the executive and legislative branches must establish a realistic sequence of milestones that, if met, could finally integrate Russia fully and permanently into the Western community of democratic states and market economies.

This mission can be understood as four broad tasks: (1) ending Cold War legacies, (2) integration of the Russian state into Western international institutions, (3) integration of Russian society into the West, and (4) cooperation in fighting the war against terrorism. To achieve progress in all of these agenda categories, democratic consolidation within Russia must be understood as a necessary precondition.

1. Ending Cold War Legacies.

The United States must stop treating Russia as the Soviet Union. The Russian state decided to accept many international obligations once assigned to the USSR. If Russian government leaders willingly accepted these responsibilities, be they treaty obligations or Soviet debts, then they must be held accountable for their deci-

sions. However, the United States and the U.S. Congress in particular are not commensurately obligated to keep in place legislation written specifically to punish or influence the Soviet communist regime. Congress should review all laws written during the Cold War designed (quite rightly) to punish the USSR. Restrictions on high technology exports, severe dumping laws regarding Russian goods (especially steel), and the Jackson-Vanik Amendment to the 1974 Trade Act are examples of effective tools from the Cold War era that need review today. Congress would be giving President Bush a much needed deliverable if American lawmakers repealed Jackson-Vanik before the May summit.

Some executive policies from the Cold War, such as the requirement that Russian diplomats report their travel plans beyond a 25-mile radius from Washington, also should be abolished. And without question, the most harmful lingering legacy from the Cold War era is the American visa regime still in place that limits and aggravates legitimate Russian travel in the United States.

Russia also still has many laws on the books that are leftovers from the Cold War era. For instance, Russia still refuses the use of Russian airspace for commercial GPS. Russia also still has in place an outdated visa regime and registration system for American travelers to and residents in Russia.

The Bush and Putin administrations should invite Russian and American lawmakers to join them in establishing a special taskforce of executive and legislative officials whose mandate would be to eliminate the laws and executive orders put in place during the Cold War.

II. Integration of the Russian State into Western International Institutions.

The best strategy for insuring long-term cooperation between Russia and the United States is to imbed Russia into Western international institutions. The United States pursued this strategy with former enemies Germany and Japan (as well as Italy and Austria) after World War II. In comparative terms, the integration of Russia has gone much slower after the end of the Cold War. The fortuitous combination of a new Russian president and September 11th offer a unique opportunity for accelerating the integration process.

A. Push for Russian membership into the WTO.

President Putin has stated his desire to see Russia join the WTO. By pressing forward with a new bilateral trading agreement with Russia, the United States should become the leading advocate for Russian accession. Because Russian domestic manufacturers are still weak and disorganized, it will be easier for Russia to join the WTO today than it will be when these domestic interest groups become more consolidated. 2003—not the 2005 preferred by some European diplomats—should be the target year for membership.

B. Codify NATO at 20.

Putin has hinted several times that he would like to see Russia become a NATO member. These statements are both encouraging and dangerous. It is encouraging that the Russian president is not continuing the ineffective anti-NATO rhetorical assault pursued by many Russian foreign policy leaders throughout the 1990s. At the same time, Putin's statements also could be fueling unrealistic expectations within Russia. In particular, Putin has stated that Russia could join NATO if NATO becomes a political organization. But NATO will never (or should never) become a purely political organization. It is a military alliance. Like all other Western international institutions, Russia can join only if it accepts the rules of membership and does not try to change the rules of membership as a precondition for joining. Russian membership into NATO is a worthy, but distant goal. (I like the year 2017—100 years after the Bolshevik revolution—as a target date.) To occur, however, Russia and NATO must establish interim arrangements that prove the benefits of cooperation to both sides.

The Permanent Joint Council (PJC) is already in place, but ineffective. Russia's full participation in NATO's political arm, the North Atlantic Council, must be must formalized. Above all else, NATO must clearly articulate what issues can be discussed with Russia at the table and what issues cannot. One of the problems with the PJC formulation was that the list of possible issues was exhaustive, while the basic dynamic was bilateral, that is the nineteen countries of NATO first agreed on a course of action and then presented a unified position to Russia. NATO at 20 should treat all countries similarly, letting Russia in on initial deliberations. At the same time, the agenda of NATO at 20 should be as limited but as meaningful as possible. Perhaps focusing only on one issue—counterterrorism—might give NATO at 20 its best chance of success.

In addition to framing clearly and limitedly the new agenda of Russia-NATO relations, NATO allies can take several steps to make the alliance less threatening to

Russia. As NATO expands eastward, the alliance should pledge not to deploy nuclear weapons on Russia's borders. A bolder step would declare all of East Central Europe—including Kaliningrad—a nuclear free zone. NATO and Russia should also codify agreements to guarantee communication and transport lines between Russia and Kaliningrad on the one hand and NATO and the Baltic states on the other. More generally, Russia and NATO should pledge to reduce the number of conventional weapons in Central Europe and European Russia.

C. End the Boycott of Russian arms purchases by NATO members.

The announcement of a new policy allowing NATO allies to buy Russian arms would not produce massive new contracts for the Russian arms makers. Symbolically, however, such a policy change would undermine the claim of the Russian military industrial complex that NATO expansion is principally an export promotion policy for Western arms makers.

D. Push for a Closer Relationship between the European Union and Russia.

In many respects, it will be easier for Russia to join NATO than the European Union. In Russia, however, even the most astute foreign policy observers do not understand the difficulties of Russian membership into the EU. They must be educated. However, the EU also must be pushed to establish more creative ways for engaging countries on its periphery. At the EU expands, it eventually will operate on a tiered system, with the core interacting a different level of intensity and degree of integration than some new members. Trading regimes similar to NAFTA may be a way to offer greater integration of Russia into European trade and investment markets without undertaking the steps necessary for full membership.

E. Sign a New Arms Control Agreement with Russia.

The Bush administration made a mistake in not seeking to negotiate a new treaty to replace the ABM treaty. The Russians were ready to allow the United States to do almost anything regarding the research, development, and deployment of missile defenses, just as long as these plans were governed by a bilateral agreement. The United States should proceed with research and development of missile defense systems. In doing so, however, the United States has an interest in maximizing understanding within Russia of our intentions and capabilities. Instead, the unilateral abrogation of the ABM treaty has heightened suspicion and misunderstanding in Russia.

As a partial remedy, the Bush administration has rightly announced its intention to sign a new strategic arms reduction agreement with Russia. This document should be a treaty, even if only a 3-page document. A treaty offers the best assurances for clarity of intentions and transparency of capabilities on both sides. Even the best of friends forget what they agreed to handshakes. Until Russia has fully integrated into the West, the motto must always remain Ronald Reagan's famous quip, 'trust but verify.' It is silly to continue to think of Russia as a strategic competitor. It is imprudent and misleading to pretend that Russia is an ally with whom treaties are no longer necessary. After all, even with its closest partners in Europe, the United States still maintains a credible commitment of mutual defense through a treaty—the North Atlantic *Treaty* Organization. A treaty would also allow the United States to restrict the MIRVing of Russian rockets. The absence of a treaty will make it difficult for American officials to insist that Russia not return to a policy of putting multiple nuclear warheads on its rockets. Finally, a treaty provides the best opportunity for public scrutiny and debate in both countries. It is more democratic than an executive order.

F. Missile Defense Cooperation.

If Russia becomes a more cooperative partner and a successful joiner of Western institutions, then American leaders could begin to build joint missile defense systems with Russia. The first step towards such cooperation could begin now by jointly modernizing and sharing information from our respective early warning systems. The second step might be a joint research and development program that takes advantage of Russian technologies. Russia, after all, has pursued missile defenses with greater vigor for a lot longer than the United States. American officials should seek to take advantage of this research and development.

III. Integration of Russian Society into the West

Some believe that the integration of the Russian state in Western institutions will make Russia a trusted ally of the United States. They are wrong. Russia will only be a full and respected member of Europe and a trustworthy ally of the United States if it is a fully consolidated democracy. Throughout the twentieth century, the United States had to forge alliances with dictatorships and democracies. Even Sta-

lin's USSR was once an American ally. Over time, however, the democracies on the list proved to be the more effective and reliable allies, while international institution proved incapable of taming autocracies like the USSR. A semi-democratic Russia will always be a quasi partner of the United States. Integration helps the cause of democratic consolidation within Russia, but integration alone will not bring democracy to Russia. In addition, the forces for democracy within Russia must be supported and strengthened. This is best done by integrating Russian societal forces directly into the world community of democratic societies.

Putin's real efforts to integrate Russia into the West coupled with his equally real efforts to limit democratic freedoms within Russia are evidence that integration alone does cause democracy. Although Mr. Putin has made great strides in reforming the Russian economy, he has weakened Russia's already fragile democratic institutions. He has emasculated the upper house of parliament, impeded party, trade union, and ngo development, destroyed the most important outlets of the independent media, and demonstrated an indifference to the human rights of his own citizens by how he has conducted his military forces in Chechnya. Because the United States needs Russia now in our fight against terrorism, some have suggested that the Bush administration should devote less attention to Russia's antidemocratic drift.

This would be a terrible and shortsighted mistake. Because Putin is committed to integrating Russia into the West, Bush and other Western leaders actually have the opportunity to push Putin in the right direction. (This would not be true if Putin was an anti-Western, autocratic despot.) President Bush needs to work with his new friend in the Kremlin to recalibrate expectations within Russia about the benefits of cooperation with the West and elevate democratization in Russia as an American national security interest.

A. Democracy as the Cost of Admission into Western Institutions.

When discussing NATO or other Western clubs, Mr. Bush should state clearly that long-term cooperation and eventually membership will be conditioned upon democratic consolidation in Russia. During the Cold War, NATO made compromises on this commitment to democracy for some members. Such compromises need not and should not be tolerated now. Russia should not aspire to become Turkey, a troubled NATO partner that has struggled unsuccessfully to join the EU. Rather, Russia should be encouraged to aspire to become another Germany, a full partner of and a major player in Europe.

B. Speak Clearly about Chechnya.

The Bush administration was right to call upon the Chechen leadership to sever its ties with international terrorist organizations. At the same time the Bush administration must emphasize that not all Chechens—not even all Chechen fighters—are terrorists. The Bush administration also should actively encourage negotiations between Chechen leaders and the Russian government. Moderate Chechen leaders and the Russian government actually have a mutual enemy in the extremists who have been attracted to fight in the Chechen war. The negative lessons of Russia's war against terrorism almost must be realized. Fighting a just cause by unjust means has produced disastrous results for Russian national security.

C. Increase Support for Russian Democratization.

The best way to support further democratization within Russia is to increase direct assistance to Russian democrats. If many other items on my list require executive initiative, this policy change does not. Congress should pass the legislation introduced by Tom Lantos last summer, which would provide for increased funds for Russian democracy. In honor of the highly effective Jackson-Vanik legislation from thirty years ago, Congress should establish a Jackson-Vanik Foundation for the support of religious and human rights in Russia. The foundation could be dedicated to the training and technical support of Russian non-governmental organizations dedicated to improving the quality of Russian democracy.

D. Increase Funds for Education in Russia and the United States.

Education is the ally of democracy and democracy is the ally of the United States. The United States must devote greater resources to developing higher education within Russia and to promoting the study of more Russians within the United States. Special emphasis must be placed on promoting public policy schools. Subsidizing internet access and promoting the study of English within Russia are two additional powerful tools for promoting democracy within Russia and integrating Russian society into the West.

E. A Parallel Society-to-Society Summit.

In May, Presidents Bush and Putin will meet for a summit in Moscow that will be dominated largely by an old agenda from the Cold War era—arms control, regional conflicts (Iran, Iraq, Middle East, North Korea), European security (i.e. NATO expansion), and human rights problems within Russia. This agenda does not reflect the new breadth of relations between American and Russian societies. To underscore the new sinews that bind Americans and Russians, the Bush administration, U.S. lawmakers, business leaders, scholars, and non-governmental organizations should collaborate with their Russian counterparts to convene several summits at the same time in May. Each group—the U.S.-Russia business community, lawmakers from the Duma and the U.S. Congress, Russian and American scholars, and NGO leaders from both countries—could meet, generate a list of ideas for promoting greater U.S.-Russian cooperation, and then present these ideas to their respective state leaders at the May summit. These multiple sessions would highlight the new nature of U.S.-Russian relations that often is ignored in analyses of the state-to-state relationship.

IV. Russian-American Cooperation to Fight Terrorism.

The Bush and Putin administrations already have done much to develop this agenda. Two outstanding issues, however, need immediate attention.

A. Cooperate to Fight Terrorism in Georgia

In the wake of September 11th, Russian military commanders in the Caucasus may wrongly believe that they now have a green light to pursue terrorists within Georgian territory. Such an intervention would have disastrous consequences for Georgia and U.S.-Russia relations. As an act of preventive defense, the United States must become more engaged in helping the Georgian government to secure its borders. Working on opposite sides of the Georgian border, American and Russian military officials might even cooperate to secure the area. Above all else, the United States cannot allow Russia to 'fight terrorism' unilaterally within Georgian territory.

B. Recognition of Russia's Role in the War in Afghanistan.

Russian military advisors, Russian trained soldiers, and Russian weapons played a far greater role in the war in Afghanistan than have been reported in the West. When visiting Russia in May, President Bush should help to clarify the record by recognizing Russia's role. He could improve dramatically Russia's image of the United States by giving a few medals of honor to those Russian military or emergency personnel who assisted in the war effort. The last time such a gesture occurred between the United States and Russia was after World War II. Because World War II is the most revered moment of recent Russian history for most Russians, a symbolic gesture that recaptured some of the spirit of World War II would have tremendous resonance within Russia today.

CONCLUSION

In our fight against terrorism, many of our new coalition partners will be temporary allies. However, our newly developing relationship with Russia has the potential to blossom into something deeper and more lasting. The key condition for such a positive outcome is the deepening of Russian democratization at home and integration into Western international institutions abroad. Throughout the twentieth century, the United States had to forge alliances with dictatorships and democracies. Even Stalin's USSR was an American ally for a time. Over time, however, the democracies on the list proved to be the more effective and reliable allies. Not infrequently, ostensible gains in the short term from partnerships with anti-democratic regimes and movements—such as the Shah in Iran, the Suharto dictatorship in Indonesia, the mujaheddin in Afghanistan, and the apartheid regime in South Africa—were more than offset by setbacks to American security and embarrassments to American ideals in the long term. Today, it is not a coincidence that no democracy in the world is an enemy of the United States, while every sworn enemy of the United States is a dictatorship. Russia has the chance to join the list of our permanent friends, but only if we take seriously Russian integration into our Western institutions and Russia's takes seriously democratization. The potential for breakthrough—for a fundamentally new and improved relationship between Russia and the West—has never been greater.

Mr. GALLEGLY. Thank you very much, Dr. McFaul.

Our next witness is Director and Senior Fellow of the Russia and Eurasia Program of the Center for Strategic and International Studies. We welcome Dr. Celeste Wallander. Doctor?

STATEMENT OF CELESTE A. WALLANDER, Ph.D., DIRECTOR AND SENIOR FELLOW, RUSSIA AND EURASIA PROGRAM, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES

Ms. WALLANDER. Thank you, Mr. Chairman. I am grateful for the opportunity to contribute to the work of your Committee as the United States faces this challenge of crafting a relationship with Russia that builds on the positive experience of cooperating to counter the threat that has been posed to American, Russian and even global security by transnational terrorism and the states that make it possible.

In my written submission to this Committee I provide background and detailed analysis on the bases of Russian foreign policy and specific Russian policies toward an array of important countries. Rather than repeating those details here, I want to ask that the written submission be entered into the record and focus here instead on the developments in actual Russian policies, the policy implications and the tasks they pose for American foreign policy.

The policy bottom line is that Russian foreign policy primarily serves Russia's current economic interests and a medium term economic development strategy. Current interests mean first and foremost energy, energy markets in Europe and increasingly energy markets in Asia, energy reserves that Russia can claim and develop in the Caspian, as well as those in other Russian regions, such as: Siberia and the Far East, and energy transport corridors from the Russian heartland to Europe primarily through natural gas pipelines from Siberian and Far Eastern energy sources to Japan, Korea, and China, from eastern Central Asia to Asia and other global markets and, most complicated and laden with foreign policy dilemmas, from the Caspian to regional and global markets.

In looking at Russian relations with Europe, including Turkey, we have to keep in mind the countries of the former Soviet Union in the south and increasingly Asia cannot be understood without knowing that energy accounts for 50 percent of Russia's exports. And, those export revenues make possible balanced budgets, timely and even early Russian payments on Russian and Soviet era debt and also as a source of Russian investment income.

Current concerns mean, second, arms sales. Russian arms sales through straight and also through private entities in 2001 were \$4.4 billion. The Russian defense budget in official nominal terms was at \$9 billion. Indian and Chinese purchases alone account for the bulk of all Russian Sukhoi aircraft production.

Russian shipbuilding enterprises depend on contracts with India for frigates, a kilo class submarine and the Admiral Gorskikh aircraft carrier. Russian shipbuilding companies will construct two patrol boats worth a \$40 million contract to Vietnam.

Surface to air missile defense systems, advance tanks and helicopters are sold to a variety of countries as Russian soldiers fight in Chechnya with old even World War II stocks of weaponry. Arms sales and the foreign policy relationships that support and build upon them are keeping Russian defense industries afloat.

When we think about the Russian-Iranian relationship, think about the fact that there was a contract signed by Iran with a firm in the Siberian town of Ulan-Ude last summer for 30 military transport helicopters with a value of \$150 million. Having sales of just \$100 million a year puts a company in the top ten Russian defense exporters.

Similar points can be made regarding specific Russian interests in ferrous and non-ferrous metals exports, nuclear technology and missile and space technology, the other sectors where Russia has something to sell that foreign buyers are willing to buy.

My point is simply that keeping the economy right now afloat, even for a leadership that seeks to diversify, modernize and integrate, means supporting the sectors that have something to sell worth buying, and that means creating and reinforcing foreign policy relationships.

Now, some of these foreign policy relationships have clear positive effects for U.S. interests. Russia's strong and growing trade relations with Europe are a major force in Putin's focus on the West. Well before the decision following the September 11 attacks, Putin's foreign policy had established stronger ties with important European countries that are also strong U.S. allies, particularly Germany and Britain.

Putin's foreign policy pragmatism has underwritten an improvement in Russian relations with Poland as Russia seeks to develop new natural gas pipelines to Europe. The Russian-Turkish rivalry that has been rooted in the geopolitics of competing influence in the Caucasus in Central Asia has been moderated by agreement on constructing the Blue Stream natural gas pipeline in the Black Sea.

These are developments the U.S. welcomes, both for increasing security, prosperity and cooperation in Europe on its own terms and because they create interest and policies that the U.S. and American businesses can work with.

Other developments are more problematic. Russia's ambivalent policies toward energy transfer corridors in the Caspian have been a source of constant concern for U.S. foreign policy, which I certainly do not need to remind you, because they have combined rational, self-interested commercial policies with hegemonic, zero sum impulses for keeping out competitors or even partners and trying to set the terms by which the weaker countries in the region, particularly Azerbaijan and Georgia, participate in the global economy.

The balance now appears to be tilting in favor of commercial cooperation, especially with improvements in Russian-Azerbaijani relations and now also Russian interest in participating in the Baku-Tbilisi-Ceyhan pipeline. However, it is a foreign policy tangle that requires constant U.S. attention and support for the sovereign countries in that region and their right to determine their own economic and foreign policies. That sometimes creates problems and differences in U.S.-Russian relations.

Now, it is worth managing these complications in the short run because in the medium term Russian objectives are in our interest. The Putin leadership's development strategy has positive implications for its foreign policy. These medium term objectives are investment and diversification of the economy. Both of those require

internal integration, and that is key to our influence and to our interests.

Although, in the medium to long term, the Putin leadership understands, a Russian economy that produces and sells only energy and defense products to others is a country that will never be modern and successful. In the contemporary world economy, it is openness, participation and interaction that create modern, successful economies because that is how competition, information and capital, human as well as financial capital, create new productive enterprises.

This is the international economy that the western world, the U.S., Europe and Japan primarily, created in the twentieth century, and we hold the key to Russian participation in that economy in the 21st century. This is the other part of Putin's foreign policy initiatives, especially and even in Europe—business relationships, investment and stimulating Russian entrepreneurship through cooperation and competition, healthy competition with western firms.

Whenever I go to Moscow, I am positively tripping over European businessmen and businesswomen actively involved in the consumer, technology and other related sectors or those developing new ideas for investing in and starting new enterprises in Russia. They are also outside Moscow in Russia's northwest regions and in cities like Volgograd and Nizhniy Novgorod.

However, it is not only Europe, but some of the other countries, we neglect to think about where there are business relationships in this modern sense developing, including especially India where there are growing links and modern sectors such as computer software and information technology.

Most of all, Putin's medium term development objective is a major opportunity in the U.S.-Russia relationship, and it is why WTO membership, World Trade Organization membership, occupies so much of Russian foreign policy attention. It is not the current or economic trade relationship in U.S.-Russian relations, which still remains relatively limited, but Putin's medium term objective that has sustained the improvement in U.S. relations over the last year.

Putin has prioritized the economic agenda over differences in political and security areas when necessary. We have seen this in arms control, in the moderated rhetoric on NATO enlargement, in cooperating on a smart sanctions regime for Iraq and in the retreat from a strategic partnership from China.

The question is whether we are able to manage the complications that arise from the immediate Russian concerns and relationships, particularly Russia's economic interests in Iran, Iraq and China, as well as lingering issues that plague U.S.-Russian relations as a consequence of the Soviet legacy in the military and security field.

Simply because Putin has set his objective as economic development does not mean we can easily escape decades of traditional conceptions of security issues or the concrete realities of weapons, military forces and conflict prone regimes in the former Soviet states. It takes time and constant effort to restructure the security relationship, just as it has taken very painful time to restructure the Soviet economic legacy.

Some of the signs are positive. The process of consultation on U.S. intentions and Russian concerns on missile defense helped us to manage the December decision that the U.S. would withdraw from the ABM treaty even if it was not the outcome the Russian Government preferred. The current consultations on offensive nuclear weapons reductions create the opportunity for a similar context of information, opportunity to explain reasoning and express reservations and possibly even to find agreement on a mutually acceptable, legally binding agreement or treaty.

I would include in this the opportunity for cooperating in non-proliferation and control of WMD. This is one of the most successful areas of security cooperation that we have seen since the end of the Cold War, but is still one fraught with complications and obstacles that constantly needs to be managed.

Similarly, the decision to offer Russia a meaningful role in security decisions and actions within NATO is one that rightly values the positive role of consultations and inclusion in getting Russia involved in our own security policy and priorities.

Although it is not as ambitious and far reaching as the original idea proposed by Britain's Tony Blair, the NATO decision this week to offer a Russia NATO Council is a substantial improvement over the permanent Joint Council because it is pragmatic and forward thinking, and it is going to be focused on real security issues and real security missions, including terrorism, regional conflicts and humanitarian crises.

We are not going to overcome decades of crises. We are not going to overcome decades of this worst case scenario approach and geopolitical competitive thinking overnight. Even with the inspiration of meeting the common threat posed by global terrorism, it is a process that has to constantly be worked on.

One important current example is whether American presence in Central Asian bases will contribute to U.S.-Russian cooperation against terrorism and related problems of criminal trafficking in the region or whether it will become a flashpoint for competitive struggle for influence in the region.

During a trip to Moscow earlier this month, I found Russian officials and informed analysts generally conflictive in their attitudes on this question. The easy response is to be competitive, but Russians are struggling with the idea that it might be in their interest to have the United States involved in the region.

Similarly, the U.S. decision to aid Georgia in trying to control its borders and its territory against terrorist infiltration at bases is eliciting contradictory responses in Russia. Just today, Foreign Minister Ivanov on the one hand said he thought it was negative, it was counterproductive that the United States was there, while praising the fact that the United States has come around to the Russian way of thinking about the role of terrorist groups in the Caucasus.

In closing, I would argue that the key question for U.S. policy in Russia as we approach the summit is whether such ambivalence and concerns are inspired by opposition to U.S. presence or to American's predominant power and the unilateralism that seems to accompany it.

Let me be clear in my assessment. I do not think that the Russian Government's concern now is U.S. presence itself. They are not rooted in zero sum Cold War thinking. I think the evidence of the last 2 years is that Russian foreign policy is moving steadily, although maybe unevenly and slowly, away from reactionary competitiveness.

The question for us, the United States, is whether we can craft and sustain a positive agenda across economic, political and security issues that reinforces the positive trends and works through still problematic issues. The signs are that we can, and in fact that we are, but we need to be at least as pragmatic and focused as Putin's U.S. policy has been in the last year.

Thank you.

[The prepared statement of Ms. Wallander follows:]

PREPARED STATEMENT OF CELESTE A. WALLANDER, PH.D., DIRECTOR AND SENIOR FELLOW, RUSSIA AND EURASIA PROGRAM, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES

Mr. Chairman, I am grateful for the opportunity to contribute to the work of your committee as the United States faces the challenge of crafting a relationship with Russia that builds upon the positive experience of cooperating to counter the threat posed to American, Russian, and global security by the al Qaeda and the Taliban regime. Even after the successful mission in Afghanistan, Russia occupies geopolitical and policy space crucial to the conduct and success of the long-term counterterrorist mission that President Bush has placed at the center of American policy. Our steps in the coming months will determine whether and how we realize the opportunity as we approach the Russia-U.S. summit in May. I hope to contribute by outlining the bases of Russian foreign policy under Putin, Russia's current relations with a variety of countries, and the implications for U.S. policy and national interests.

BASES OF RUSSIAN FOREIGN POLICY UNDER PUTIN

The domestic political and economic coalitions behind President Putin differ substantially from that of the Yeltsin period, a fact which has important effects on Putin's foreign policy. In political terms, Putin's support and legitimacy are based on his claim to have brought a measure of order and stability to daily life in the country. His career in the KGB, reputation as an effective official in St. Petersburg, and determination to fight in Chechnya earned him support not only in security and military circles, but in public opinion. Leveraging early support, the Putin leadership has created a stronger and more centralized state as a way to create stability, restore Russian power, and create a market economy able to function in a globalized world. Determined to end what in academic circles is called "state capture," Putin has sought to break to political power of the oligarchs and of regional leaders in Moscow. He has launched attacks on certain oligarchs, against much of the independent media, and regional governors not in his circle. Putin has succeeded in reducing the power of the oligarchs and regional governors. He largely controls the lower house of the Russian legislature, and consolidated control of the Federation Council by changing the rules on who serves in that body.

More than political order, however, the Putin government's support derives from the economic growth that began in 1999 and by the end of 2001 had resulted in 20% growth in the economy since the August 1998 crisis. Political support and a successful economy became mutually reinforcing: government surpluses contributed to macroeconomic stability, allowed the government to pay pensions and wages, and had numerous other tangible economic effects that enabled Russians to feel more secure and hopeful. This in turn created space for longer term thinking about economic reform, and especially a strategy for participation in the international economy. The Putin leadership team is less mired in breaking up the Soviet economy, and clearly focused upon building a Russian economy that will provide the country the resources and power to play the role of one of the world's leading countries. Unlike Yeltsin's habit in the last half of the 1990s of asserting by right Russia's great power role in a multipolar world, Putin's Russia is embarked upon a policy to create a Russian economy that makes Russia a world power. Whether the policy will be

successful remains to be seen, but Russian foreign policy can only be understood if we understand that Russian foreign policy essentially serves its economic goals.

THE SHAPE OF THE RUSSIAN ECONOMY AND ITS IMPLICATIONS FOR FOREIGN POLICY

The Russian economy grew 5.4% in 1999, 8.3% in 2000, and 5.2% in 2001. In the first two years, growth was primarily due to the effects of devaluation of the ruble (and thus the effects of import substitution as Russian goods became more competitive), and favorable international oil and gas prices. Later in 2000 and through 2001, the Russian economy confounded pessimistic expectations as the effects of reduced costs and increased competitiveness fueled growth driven to a greater degree by demand and consumption. Industrial output grew 4.9% in 2001, and a growing percentage (over 61%) of Russian enterprises are reported to be profitable. Real wages and real disposable household incomes continue to grow in 2001 (at 16.7% and 5.4% respectively), which contributed to continued strong domestic consumption. Fixed capital investment increased 8.7% in 2001, and capital outflows decreased from \$2.3 billion per month at the beginning of 2001 to \$1.5 billion per month in the third quarter (the most recent period for which World Bank figures are available). Russia's trade surplus was \$51.1 billion in 2001, and the government budget surplus was 2.4% of GDP.

However, despite the overall positive picture, there are clear problems. Russia's economy remains too concentrated in natural resources exports (which account for 70% of the total), and the positive investment figures remain concentrated in the extractive industries. Only energy and food production have maintained their growth rates in the past year. And although overall industrial growth was a respectable 4.9%, it was flat in the fourth quarter. Russia's lack of a system for financial intermediation means that small and medium businesses still have a difficult time getting started, limiting Russia's ability to diversify its economy. Although Russia will likely maintain economic growth even if the price of Urals crude oil falls as low as \$13/bbl, any reduction in global prices for energy reduces resources: it is estimated that every \$1 change in the price of a barrel of crude oil is worth \$1.2 billion to the Russian economy, with about one-third of the amount going to the government budget in taxes and duties. Inflation in 2001 was 16% (higher than the 12% government target), and the ruble appreciated 7% in real terms in 2001, reducing import substitution competitiveness. Indeed, Russian imports increased \$7 billion and exports decreased \$2 billion in 2001. The country needs to invest some \$2.5 trillion over the next 20-25 years to replace aging Soviet infrastructure and make up for the absence of investment in the 1990s.

Therefore, Russia is running a race it can only win by creating new industries and developing new sectors, even as it remains dependent on international energy markets. Energy exports create benefits that ripple through the private economy and government budget, but they undermine competitiveness by causing appreciation of the ruble. Eroding competitiveness reduces production in the consumer sectors that did well after August 1998, and their slowdown depresses demand in the machine building sector. Without a system by which profits and savings can be invested in new enterprises, investment and productivity will remain locked in the extractive sectors.

In addition, it is important to understand that the manufacturing sectors of the Russian economy that are internationally competitive are military arms, nuclear power plants, and space technology. The domestic market for all three is very limited, which is one reason why foreign markets are important. The first two sectors pull Russian foreign policy toward countries like China, Iran, and India, which have an interest in the goods, ability to pay, and difficulties on Western markets. Russian arms sales in 2000 were about \$4 billion, while the entire Russian defense budget was just under \$8 billion. Virtually none of Russian defense spending is for procurement, which means that Russian foreign arms sales are keeping its defense enterprises open and operating. This is significant not only in economic terms, but also politically, because much of Russia's defense plants are located in single-factory towns as a consequence of Soviet industrial practices, and the populations of those towns are entirely dependent on the military economy for survival.

Another sector of the Russian economy with a stake in Russian foreign policy is the consumer sector that has been important for growth over the past two years. Because of the import substitution effects, the sector has done well, but as these effects diminish, the sector will need substantial investment and advanced management skills to continue to succeed. This is one of the sectors of the economy where business interests have pushed for improvement in Russia's foreign investment climate. In 2000, Russia attracted only \$4.4 billion, or one-half of 1% of the global total. Much of this investment has been concentrated in medium to small consumer

oriented industries in Russia's northwest regions, those near Europe. One success story has been Cadbury's investment in the Novgorod region, and there are others in food processing, breweries, and soft drink production. These industries, their interest European business contacts, and their support for corporate governance and banking reform necessary to attract foreign direct investment are a fascinating foil to the interests of Russia's aging but persistent defense industries.

The result is a Russian foreign policy dependent on foreign markets for energy, yet at the same time seeking investment and trade across a broader array of businesses. It is a Russian foreign policy that seeks to maintain traditional trade partners in traditional sectors, yet seeks new opportunities with countries—particularly those of Europe, developed Asia, and the U.S.—that can bring capital and experience to diversify the Russian economy. It is a Russian foreign policy that seeks to sell arms to China, and join the WTO, all as part of the same set of incentives and constraints.

RUSSIA AND EUROPE

Putin has pursued a vigorous diplomatic agenda in Europe. Putin has met with the leaders of Germany, the United Kingdom, France, Italy, Sweden, and Finland among others, and with several of them multiple times. He has held five bilateral summit meetings with German Chancellor Gerhard Schroeder in just over one year. Putin has emphasized repeatedly in his travels and foreign policy statements that Russia is a European country and seeks to develop ties with European partners. Commentators commonly attribute Putin's European orientation to his St. Petersburg origins, or his KGB service in East Germany, and they may play some role. But the more serious questions of foreign policy interests are explained by Russia's economic interests in Europe.

Europe has replaced the countries of the former Soviet Union as Russia's primary trading partners. Russian exports to the EU countries amount to about 13% of total Russian GDP. EU countries account for 34% of Russian exports, and another 22% of Russian exports go to EU aspirant countries, which means that in the next decade Russia may send well over half its exports to the EU. Natural gas is a substantial part of this trade. EU countries import 20% of the natural gas they use from Russia alone. In 2001, Russia and the EU agreed to develop a new gas pipeline through Poland, one that would expand exports and bypass Ukraine (where old Soviet era pipelines have been the main transit method for Russian natural gas exports to Europe).

Russian relations with individual European countries have improved considerably under Putin, but even more significant is the development of the Russia-EU relationship. In the Yeltsin era, the EU was largely ignored, and it remains little understood in Russian political circles. However, the Putin government has worked to develop the potential created by the EU's Partnership and Cooperation Agreement for developing business ties and managing the potential negative effects on Russia of EU enlargement in Central and Eastern Europe. Despite the problems it may create for trade and travel in eastern Europe, Russian foreign policy is now more positive on EU enlargement, and on EU programs for regional development in northeastern Europe, particularly those addressing Russia's Kaliningrad enclave in EU regional cooperation programs.

At the EU summit in Sweden in 2001, the emphasis was on involving Russia in European affairs where possible, part of a consistent policy on the part of EU members to move Russia more to the center of Europe's economic and security policy. Russian Foreign Minister Ivanov declared that Russia views the EU's agreement to create a 60,000 strong rapid reaction force by 2003 in positive terms, and said that Russia was ready to study the possibility of cooperating with or contributing to the EU force's crisis operations. This is an important development for a Russia that not long ago made little distinction between the EU and NATO. Russia and the EU held a productive summit in October 2001, including an agreement for regular meetings in the political security spheres.

Russia's growing base of relations in Europe extends beyond the major players of traditional Western Europe. Russia-Lithuanian relations are so positive that Putin reminds Lithuanians that they are "European." Putin recently assured Lithuanian President Valdas Adamkus that sovereign countries have the right to enter whatever security arrangements they see in their interests. Russian-Polish relations are constructive across a broad range of political, security, and economic issues. Putin's visit in January 2002 was remarkable: in addition to discussions of how Poland can facilitate solutions to problems Russia is likely to face with Poland's accession to the EU, Putin laid flowers at a monument to Poland's WWII resistance army, and visited a monument to victims of the 1956 Soviet intervention.

More significantly, Putin's approach has meant that Russia has set aside the geopolitical competition in relations with Turkey that Yeltsin's government never quite achieved in order to focus on economic ties, particularly Russian exports of natural gas. The potential of geopolitics in the relationship has been real, with Turkey emerging as a potential competitor in Central Asia and the Caucasus, and Russia willing to provide Cyprus with air defense systems. Turkey's support for the Baku-Ceyhan pipeline was a major irritant in Russian-Turkish relations, as was Russia's war in Chechnya.

But Putin's government moved more strongly in the direction of cooperation with Turkey. It pushed through passage of a package of tax credits to support the building of Blue Stream, a natural gas pipeline under the Black Sea to supply Turkey. In early 2002, Russia's policy on the Baku-Ceyhan-Tbilisi pipeline has shifted to one not only of support, but with oil companies YUKOS and LUKoil seeking to invest. This removes a major source of competition and strain in the relationship. Russia is willing to sell military helicopters to Turkey while NATO allies are reluctant because of concerns about Turkish policy on its Kurdish minority. And despite Chechnya, Russia and Turkey agreed in late 2000 to stronger cooperation in counterterrorism.

RUSSIA AND ASIA

At the same time, Russia has significant interests in relations with countries in Asia. A major component of this interest is economic opportunity. Russia sells natural resources, energy and conventional weapons to China, India, and Iran. In late 2000, we saw Russian trade agreements worth over \$1 billion in arms sales with China, and a broader package of trade agreements worth some \$3 billion with India. Russian officials have stated that they will pursue internationally legal sales of conventional arms to Iran even at the risk of the US imposing sanctions. Contracts discussed with Iran in 2001 could be worth over \$4 billion in the next few years. While on the one hand, poor U.S. relations with Iran are a problem for Russia because Russian-Iranian relations are an irritant, on the other Iran's isolation is one of the reasons its energy, military, and regional security relations with Russia are so strong. Russia might welcome removal of the irritant, but it might lose the practical advantages from which it has managed to benefit so well.

In India, Putin succeeded in not only getting agreements on conventional arms sales, but signed agreements on nuclear technology, trade, and exploring joint efforts in information technology. Given Russia's limited potential economic relations with China (which is geared far more toward trade with the US), the Russian leadership's attempt to focus on India in more areas than merely arms sales is evidence that the foreign policy is driven by more than unidimensional military or geopolitical concerns.

Japan could well hold the key to keeping Russia whole: the Far East's economy is in shambles, evidenced only most dramatically by the failure of its electricity system last winter (with temperatures falling to 50 degrees below zero, much of Russia's Far East went for days at a time with electricity blackouts). Russian officials talk of Russia's timber and hydroelectric resources, and even gas and oil (including development of Sakhalin Island oil deposits for the Far Eastern energy market), as a solution to Japan's perennial materials and energy dilemmas, and Japanese investment as a solution to Russia's economic failures in Siberia and the Far East. Japanese companies are involved in multinational business projects to develop oil and natural gas off the Russian island Sakhalin. The dispute over the Kurile Islands remains a serious obstacle to improvement in Russian-Japanese relations, and no solution is in view, but in the past few months there has been a series of continuing official and unofficial meetings on the issue, which at least preserve options to find a solution. Unlike their fear of China's rise and potential designs on Russian territory, many Russian Far East elites welcome the prospect of Japanese—and Korean—investment.

RUSSIA AND EURASIA

The effects of Russian pragmatism are more difficult to find in its relations with the countries of the former Soviet Union. In dealing with the countries of Central Asia, the Caucasus, and its western borderlands, Russian foreign policy displays a mix of economic and business realism mixed with geopolitical pressure. In part, this is because security concerns predominate in Russia's preoccupations on its borders, and traditional thinking remains influential in security thinking. Stability (or at least the Russian version of it) is crucial. Among the consistent first order threats to Russian security cited in its national security concept, military doctrine, and foreign policy concept were instability, primarily in Central Asia and the Caucasus,

and armed conflict in Tajikistan, Afghanistan, Chechnya, Abkhazia, and Nagorno-Karabakh.

Without doubt, Russian policy in the 1990s contributed to these threats through the use of force and interference to maintain Russian influence and presence in the region. But equally without doubt, these countries face significant indigenous sources of instability and conflict. Despite their existence as independent sovereign states, there is in fact little of border security and controls between old Soviet and current Russian borders, and the post-Soviet Eurasian space remains permeable and vulnerable to armed conflict. Most striking has been the ability of the Islamic Movement of Uzbekistan (IMU) to operate in Afghanistan and Kyrgyzstan, as well as in Uzbekistan. Drug trafficking (in part enabled by corrupt Russian officials and military) has fueled instability and insecurity in the region. In the Caucasus, Georgia's inability to control its own territory has enabled armed Chechen groups to use its territory at least for refuge and possibly for launching attacks.

Russian behavior toward Georgia has become a bewildering array of conflicting positive developments (such as a new willingness to conduct dialogue with Shevardnadze, and a new positive attitude on Georgia's role in the Baku-Tbilisi-Ceyhan pipeline) and increasingly negative actions (primarily support for Abkhazian separatism, and even possible direct military intervention against Georgian territory in the Kodori Gorge). Russian policy seems stuck between its own contribution to instability in the region, and its newfound interest in economic and business priorities. Russia also seems to be stuck in a situation where it cannot find a solution to the dilemmas thus posed on its own, but still unwilling to welcome Western involvement in the region for fear of being edged out. The result is a costly stalemate and increasing concerns that Georgia may not survive the crisis. While it is probably true that a withdrawal of Russian forces from the Gudauta base and from the Abkhazian region of Georgia would lead to new fighting, it is also the case that Russia has done little to work for a long-term solution to conflict in the region that does not depend on Russian military dominance.

Russia has long identified Islam and international terrorism as a threat. The Chechen's separatist war, in this context of Russian security perceptions, is just one manifestation of Islamic radicalism with international ties and terrorist means stretching from Afghanistan to the Black Sea. It is crucial to understand how instability, Russian weakness, Islam, and international terrorism have been linked in the Russian perception. A component of this perception has been for some time that the West is a potential ally against this threat, because it too has been a target. This perception is the reason Russian officials suggested joint operations against Osama bin Laden in Afghanistan long before September 11th.

The mix of economic and security motives behind Putin's foreign policy are apparent in the importance of the Shanghai Cooperation Organization in Russia's policy in Eurasia. Bringing together the dominant regional powers China and Russia, along with the Central Asian states of Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan (Turkmenistan is not a member in line with its policy of neutrality), the SCO is focused on a mix of regional economic (primarily oil and gas) and security (primarily counterterrorism) issues. While clearly an effort to keep a strong Russian hand in a region it deems in its sphere of influence, the inclusion of China demonstrates the pragmatism that runs through Putin's foreign policy. And the inclusion of economic issues simply reinforces the theme: Russia's Eurasia foreign policy is a marriage of security concerns and economic ambitions.

Part of Putin's Eurasia policy has been an active effort in relations with the countries of the former Soviet Union. Russia has built an economic union with Belarus and maintains strong military cooperation with it as well. Moldova has moved to closer relations with Russia since communists won elections in February 2001. Kazakhstan has been open to better relations. Russian efforts to develop pipelines and new oil fields in the Caspian have been successful. The Putin government appears to have chosen a clearer course than the Yeltsin elite, which pursued contradictory policies of exclusion and partnership at different times. The Putin political and energy elite appears to be more consistently interested in participating in extraction and pipeline projects in the region, although it continues to oppose projects and routes in which it would not have a stake.

The forms of Russian influence in some of its neighbors also appears to be shifting from its sheer size and relative power to economic ties. Russian businesses in Ukraine are buying into its energy and aluminum industries. LUKoil, Gazprom, and United Energy Systems (the electricity monopoly) are buying stocks and shares in many industries in countries in the former Soviet Union. Russia has pressured both Georgia and Ukraine to pay their debts by threatening and implementing cutoffs of energy delivery.

Given this, it should come as little surprise that Russian-U.S. relations were problematic before September 11th. There was little to work with. We are not as important an export market as Europe for energy, and our business contacts have not focused on small and medium manufacturing where new Russian businesses have been active with European partners (our energy interests have bumped up against competitive and even illegal behavior in Russia's energy markets). We are not a market for nuclear reactors or conventional military arms. There is some potential for partnership in air and space technology, most clearly demonstrated in Russia's important involvement in the international space station and in Boeing's successful investments in Russia, but the potential has not been realized because of competition and security concerns.

In addition, because the Russian economy has been doing well the past two years and because the government has run surpluses, the U.S. lost the single most important lever of influence it wielded over Yeltsin in the 1990s: IMF credits, potential financial support, and debt reduction. The Putin government not only had different political and economic priorities, it found that it did not need the U.S. to achieve its priorities.

The agenda has been dominated by the after-effects of failed priorities in economic relations with the Yeltsin government (primarily the IMF, debt controversies, and money laundering scandals), or strategic issues left-over from the Cold War, mainly START and the ABM Treaty. An indication of just how poor U.S.-Russia relations had become was that when we wanted to put some substance behind our criticism of Russia's war in Chechnya over the past two years, we had no issues or incentives worth much to threaten to link to Russia's brutal war. When the U.S. decided to withhold IMF credits in early 2000 in response to the war, it had no effect on Russian policy.

This had begun to change in the last year. One of the logical priorities that follows from the Putin government's economic aspirations is greater success in international trade markets. Russian economic officials believe that Russian goods do not have equal access, and that in particular a potentially successful sector of its export economy—metals such as steel and aluminum—are unfairly targeted by anti-dumping measures in the West. By joining the World Trade Organization, Russian officials believe that they will benefit from the multi-party arbitration mechanisms that members are entitled to, rather than the unilateral imposition of restrictions that Russia, as a non-member, is subject to.

In addition, Putin's more pragmatic approach and stake in relations with the European countries had shifted Russian strategy on both ABM Treaty abrogation and NATO enlargement. While continuing to oppose both, Putin shifted Russia policy to one that sought compromise and engagement with the U.S. Recognizing that Russia could not prevent a U.S. decision to proceed with missile defense, the Putin government sought to modify that decision through negotiations, and when the American decision came to withdraw from the treaty, calm acceptance. Since that decision, Putin's military and foreign policy team has been engaged with discussions on offensive nuclear forces reductions, despite conditions that do not look very promising from the Russian perspective. Putin's practical approach has meant Russian engagement in consultations that do not guarantee a legally binding agreement or treaty, and that are likely to preserve a considerable American "hedge force" beyond the targeted reductions to 2200 warheads.

Well before September 11th, Putin told several European leaders and publics that although Russia did not want to see NATO enlargement, it would live with it. Instead of threatening counter-military actions (such as deploying tactical nuclear weapons in the region), Putin suggested that Russia should be considered a candidate for NATO membership itself, particularly if the alliance shifted further toward an political organization. More practically, Russia has been engaged in discussions on the idea of a "NATO at 20" which would involve Russia as an equal partner in a limited and defined set of security issues that could be constructively discussed with Russia at the table.

The basis of Russian shifts on missile defense and NATO, however, remained Putin's foreign policy of diversification and practicality. The ability of the U.S. to exercise linkage remained minimal. Russia relations with Iran have continued apace, and even accelerated. Russia's war in Chechnya has not ended, and to the extent that some concern for standards of international human rights matter (for example, in investigations and trials of military atrocities) the influence comes from the Council of Europe and the OSCE. Russia and China signed an agreement on strategic partnership that some read as the basis for alliance this summer. Meetings between President Bush and President Putin this year in Ljubljana and Genoa were

promising, and there was much to work with, but the promise was in the potential for overcoming problems, rather than a substantial positive cooperative agenda.

WHAT COMES NEXT

Much attention in the U.S. has focused on Putin's speech of September 24th, declaring Russia's support of the U.S. war against international terrorism. Putin's speech was a significant step. It contradicted and silenced voices in Russia's security and military elites that had voiced doubts and even opposition to U.S. counterterrorism. Putin made a decision to embrace the common interests now apparent in confronting and defeating international terrorism. Putin's speech, and subsequent Russian policy, creates a historic opportunity to create meaningful cooperation between our two countries.

However, most commentary is wrong in deeming this decision as a complete break with Russian policies, and in claiming Putin is alone in charting this course. As my analysis has shown, the foundations for a Western-oriented policy have been laid over the past two years, and have sturdy roots in Russia's emerging political and economic elites. Russia's primary interests in economic development and in Eurasian stability give it solid interests in the international status quo, including the fight against global terrorism that threatens the existing global system.

However, it is crucial to understand that while international terrorism has illuminated our common interests, it remains to be seen just how broad and deep those common interests are. It is far from clear that the U.S. and Russian define international terrorism and its sources in precisely the same way. We probably do not agree on the nature and extent of terrorism in Chechnya and the Caucasus, or in Iraq. We have agreement on fighting the Taliban in Afghanistan, but that agreement may not extend to pursue terrorism around the globe as the U.S. views as necessary.

Furthermore, it is important to understand that Putin's foreign policy is based both on relations in the West and in Eurasia. Analyses often pose a dichotomy between good Russian relations in the West versus an orientation toward the East. For some time, Putin's foreign policy has not accepted such a dichotomy, and has sought to craft a policy that seeks self-interested economic and security relations with neighbors from Finland to Japan. Simply because Putin has chosen to support the U.S. against terrorism does not mean Russia loses its interests in relations with Iran, China, and other Eurasian countries. We need to be prepared for Russia to continue on the path of diversification and pragmatism it began over the past years.

In addition, it is useful to keep in mind that U.S. policy and perception of the primary threat to its national security has changed at least as much as Russia's. Putin's conception of Russia's national interests as laid out in his speech of the 24th of September has a basis in the foreign, security, and military documents that Putin has approved in the past two years. The attacks of 9/11 crystallized common interests that were in the making, creating the opportunity for partnership and cooperation to achieve our common security interests.

This should be viewed as good news: Russia's potential cooperation can be rooted in an established set of priorities and goals that have been the target of Russian foreign policy for some time. Putin took the lead on this policy, and is not supported by all, but he is not alone. Significant Russian business, political, and security interests were behind his initiatives before 9/11, and they continue to be so now. We are not faced with the dilemmas of the Yeltsin years, where the opportunity for cooperation rested solely with one man. Putin needs our support to sustain his choice, but he will also find support within Russia.

This is where obstacles meet opportunity. Three important constituencies in Putin's foreign and security policy—business, intelligence, and the military—can be engaged by U.S. policy in the months and years to come. As we approach the May summit, it is vital that American foreign policy not focus only on the economic and business side of the relationship. US policy now takes Russian international economic interests seriously, and that is a very positive development. However, an economic policy and relationship is not a substitute for a comprehensive foreign policy that engages Russia in the political and security sphere as well. Putin's coalition and constituency is strongly economic, but it is by no means only economic. Putin's long term strategy is one of Western integration, but that does not mean that Russia does not have political and security concerns that can be ignored for the economic relationship. We have every interest in engaging a pragmatic Russian foreign policy leadership in a pragmatic and comprehensive security policy of our own that finds synergies in an economic, political, and security engagement with Russia to reinforce the positive developments that have emerged so clearly in the past year,

and that enables us to constructively solve the remaining areas of disagreement in our relationship.

Mr. GALLEGLY. Thank you very much, Dr. Wallander.

Our next witness is Executive Vice-President of the U.S.-Russia Business Council, Mr. Blake Marshall. Mr. Marshall?

STATEMENT OF Z. BLAKE MARSHALL, EXECUTIVE VICE-PRESIDENT, U.S.-RUSSIA BUSINESS COUNCIL

Mr. MARSHALL. Thank you, Mr. Chairman and Members of the Committee, for the opportunity to testify today on behalf of the 260 member companies of the U.S.-Russia Business Council. I am pleased to join you today on Capitol Hill to discuss business community perspectives on Russia's unprecedented economic transition.

You have my prepared statement for the record. I would certainly be pleased to answer any questions you might have following my remarks. Given our limited time, I thought what I would do is make a few brief remarks to give you a sense of the current business climate and economic environment in Russia, offer you some recent examples of the policy progress the Putin Administration is making to improve that business climate and conclude by making a couple of points about our bilateral relationship.

First with respect to the current business climate, I want to make two over arching points. Within the business community, there is a growing, palpable sense of optimism that the Putin team's economic policy is sound and that in contrast to the empty promises of the past they are delivering with real concrete actions far beyond the rhetoric.

As Mike McFaul just said earlier, Putin is great for the market. Those concrete actions include recent demonstrated progress in terms of pension reform, corporate governance, tax reform, money laundering legislation, judicial reform and many others.

Second, generally speaking, the business community is more optimistic than it has been since prior to the August, 1998, financial crisis. This time they are showing the profits to prove it. A survey of 100 multinationals conducted by the Economist Intelligence Unit last year showed that more than 80 percent of the companies surveyed reported making a profit.

The top ratings agencies, difficult to please customers admittedly, concur with the business community sense that Russia has become an increasingly attractive place to invest. In October, 2001, Fitch raised its Russia rating from B to B+, citing "exceptional macroeconomic performance and acceleration in structural reform."

Last December 19, Standard & Poor's again upgraded Russia's long-term sovereign credit rating from B to B+. Just 2 years ago, you will recall, S&P had Russia at Selected Default, and just last week S&P upgraded the outlook on Russia's sovereign debt from Stable to Positive.

Portfolio investors have been quick to respond as Russia is one of the best performing emerging markets in the world in the past year. The Russian stock market was up 81 percent last year, including a 44 percent rise in the fourth quarter alone. The market diversification away from oil and gas concerns is also very encouraging to the business community. For example, just 3 weeks ago

fruit juice and dairy provider Wimm Bill Dann placed an IPO. It was the first initial public offering by a Russian firm since two telecoms took that route in 1999.

Meanwhile, foreign direct investment, which has totaled roughly \$18 billion over the past decade, is also beginning to increase. They have a long way to go. That is for sure. That figure compares with \$350 billion in China, but we expect FDI to grow quickly in the near term, perhaps even doubling by 2005.

Included in the FDI statistics are several prominent successful examples of the stakes American companies have made to commitments they have exhibited to the Russian market. Ford Motor Company, for instance, is investing \$150 million in Leningrad Oblast in northwest Russia to produce the Focus platform, one of their most successful models.

Also in northwest Russia, Philip Morris invested \$330 million in 2000, and they hope to recoup that initial investment by the year 2009. Not only have they since last year added another \$100 million to that commitment; they have accelerated their projections, and they now believe by the second quarter 2003 they will have their initial investment return.

Announced in early 2001, General Motors and Avtovaz signed a \$330 million deal. The European Bank for Reconstruction and Development was so impressed by the terms of the transaction that they assumed both an equity and a debt stake in the deal, part of the EBRD's 50 percent increase in its funds dedicated to Russia and the NIS over the next 5 years.

Finally, two quick examples from the energy sector that Celeste mentioned just a few minutes ago. The Caspian Pipeline Consortium, led by Chevron Texaco and ExxonMobil, has opened its 1,000 mile pipeline at a cost of \$2.6 billion, of which \$2.2 billion was invested directly in Russia.

Most recently, ExxonMobil announced a \$4.7 billion commitment to Phase I development for Sakhalin-I, an offshore project in the Russian Far East, the total value of which could exceed \$20 billion over the life span of the project.

Now, these projects do not take place in a vacuum. I want to share with you three important points about the economic environment in Russia. First, after a GDP growth of 5.4 percent in 1999 and 9 percent in 2000, in the midst of a global recession last year, Russia posted an impressive 5 percent growth. This marks the first time that post Soviet Russia has registered three consecutive economic expansions.

Second, Russia is running surpluses across the board—a budget surplus of more than \$7 billion, its first such surplus, a large current account surplus, a \$50 billion trade surplus and gold and currency reserves totaling some \$37 billion.

Third, as a result, Russia finds itself in a very good position to manage its \$30 billion of foreign debt that comes due this year and next. In fact, Russia repaid more than \$17 billion in foreign debt last year, including \$2.8 billion ahead of schedule. If necessary, a several billion dollar cushion could probably be negotiated through the Paris Club or an IMF loan, and the key determinant of whether they will need that sort of relief next year, probably in 2003, is, of course, the price of oil.

Much of Russia's economic forecasting is tied to a world oil price of around \$18.50 per barrel. One could argue that with declining oil prices, Russia has increased its incentive to further the reform process in other areas so that they can generate revenue and not be so subject to the whims of the price fluctuations in the energy sector.

When it comes to the policy progress and how you grow the economy and make that growth sustainable, essentially investors care about three things that fall into the make or break category—political stability, the tax regime and property rights.

Fortunately, Russia has demonstrated meaningful progress in each of these critical areas, having tackled political consolidation in President Putin's first year in office, before last year moving on with landmark legislation in the area of corporate tax return, the profits tax that was revamped last year and a land code, among other things.

What I would like to do next is briefly outline two key areas to give you a sense of some of these challenges and how the Russian Government has responded to them. First, tax reform. In the past few years, Russia has overhauled its income tax, its value added tax regime and the corporate profits tax. As far as the 13 percent flat income tax is concerned, receipts increased last year in 2001 54 percent on a year on year basis since it was adopted despite the abolition of higher tax brackets.

The new profits tax, which just took effect in January of this year—it was signed last summer by President Putin—includes two major accomplishments that will have far reaching impact on bottom line performance for companies; a rate reduction from 35 to 24 percent, and full deductibility of legitimate business expenses, something the business community has been arguing in favor of for years and years. Lo and behold, with a flat income tax of 13 percent and a profits tax of 24 percent, suddenly out of nowhere Russia has one of the lowest marginal tax rates in the world.

The second area is investor protections where much work remains to be done in several areas that go directly to the core of investor confidence—capital dilution, transfer pricing and asset stripping and the failure to comply with information disclosure requirements.

In terms of recent improvements, the Putin team has strengthened the powers of the Federal Securities Commission, which: Imposed fines on 1,400 companies in 2000 for failure to disclose—that was a tenfold increase over the previous year; drafted amendments to the criminal code related to non-disclosure, which will carry a punishment of up to 3 years in prison; began developing a new law on insider trading designed to take effect next January, 2003; approved a draft corporate governance code based on OECD guidelines, which the private sector has commented on extensively; and adopted amendments to close exploited loopholes in existing laws, such as the law on joint stock companies and the bankruptcy law.

Now I have brought you up to date on what the Russian Government is doing, so now I would like to move on and conclude by discussing what the U.S. Government can do to support Russia's transition.

One of the things identified by the business community, indeed one of the highlights of our transition paper submitted a year ago to the new Bush Administration, is the unmistakable importance the business community attaches to terminating the application of the Jackson-Vanik Amendment to Russia. I recognize that this is not the Committee of jurisdiction. Nevertheless, perhaps the most important thing I can do today is to express our strong support for filing away this anachronism in the Cold War archives where it belongs.

Furthermore, we believe that the Jackson-Vanik and Russia's WTO accession are two separate issues and should be treated as such. At no time since Russia has applied for WTO membership in 1993 has any U.S. official linked Jackson-Vanik to Russia's WTO accession. To do so now would be perceived as moving the goalpost and, in our view, would be tantamount to negotiating in bad faith. Not only would this artificial linkage become counterproductive for the WTO negotiating process itself, but it would also have an adverse impact on our most important foreign policy relationship.

To conclude, I would like to offer one final thought in terms of what the U.S. Government can do. Grant Russia the market economy status it rightly deserves under our trade law. The application to do so is currently under review at the Commerce Department, and the U.S.-Russia Business Council has submitted its commentary in support of that petition.

On behalf of the Council's 260 member companies, thank you again, Mr. Chairman, and Members of the Committee, for the opportunity to share these thoughts with you today. I look forward to your questions.

[The prepared statement of Mr. Marshall follows:]

PREPARED STATEMENT OF Z. BLAKE MARSHALL, EXECUTIVE VICE-PRESIDENT, U.S.-RUSSIA BUSINESS COUNCIL

I. OPENING REMARKS

Thank you, Mr. Chairman and members of the committee, for the opportunity to testify today on behalf of the U.S.-Russia Business Council.

The U.S.-Russia Business Council is a Washington-based nonprofit trade association formed in early 1993. The Council's mission is to expand and enhance the U.S.-Russian commercial relationship on behalf of 260 American firms active in U.S.-Russian trade and investment. Guided by member interests, the Council promotes an economic environment in which U.S. business can succeed in a challenging Russian market. To achieve its mission, the Council conducts activities and provides services that fall into the following categories: company-specific assistance and problem-solving; Russian and U.S. government policy work; information products; Russian business relationships; and formal and informal briefing and networking opportunities.

I am pleased to be here on Capitol Hill to convey the business community perspectives on Russia's economic transition and the commercial climate in Russia. Our message from the business community seeks to ensure balance in the discussion of Russia's transition by conveying several positive aspects of what we see unfolding in Russia. I want to stress several important points in reference to the commercial climate.

- A viable market economy has taken hold in Russia. The Russian market will continue to grow, and U.S. firms want to be well positioned vis-a-vis European competitors.
- American companies have recovered from the 1998 financial crisis fallout, are meeting their corporate benchmarks and are increasingly posting profits.
- Within the American business community in Russia, there is a growing sense of optimism that the Putin team's economic policy is sound and that, in con-

trast to certain empty promises of the past, the Putin Administration is promoting real change when it comes to Russia's economic transformation. The Putin team's rhetoric is backed by a series of concrete actions on issues ranging from tax reform to corporate governance, just two of many areas where structural changes are needed to sustain economic growth. Recent developments indicate how serious the Russians are in additional areas where bold steps are required: currency controls, pension reform, land reform, money laundering, judicial reform, and many others.

- The business community has initiated a healthy dialogue with the Russian government entities charged with structural transformation. This exchange on proposed legislative and administrative changes ranges from tax reform to commentary on Russia's recently adopted e-signature law, and it includes several WTO-driven initiatives.
- U.S. government support is crucial to the success of this effort, and intense and ongoing engagement with Russia should not be exclusively focused on strategic and geopolitical issues. Cooperative public-private engagement on the commercial front helps to advance an overarching U.S. interest in further integrating Russia into the global economy. I am pleased to note that our organization is helping to shape a new initiative in this regard, the Russian-American Business Dialogue, to which I will return later in my statement.

II. BUSINESS CLIMATE

In rendering an outlook for a country such as Russia, our challenge is to weigh competing variables, collecting anecdotal and empirical evidence to try to balance the "transition fatigue" identified by some companies with the long-term commitments evidenced by most. The same is true for the juxtaposition between long-term optimism versus the short-term pressure companies feel to make their quarterly numbers and move from red to black on the P&L sheet. The business community's positive outlook on Russia often does not correlate to mainstream media coverage of the pitfalls of Russia's unprecedented transition, perhaps in part because companies are closer to non-headline incremental movement.

Generally speaking, the business community is the most optimistic it has been since the period prior to the August 1998 crash, with more multinational corporations operating in Russia now than prior to 1998. This optimism ranges from business development plans to profits. A survey of 100 multinationals conducted by the Economist Intelligence Unit generated some interesting data to this effect.

- No company in the survey believes that political risk is increasing, with 82 percent actually seeing an improvement.
- Two-thirds feel that the tax environment is getting better, with only 5 percent believing it is becoming worse.
- More than 60 percent are currently operating at pre-crisis levels.
- More than 80 percent reported making a profit in 2000, and more than half expected sales in 2001 to grow between 10 percent and 25 percent.
- More than 70 percent hired new personnel in 2000 and planned to continue hiring in 2001.

Essentially, investors care about three things that fall into the "make or break" category for any decision matrix: political stability, the tax regime (rates, transparency/predictability and enforcement/appeals) and property rights (whether shareholder rights or intellectual property rights). Fortunately, Russia has demonstrated recent and meaningful progress in these critical areas, having tackled political consolidation in Putin's first year in office before moving on last year to pass a reduced corporate profits tax, a Land Code, and a money-laundering law.

While pressing forward in 2001 in other areas such as pension reform and judicial reform, the Russian government also gave a boost to entrepreneurial activity by passing a new law that reduces the number of business activities requiring a license from 2,000 to just 100. The law also instituted a "one-stop shop" for the registration of new firms. As the World Bank and others have demonstrated, the rapid growth of Central European and Baltic economies in the 1990s was due in large part to small and medium-size enterprises (SMEs). Firms in those countries with 50 or less employees account for more than half of all employment, whereas in the former Soviet countries only one-fifth of workers are employed in small firms.

The business community has been quick to recognize the momentum: an analyst at Aton Capital recently noted, "In the past two years, the current administration has probably implemented more reforms than Boris Yeltsin managed in his nine years in power." That momentum is unabated in early 2002, as the State Duma's

spring session will focus on more than 500 bills, 101 of which have been labeled “priority measures.” Among the priority measures are an extension of the private property provisions of the Land Code to agricultural plots, as well as further steps in the areas of tax and pension reform, the latter of which is expected to generate up to \$3 billion in investment assets over the next two years.

While implementation is the key to realizing economic benefits, the good news is that the policies are sound and the leadership exudes confidence. This has spawned a new surge in investor confidence in the team led by Minister of Economic Development and Trade German Gref and the coherent economic program they have fashioned to chart Russia’s course. The business community believes the Russian government has made good use of the “breathing room” it was afforded by the twin benefits of devaluation dividends and high oil prices—that is, they are laying the groundwork for sustainable economic growth rather than cycling through tranches of IMF money.

Foreign Investment and Market Sentiment

Russia has plenty of absorption capacity when it comes to investment inflows. The FDI stock in Russia is only five percent of GDP, which is one of the lowest in the world, and much of that amount is attributable to returning flight capital. Furthermore, according to Council member Troika Dialog, foreign investment is heavily concentrated in “islands” of opportunity where local officials have made a concerted effort to assist with a daunting bureaucracy and an unstable tax system: the top 10 regions account for 83 percent of FDI.

Russia attracted \$3.2 billion in FDI in 1999 and \$4 billion in 2000 (including an 18 percent increase in investment in fixed assets). According to the Central Bank of Russia, foreign direct investment in the first nine months of 2001 was \$2.9 billion, while preliminary data indicate that gross capital fixed investment grew by 8.7 percent in 2001 to just over 17 percent of GDP. Even with the 50 percent surge in FDI that Russia hoped for in 2001, it would still equate to one-sixth of China’s 2000 total and less than three percent of the U.S. figure for 2000. While cumulative FDI in Russia over the past decade is estimated at roughly \$18 billion (compared with over \$350 billion in China), with demonstrated improvements in the tax environment and other policy realms, FDI is expected to grow quickly in the next few years, perhaps doubling by 2005.

The top ratings agencies concur with the business community’s sense that Russia has become an increasingly attractive place to invest. In October 2001, Fitch raised its Russia rating from B to B+, attributing the revised rating to “exceptional macroeconomic performance and acceleration in structural reform,” and suggested that its strengthened policy framework makes Russia “well placed to weather even a severe global downturn and rising risk aversion.” The following month, Russia redeemed its \$1 billion Eurobond, in what some analysts described as “Russia’s first-ever full non-restructured redemption.” Moody’s responded by raising its Russia rating two notches to Ba3, citing the Russian government’s commitment to debt service, prudent monetary policy and structural reform. On December 19, Standard & Poor’s again upgraded Russia’s long-term sovereign credit ratings from B to B+—just two years ago, S&P’s minimum rating was SD (Selected Default); and just last week, S&P upgraded its outlook on Russia’s sovereign debt from stable to positive.

Both in terms of publicly traded debt and the Russian stock market, Russia has to be viewed as one of the best performing emerging markets of the past year. The RTS, Russia’s main market barometer, was up 81.4 percent in 2001, including a 44.1 percent gain in the 4th quarter alone. The market diversification away from oil and gas is also encouraging—for example, fruit juice and dairy provider Wimm Bill Dann launched an IPO earlier this month, the first such offering since two Russian telecoms (MTS and Vimpelcom) placed shares in 1999. Furthermore, with yields declining to near 10 percent, prominent Russian companies such as Sibneft, TNK, Gazprom, Severstal, MTS, and Vimpelcom have announced plans to follow the lead of Rosneft, which last fall issued the first corporate Eurobond since 1998 (\$150 million). Finally, in addition to these corporate placements, the fact that the yield on Russia’s 30-year Eurobond dropped more than five points last year is another sign of investor confidence and declining risk.

Commercial Activity: The Stakes for American Companies

The optimism and the FDI statistics are easily translated into company activity, as evidenced by a few examples of the long-term commitments American firms have made to the Russian market.

- Ford Motor Company is investing \$150 million to produce the Focus platform in Vsevolozhsk, in Leningrad Oblast. Ford planned to sell 4,500 cars in Russia in 2001, which is 230 percent more than in 2000. The Focus model is the

company's leading seller in Russia, and by 2005 annual sales in Russia should amount to 17,800 units.

- International Paper's Svetogorsk facility, also in Northwest Russia, is the leading supplier of copy papers in Russia. With 3,200 employees, the factory is ahead of the ramp-up schedule approved by International Paper's Board of Directors.
- In 2000, Philip Morris inaugurated its \$330 million Izhora facility in Northwest Russia, the company's largest, newly built facility in Eastern Europe. Last fall, Philip Morris announced an additional investment of \$100 million to expand its production capacity. The company had expected to recover the \$330 million invested in the factory by 2009, but the enterprise is operating so successfully that management now expects that initial investment to pay for itself by the second quarter of 2003.
- During the trade mission to Russia led by U.S. Secretary of Commerce Don Evans last fall, Frito-Lay announced a \$40 million investment to build a new plant in the Kashira region of Russia.
- Boeing has invested \$1.3 billion in Russia over the last decade on projects such as the International Space Station and the Sea Launch satellite-launching venture. With 350 Russian aerospace engineers at its Moscow Design Center, the company is also working with Russian design bureaus Sukhoi and Ilyushin to develop a regional aircraft.
- Announced in early 2001, the \$330 million GM/Avtovaz deal is a tremendous example of successful international investment in Russia. Its bearing on market psychology is evidenced by a wide range of analyst comments, who described it as: "a tremendous vote of confidence in the Russian economy, which will likely lead to other foreign investments . . . it will have a positive catalytic effect on foreign investors who have been sitting on the fence . . . a very positive sign for foreign companies to begin to look at Russia as a target for investment plans." The EBRD was so convinced of the potential that it took both a debt and an equity stake in the project, part of the bank's optimistic outlook on Russia overall, which yielded a 50 percent increase in its funds dedicated to Russia/NIS over the next five years.
- The Caspian Pipeline Consortium (CPC) is one of the latest manifestations of the optimism surrounding the investment climate. The total cost of the 1,000 mile pipeline project will be \$2.6 billion, of which \$2.2 billion is being invested in Russia. Almost half of the money is coming from two U.S. corporations, principally Chevron Texaco (30%) and Exxon Mobil (15%), with much of the rest from companies with substantial U.S. shareholdings (BP and Shell). The CPC opens up a new major oil export facility from the Caspian to world markets, and several companies shipping production from Kazakhstan will share in the success. The first tanker loadout from Novorossisysk in October 2001 required the approval of the CPC Quality Bank by the Russian State Customs Committee, the Central Bank, and the Ministry of Finance, among others—the Russian government delivered on its commitment.
- Most recently, Exxon Mobil announced a \$4.7 billion commitment to Phase-I development of the Sakhalin-I offshore project, which could total \$20 billion upon completion.
- The investment climate has also been the beneficiary of a vote of confidence by the U.S. Government, as the U.S. Export-Import Bank recently issued a loan guarantee of \$3.2 million to MDM Bank from Commerzbank, the first such facility extended to a Russian bank since August 1998. (MDM also received a syndicated \$13 million loan from Western banks in November 2001.)
- Finally, another helpful barometer comes from gauging employment trends such as "relocation services" for expatriates. According to Ernst & Young, "not since 1997 have we seen such a surge in European and global clients returning to the market . . . Client activity is up 50 percent on the same period last year, giving further credence to the general market revival sentiment."

III. THE ECONOMIC ENVIRONMENT: A PROMISING BACKDROP

The business community's optimism about the Russian market is supported by impressive trend-lines with respect to macroeconomic statistics. In fact, many of last year's macroeconomic forecasts had to be revised upward during the year as Russia's performance exceeded expectations. To put these accomplishments into per-

spective, however, we should bear in mind that Russia's per capita GDP is one-half of Hungary's and one-third of that found in the Czech Republic.

Russia posted growth rates of 5.4 percent in 1999 and 9 percent in 2000 (with even higher jumps in industrial productivity). In the midst of a global recession, the 2001 figure has been initially reported as 5 percent, with production in the five core sectors of the economy (agriculture, construction, industry, retail trade, and transportation) registering a 5.7 percent increase. This marks the first time that post-Soviet Russia has registered three consecutive expansions. According to Andrei Illarionov, President Putin's economic adviser, real incomes climbed by 6 percent in 2001, capping off a three-year run that constituted the country's strongest performance since the 1966–69 Soviet economy. Most analysts expect growth of up to 3.5 percent in 2002.

While Russia did not make its inflation target last year, (the 2001 budget projected a 12 percent annual rate), the final 2001 figure of 18.6 percent represented continued improvement over the three previous years, when it registered 20.2, 36.5 and 84.4 percent. Whereas barter represented more than half of all economic transactions in 1998, the Russian economy today is increasingly monetized, as that proportion has dropped to less than 20 percent.

Perhaps most important, Russia is running surpluses across the board. Russia enjoyed a budget surplus of more than \$7 billion in 2001 (more than 6 percent of GDP), from which it devoted \$5.5 billion to debt service and \$1.5 billion to increase cash reserves. Thanks to improved tax collection, primary surpluses have doubled in recent years, from 8 percent in 1997 to around 16 percent in 2001. Much of this improvement is attributable to successful collection from Gazprom, UES and 18 oil companies: these firms contribute more than 40 percent of taxes to the federal budget (and Gazprom is responsible for half of that amount). Russia's good fortune also includes a large current account surplus (\$34 billion), a \$50 billion trade surplus, and gold/currency reserves of \$37 billion, which have tripled since early 2000.

Thus Russia finds itself in a good position to manage its foreign debt burden, roughly two-thirds of which stems from Soviet-era obligations. Last June, Prime Minister Kasyanov announced that Russia will not seek to restructure its debt service in 2002 and 2003, when the country faces \$14 billion and \$16 billion in debt service, respectively. Having repaid last year more than \$17 billion in foreign debt—including \$2.8 billion ahead of schedule—Russia has lowered its outstanding debt from more than \$150 billion to \$133 billion. Finally, this spring Russia plans to issue \$2 billion in new bonds maturing in 2010 and 2030 to cover its \$6.6 billion in holdover foreign trade debt from the Soviet era, which has climbed from a nickel to 40 cents on the dollar recently.

Most analysts agree on three key points: Russia's 2002–03 debt load seems manageable; if needed, a several billion dollar cushion can be negotiated through an IMF loan and/or a Paris Club restructuring; and the key variable in the equation is the price of oil. Much of the forecasting is tied to oil prices hovering around \$18.5 per barrel. Each dollar increment below that target costs the federal coffers roughly \$700 million to \$1 billion, which means a return to deficit spending at \$14.5 per barrel. The assumptions are especially shaky and all bets are off if the average price falls into the "danger zone" of \$10–12 per barrel. The downward pressure on oil prices may provide an added impetus to speed up the pace of reforms. One could argue that prices zooming through the 20s contributed to a false sense of economic security and, if taken to the extreme, acted as a disincentive to bolster the reform process.

IV. OBSTACLES TO GROWTH AND RECENT POLICY PROGRESS

I've devoted time to discussing the optimistic approach American companies have toward the Russian market, but I want to make clear that this optimism is grounded in a realistic assessment of the obstacles that must be surmounted if free market activity is to truly flourish. Investors have a keen appreciation for the challenges that lie ahead and are, on balance, comfortable with their own calculations of risk vs. reward. What I would like to do next is briefly survey a few of the key commercial issues and outline recent policy progress to give you a sense of some these challenges and how the Russian government is responding to them.

Having accomplished his three major priorities in 2000—federal reform, customs reform and some pieces of the new Tax Code—President Putin laid out an ambitious set of priorities for 2001, beginning with a continuation of critical tax reforms, especially the Corporate Profits Tax. He signaled another affirmation of property rights by designating the draft Land Code a top priority, and in October 2001 he signed into law a Land Code codifying the rights of sale and disposal for nonagricultural

land, the collateral provisions of which will also spur the development of credit markets.

He also noted his intention to overhaul Russia's system of currency controls to bring it in line with world practice, based on a recognition that the current regime stifles legitimate business but does not stop \$20 billion in capital flight each year. Last summer, the Russian government reduced the mandatory currency conversion requirement for export proceeds from 75 to 50 percent. That step, coupled with other measures under discussion to ease restrictions on capital operations, signifies an important philosophical reorientation as to how to keep capital inside the country—by delivering on a policy agenda that improves the local investment climate.

At the same time, important new legislation sought to distinguish between capital flight and money laundering. The new law "Concerning the Counteraction of the Legitimization (Laundering) of the Proceeds of Crime" was signed by Putin on August 7, 2001. Among its features are the Article 6 controls established for transactions exceeding \$20,000, including cash transactions and those involving accounts in countries with no disclosure requirements or numbered accounts.

Russia's policy progress should be assessed in relative terms. For instance, we have seen virtually no progress on reforming and re-capitalizing Russia's banking sector, where minimum capitalization requirements and other measures have yet to be introduced, and there is still a great reluctance to allow foreign banks to help develop this sector. A vibrant, truly flourishing market cannot exist without a functioning commercial banking system engaged in typical banking activities such as lending. By contrast, Russia has taken several steps to strengthen investor protections, and an important signal was sent in June 2001 with the leadership change at Gazprom, where the government retains 38 percent ownership. These changes, and similar efforts to improve the tax environment and tackle corruption, are profiled below.

Investor Rights

Much work remains to be done in several areas that go to the core of investor confidence: capital dilution, transfer pricing/asset stripping, and the failure to comply with information disclosure requirements. The progress made to date and the measure of what remains to be done can be defined in terms of enforcement and amendments to existing law.

In the enforcement realm, the Putin team has strengthened the powers of the Federal Commission on the Securities Market (FCSM), though not enough in both civil and criminal terms. In 2000, the FCSM imposed fines on 1,400 companies for failure to disclose, a 10-fold increase over the previous year. This spring, Russia is expected to codify amendments to the Criminal Code related to nondisclosure, which will carry a punishment of up to three years in jail. Also on the docket is a new law on insider trading, designed to take effect in January 2003.

Of both symbolic importance and practical significance, in December 2001 the Russian government approved a draft Corporate Governance Code based on OECD guidelines, which the private sector has reviewed and commented on extensively. While compliance is voluntary, the Code raises the public pressure to incorporate suggestions that could have a far-reaching impact—for example, the guideline that independent directors represent at least 25 percent of a company's board.

Importantly, the working groups tasked with developing the Code were not just comprised of international investors and law and accounting firms. The process also included representatives of natural monopolies such as Gazprom and UES, and major listed companies such as YUKOS and Sibneft, which along with UES and Lenenergo, have also adopted their own corporate governance codes. Russian companies are increasingly cognizant of the link between transparency and capital attraction, and this is especially the case with resource firms. For example, Norilsk Nickel consolidated its metal exporting intermediary, and Sibneft recently acquired three foreign trading companies (effectively recapturing profits left offshore).

Beyond the approval of the Corporate Governance Code, the Russian government devoted considerable effort last year to five key sets of amendments to close exploited loopholes in existing laws pertaining to Joint-Stock Companies, the Protection of Investor Rights, Affiliated Parties, Insolvency (Bankruptcy), and the framework Law on the Securities Market.

For example, in August 2001, President Putin signed the law "On Amendments and Additions to the Federal Law on Joint Stock Companies" after a two-year legislative struggle. Though several loopholes remain, the new law is a significant step forward, and it pertains to all companies (as opposed to the previous threshold of 1,000 shareholders) as of January 2002. It provides for broader shareholder rights related to new share subscriptions (including a preemptive purchase right), and the new law reduces certain ambiguities pertaining to company charter changes, mak-

ing any revisions that infringe upon shareholder rights subject to approval by 75 percent of preferred shareholders.

Several private-sector initiatives are also raising the pressure to reform, with rating systems launched by Standard & Poor's and the Institute for Corporate Law and Corporate Governance, the latter of which has seen a behavioral shift as it now fields complaints from Russian firms at the bottom of its charts. And the Investor Protection Association is working across Russia to organize small shareholders to contest board elections, successfully placing independent directors on the boards of 38 major Russian companies in 2001.

But further improvements are still needed to safeguard the rights of investors in a more uniform, predictable way, as hardly a month goes by without an American company voicing a concern in this area. The investment dispute faced by Ohio-based Sawyer Research Products is among the more publicized cases involving the collusion of local officials in seizing a plant and its inventory. It quite clearly demonstrates the link between investor rights and judicial reform and the importance of Kremlin efforts to rid the judiciary of influence and corruption. So in this as in many areas of Russian commercial policy, actions speak louder than words.

Tax Reform

Of all the commercial policy issues brought to the fore during Russia's decade-long market transition, one has consistently topped the list of investor concerns: the dire need for reform of Russia's complex tax system. Russia's tax system has been cited time and again by companies as a major obstacle to foreign investment and to business activity more generally, impeding business plans, deterring new market participants and constraining Russia's considerable economic potential.

In addition to tax policy, companies face serious tax administration issues, many of which involve interpreting and implementing laws and regulations with consistency rather than targeting firms with solid track records of paying their levies on time. Companies highlight three primary concerns about administrative procedures: central control over inconsistent regional bodies; making VAT refunds available when due; and the need for a mechanism to resolve tax disputes (without full-blown litigation).

Russia made substantial efforts to rationalize its tax system in 2000 by adopting key components of Part II of the Tax Code, which came into force on January 1, 2001. The adoption and implementation of these chapters included what could be fairly characterized as a radical liberalization of the income tax, social funds and turnover tax regimes. To put the magnitude of these accomplishments into perspective, the four chapters covering the flat Income Tax (set at 13 percent), social taxes, excise taxes, and the Value Added Tax (VAT) represent 60 percent of the revenue side of Russia's ledger. Revenues from these four line items increased by 60 percent for the first half of 2001 on a year-on-year basis. As far as the 13 percent flat income tax is concerned, receipts increased 54 percent in 2001 (y-o-y) despite the abolition of higher brackets.

The Putin Administration made overhauling the Profits Tax its top tax-related priority for 2001, and President Putin signed it into law in August, to take effect on January 1, 2002. In addition to business-friendly provisions pertaining to thin capitalization rules and depreciation of fixed assets, the bill has produced two major accomplishments that will have a far-reaching impact on bottom-line performance: a considerable rate reduction from 35 to 24 percent and full deductibility of legitimate business expenses.

The Russian government expects this stimulus will increase revenue by 1.75 percent of GDP, and businesses will also feel the immediate impact of this changed environment in 2002. The direct correlation to investment growth is striking—Alfa Bank analysts calculate that over half (54 percent) of capital investment in Russia is funded by company profits, while bank financing accounts for only 3 percent.

According to Aton Capital in Moscow, with an Income Tax set at 13 percent and a Profits Tax of 24 percent, suddenly Russia has one of the lowest marginal tax rates in the world. The revenue benefit from increased compliance and overall economic activity could be precisely the boon the Russian government needs to help manage some \$30 billion of debt burden in 2002–03.

The Corruption Constraint

Though positive sentiment prevails in the marketplace, of course one should not exaggerate the cautious optimism or mask the real distortions that still exist, as not all the news from Russia is good. As former British Ambassador to Russia Andrew Wood puts it, "there is material for pessimists to work on as well . . . The Kremlin's dominance of the Duma and influence on the media, along with the emasculation of the Federation Council, represent a certain hollowing out of democracy. Corrup-

tion, including by manipulation of the judicial system, remains a major problem—and not just for foreigners.” Indeed, Russia ranks 79th out of 91 countries in a “Corruption Perception Index” established by Transparency International.

However, there are many recent indications that the Putin team has taken note of the dire situation with respect to corruption, with hints that isolated cases may actually be part of a coordinated campaign. Among the more noteworthy episodes is the forced resignation of Nikolai Aksyonenko, the Railways Minister removed and criminally investigated for misappropriation of government funds. The effort underway goes beyond his removal and the subsequent criminal investigation. For instance, the Russian government has instituted new rules governing the discounts that shippers can receive from rail regulators, which are typically correlated to the bribes paid. Second, the judicial reforms enacted on December 17, 2001 attempt to reduce courtroom bribes by providing a fivefold increase in judges’ salaries, and the adopted measures also prohibit the involvement of state prosecutors in commercial disputes. Finally, the opportunities for graft will presumably dwindle as yet another new law reduces the number of business activities that require a license from 2,000 to just 100.

The Russian brokerage Troika Dialog has calculated that, together with corporate governance violations, this graft siphons off about \$45 billion in book value from the Russian stock market, and PricewaterhouseCoopers estimates that a successful cleanup campaign could attract another \$10 billion a year in FDI (twice the current level).

Even in the murkiest of cases, the market has a way of making the linkage obvious—since Putin dismissed Rem Vyakhirev as Gazprom CEO last May, the natural gas giant’s shares have risen 44 percent. In December 2001, new CEO Alexei Miller persuaded the Gazprom board to repurchase a 32 percent stake in its Purgaz subsidiary, which had been “sold” in 1999 to Itera, the Florida-based firm at the center of Gazprom asset-stripping controversies under Vyakhirev. Early in 2002, the Putin team has picked up where it left off last year, as a top director of Gazprom and the head of its Sibur subsidiary were recently detained by Russian prosecutors for alleged asset stripping amounting to \$85 million.

In Russia, there is always a next “test case” for investors to watch. On deck is the partial privatization of Russia’s second-largest bank, Vneshtorgbank, which both the government and the Central Bank want to manage. The EBRD is said to be interested in a 20 percent stake, and with \$4.5 billion in assets, a foreign bank might be a likely suitor—if permitted. The market access dimension will perhaps make this a dual litmus test just as the Working Party negotiations over Russia’s WTO accession heat up in 2002.

V. WTO ACCESSION AS A POLICY FRAMEWORK

For much of Russia’s decade of transition, observers have asked a central calibrating question: does Russia want foreign investment? There is ample evidence to suggest that the answer is affirmative, but in some instances it may be a qualified “yes, but . . .” This presents us with a series of contradictions that Russia has to struggle with if serious about its WTO aspirations. As the country grapples with what WTO means for certain industries, there remain strong protectionist currents with which to contend. For example, competition lags in banking, insurance and other financial services.

The business community is supportive of Russia’s aspirations because much is at stake in terms of market access and uniform acceptance of agreed rules of the game.

Background and Status

Russia first applied to join the GATT in 1993 and its successor, the WTO, in 1995. Although Russia’s official WTO accession process began in 1995, not much substantial progress was made during the 1990s. Since 1995, there have been 13 formal meetings of the WTO Working Party on Russia held in Geneva. Prior to the arrival of the Putin Administration, no official Working Party meetings were held between December 1998 and May 2000. Since that time, there have been four official Working Party meetings (the most recent occurring on January 23–24, 2002, with another meeting scheduled for April) and several unofficial meetings.

In addition to the increase in Working Party meetings, the U.S. business community is seeing a new momentum within the Putin Administration, which represents an internal recognition of the need for and benefits of WTO accession (as compared to external pressure from the international community). We are not only seeing WTO accession as a mandate from Putin himself and the Executive Branch, but the Duma has created an Experts Council on Foreign Trade and Investment, whose main task is to review current legislation in terms of its WTO compliance and rec-

ommend required changes. The Duma is currently considering amendments to 55 Russian laws related to WTO norms.

While the Putin Administration has designated WTO accession a priority for Russia, there are, however, only limited pockets of officials within the Russian government who are working on accession and who have an understanding of the need for and benefits of WTO membership. These include the Ministry of Economic Development & Trade (the lead agency tasked with negotiations), some Duma committees, and a loose smattering of staff in several executive branch agencies. Because a clear mechanism for incorporating input from the Russian private sector into the accession process has yet to be established, a private-sector initiative to address this need is being developed under the auspices of the Russian-American Business Dialogue.

Multilateral and Bilateral Negotiations

Russia has completed the information-gathering phase of the accession process, and is now focused on legislative compliance and reform in areas such as agriculture and financial services, among others. Russia attended the WTO Ministerial in Qatar in November 2001 with observer status. Until it becomes a WTO member, Russia will not be able to participate in the new round of trade negotiations.

Russia enjoys widespread support for its accession to the WTO, most notably from the U.S. and the European Union. At the end of 2001, U.S. Trade Representative Zoellick, Russian Minister of Economic Development and Trade Gref and European Union Trade Commissioner Pascal Lamy expressed their support for preparation of a draft Working Party Report on Russia during the first quarter of 2002. (This report would spell out Russia's rights and obligations as a WTO member.) Soon afterward, following the January 2002 Working Party Meeting on Russia, the decision was made to begin drafting the Working Party Report. While it is expected that the draft will be circulated to the membership by the end of March, no official time-frame has been estimated for the completion of this report.

Bilaterally, much progress has been made. Several bilateral meetings took place in 2001, including a meeting of the U.S.-Russia Bilateral Working Group on Intellectual Property Rights held last spring in Washington. Ambassador Zoellick and Minister Gref exchanged bilateral work plans in August 2001, which was followed by Zoellick's trip to Moscow in late September. Minister Gref and Ambassador Zoellick also met in Paris in December 2001 to discuss WTO accession and other aspects of the bilateral economic relationship. In early 2002, following the January Working Party meeting in Geneva, the U.S. and Russia held a bilateral meeting to address agriculture, market access and non-tariff barriers. Several other bilateral meetings are expected throughout the year.

Priority Areas

Outlined below are several priority areas that need to be addressed in order to facilitate Russia's accession to the WTO.

Telecommunications: The creation of an investor-friendly infrastructure and legislative environment (e.g., reducing existing tariff and non-tariff barriers that limit foreign participation in this sector) is critical to the development of the telecommunications sector in Russia. Russia presented a new goods and services offer in March 2001, which included its agreement to accept a WTO accord that commits to binding, pro-competition regulatory disciplines. The new offer also included an initial offer of 25 percent foreign equity in the mobile telephone sector. This goods and services offer continues to be revised based on continual bilateral and multilateral negotiations.

Financial Services: The strengthening of Russia's financial services sector is crucial to the country's economic development. Some important steps include a reduction in the number of state-owned banks; increased liberalization to allow mergers and acquisitions; greater access for foreign banks; openness to international participation in the Russian insurance industry (which remains poorly developed and whose members have promoted exclusionary legislation to date); development of a legislative framework governing the leasing industry; and improvement in access to capital and credit relationships. Another important issue is Russia's adoption of International Accounting Standards (IAS).

Intellectual Property Rights: Protection of intellectual property rights is a key factor influencing Russia's WTO accession and its ability to attract foreign investment. IPR violations—including trademark and patent infringement, counterfeiting, copyright violations, and piracy—remain epidemic. Incomplete anti-counterfeit legislation, lack of enforcement, weak penalties, corruption, and lack of education and training of law enforcement and judicial officials in this area are key impediments to better IPR protection and enforcement in Russia. Specifically, significant shortcomings remain in the country's trademark and patent laws, especially provisions

dealing with famous trademarks and geographical indications, as well as confiscation and destruction of counterfeit goods.

The WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) covers seven types of IPR: patents, copyright, trademarks, geographical indications, industrial designs, layout-designs of integrated circuits, and undisclosed information. Each WTO member is obligated to implement the TRIPS agreement through their respective domestic legislation, to incorporate the rights and obligations of an IPR-holder and the manner in which these will be enforced.

Legislative progress is being made in Russia. The government submitted a legislative package to the State Duma in July 2001. The package includes amendments to the Law on Trademarks, Service Marks and Appellations of Origin of Goods; Patent Law; Copyright Law; and the Law on Legal Protection of Computer Programs and Databases; among others. The amendments to the Trademark Law and the Patent Law have passed the first reading in the Duma, but the amendments to the Copyright Law have not. In most respects, the proposed amendments will bring Russia's legislation into TRIPS compliance.

Bilaterally, the U.S. government has not hesitated to criticize the Russian government on its failure to protect intellectual property rights: in May 2001, the USTR placed Russia on the Special 301 Priority Watch List. The USTR also began a review last year of Russia's eligibility under the Generalized System of Preferences (GSP) program, based on issues raised by the U.S. copyright industry concerning Russia's intellectual property regime. (The GSP program is currently expired; however, pending its reauthorization, the review of Russia's GSP eligibility would continue.)

Agriculture: Russia's domestic support for its agricultural sector is a major impediment to accession. It is important to recognize that the WTO does not prohibit domestic support (a popular misperception in Russia); rather, it limits certain types of support (for example, export subsidies). In WTO terminology, subsidies in general are identified by "boxes" that are given the colors of traffic lights: green (permitted), amber (slow down or reduce), and red (forbidden). The WTO Agriculture Agreement has no red box; therefore WTO members with trade-distorting domestic supports in the amber box must make commitments to reduce these measures.

Over the past 10 years, Russia's subsidies have primarily been amber-box measures. The government's main task in current WTO agricultural negotiations is to reduce these measures and focus on green-box measures. Examples of green-box measures include programs that are not directed at particular products such as environmental protection, rural infrastructure and regional development programs.

In terms of annual support levels, Russia has offered a \$16 billion ceiling on its subsidies, and this issue continues to be negotiated (WTO members prefer a figure closer to \$2–3 billion). Due to the sensitive role agriculture continues to play in the economy, Russian government officials consider agriculture one of the most politically sensitive issues of its accession.

Civil Aircraft: Russia maintains high tariffs on imported aircraft. The Russian government has confirmed that it will eventually become a signatory to the Agreement on Trade in Civil Aircraft, which, together with other WTO agreements, establishes the basic international rules governing trade in the aircraft sector.

In the interim, before Russia fully accepts these international trade obligations, a 1996 bilateral MOU on "Market Access for Civil Aircraft" commits Russia to take trade-liberalizing steps such as tariff reductions and tariff waivers. (The MOU has no expiration date.) These steps are designed to enable Russian airlines to import American and other non-Russian civil aircraft on a nondiscriminatory basis. Since the MOU was signed, Russian tariffs on foreign aircraft have been reduced from 50 to 25 percent.

While the MOU does not specifically provide for tariff waivers on imports of aircraft, it states that Russia will facilitate the participation of American and other non-Russian aircraft components manufacturers in Russia's aerospace market. Although Russian aircraft makers have applied to the Russian government for tariff waivers on imports of aircraft parts, none has been granted thus far. However, in August 2001, the Russian government took market-opening steps by repealing a July 1998 resolution on "Additional Measures for State Support of Russian Civil Aviation," which had established certain conditions for obtaining tariff waivers (or tariff reductions) on the importation of aircraft, engines and flight simulators.

Private-Sector Initiatives

The WTO negotiation process can serve as a positive framework for engaging both the U.S. and Russian governments on many of the issues of great importance to the private sector. The Russian-American Business Dialogue (RABD) is playing a key role in this process. In December 2001, the RABD issued an Interim Report to U.S.

Commerce Secretary Evans and Minister of Economic Development and Trade Gref, outlining six issue areas the private sector plans to address in its initial work plan.

The RABD plans to hold a series of WTO seminars addressing specific industry sectors and the potential impact WTO accession will have on each. These seminars will create a forum for discussion among Russian executive branch officials, legislative branch officials, international experts and representatives of the private sector. The initial seminar, scheduled for March 27 in Moscow, will focus on financial services, one of the most important sectors for Russia.

Finally, as part of the accession process, the U.S. and Russia will negotiate a series of bilateral agreements that will advance our commercial interests and provide important opportunities to pursue RABD goals through public-private partnerships. Similarly, the Dialogue will interface with USTR and the U.S. government's inter-agency process to channel regular input from the business community on issues ranging from market access to intellectual property rights, customs, financial services, and the development of e-commerce, among others.

VI. PUBLIC-PRIVATE PARTNERSHIP AND BILATERAL RELATIONS

After its first year in office, we have been impressed by the Bush Administration's commitment to ensuring that our economic and commercial relationship with Russia receives the attention it deserves. For example, Commerce Secretary Don Evans led a trade mission to Moscow with 14 U.S. companies last fall. Another indication that the U.S. Government is supportive of Russia's efforts to create a more investor-friendly environment is the creation last summer of a Russian-American Business Dialogue.

The Russian-American Business Dialogue (RABD) is a private-sector effort designed to strengthen the economic and commercial relationship between the United States and Russia and complement the ongoing official engagement between the two governments. This business-to-business mechanism was announced by Presidents Bush and Putin during their July summit meeting in Genoa.

Through the RABD, the business community is playing a leadership role in setting the commercial policy agenda and formulating policy recommendations that will strengthen the trade and investment ties between the two countries. The U.S. and Russian governments have agreed to maintain regular consultations regarding the policy priorities emanating from this private-sector initiative, and the RABD held three Cabinet-level exchanges prior to the December delivery of the Dialogue's Interim Status Report, which covered a half-dozen initial priorities:

- I. Administrative Obstacles
- II. Market Access
- III. Investment Policies
- IV. High-Tech Support
- V. Growth of Small and Medium-Size Enterprises (SMEs)
- VI. Judicial Reform

As Russian Prime Minister Mikhail Kasyanov noted in a speech to USRBC members last month, "The Russian-American Business Dialogue, which was launched half a year ago, is becoming one of the mainstays for the entire system of our bilateral economic cooperation."

The Jackson-Vanik Amendment: A Call to Action

One of the top priorities identified by the RABD—indeed one of the highlights of our "transition paper" submitted to the Bush Administration in early 2001—is the unmistakable importance the business community attaches to terminating the application of the Jackson-Vanik amendment to Russia. I recognize that this is not the committee of jurisdiction; nevertheless, perhaps the most important thing I can do today is to express our strong support for filing away this anachronism in the Cold War archives where it belongs.

The changing nature of our relationship with Russia has been startling. As this evolution unfolds, it is important that the trade and investment aspect of our relationship keep pace with the times—removing Russia from annual Jackson-Vanik consideration is an important part of this evolution. Jews in Russia today are free to emigrate, and Russia is no longer a controlled economy. Terminating the amendment's application to Russia would help foster a sense of normal trade relations between the U.S. and Russia and demonstrate to countries that continue to restrict emigration that such a step is possible with the right reforms.

Furthermore, we believe that Jackson-Vanik and Russia's WTO accession are two separate issues and should be treated as such. At no time since Russia applied for WTO membership has any U.S. official linked Jackson-Vanik to Russia's WTO accession. Such an action would be perceived as moving the goalpost on WTO acces-

sion and would treat Russia differently from other countries in the accession process.

The United States has an excellent track record in setting the highest bar for new entrants to the WTO. We are confident that the USTR will continue to seek strong commitments from Russia pertaining to the adoption of WTO rules governing its trade regime, the provision of market access in goods and services, the establishment of limits on agricultural supports, and the enforcement of the rule of law in commerce. The United States has the leverage it needs to address trade concerns with Russia, as obviously Russia cannot accede to the WTO without U.S. consent. While there remains much to be done, we are confident that the U.S. government will remain engaged on Russia's accession process and, likewise, Russia will continue to make great progress.

CLOSING REMARKS

To conclude, I wish to emphasize the Council's belief that our partnership on the trade and investment side has been going well, and working on WTO accession and promoting new private-sector linkages through the RABD are ways in which we will help our partnership reach its potential. And in terms of what the U.S. government can do, granting Russia market economy status in our Cold War-era trade laws is near the top of the list. The application to do so is currently under review at the U.S. Department of Commerce, and the U.S.-Russia Business Council has submitted its commentary in support of Russia's application.

To be sure, remaining tax, corporate governance and other structural reforms lend a cautionary note to the prevailing optimism in the business community. But the recent track record may help Russia finally close the chapter on its post-crisis recovery and begin a new chapter featuring truly sustainable, diversified economic growth.

On behalf of the Council's 260 member companies, thank you very much, Mr. Chairman, for allowing me to share the business community's viewpoints at this important time in our relationship with Russia.

Mr. GALLEGLY. Thank you very much for your testimony, all three of you. I know that it has been enlightening.

We have a dilemma here. As you heard, the bells have gone off for a vote, and I had made a commitment that our hearing would be wrapped up by 3:00, so what I would like to do is, first of all, defer to Mr. Hilliard to see if he has a question or two or Ms. Lee. And, then I have one quick question, and then we will go do our voting.

Mr. HILLIARD. I have no questions. Thank you.

Mr. GALLEGLY. Thank you, Mr. Hilliard.

Ms. Lee?

Ms. LEE. I will be very brief, Mr. Chairman.

Let me just first say thank you very much for your very thorough testimony, and let me just say that I visited Russia really for the first time last year and only spent a couple of days so it was just a very brief kind of introduction to Russia, but a couple of things I noticed. One had to do with the economic vitality that I saw, and I think, Mr. Marshall, you kind of spoke to some of the trends now in terms of the economy.

The first question I have is just in terms of the average income of a Russian citizen. Do you know or have an idea of what that is? I ask you this because I remember one thing that stood out as a result of that visit was the high end designer shops around the Kremlin and the fact that there were many people shopping in the very expensive stores. I said, you know, this is a very interesting economic phenomenon that I had not been aware of.

Where do they get their money from at this point to be able to afford those kinds of, you know, consumer items?

Mr. MARSHALL. Thank you for your very good question. I will make a couple brief remarks in response.

The average monthly wage in Russia these days is about \$122 a month. That average wage on an annual basis varies dramatically, as you might imagine, across the Russian Federation. It is much higher in the City of Moscow and in St. Petersburg than it is in the outlying regions.

The other point I would make about sort of employment trends and wage rates is that among the accomplishments the Putin Administration has recently put in place, one that I did not discuss in my remarks, is a very forward looking, progressive labor code that they have put in place to guarantee the rights of workers in the post Soviet legacy.

There is a great deal of back and forth with the Russian Parliament about these issues, and they have done a commendable job last year in codifying those results.

Ms. LEE. Mr. Chairman, may I ask one more question, please?

Mr. GALLEGLY. Without objection.

Ms. LEE. The other question I wanted to ask was in terms of the HIV and AIDS rate in Russia. We are hearing about alarming rates now, and I am wondering if any of you have had a chance to look at the readiness of the Russian health care system in dealing with this potential catastrophe and what you think we should do?

Ms. WALLANDER. One of the issues I was looking at when I was in Moscow a couple weeks ago was the HIV/AIDS issue. You are right. Russia has the greatest rate of growth in HIV infection in the world. At this point, it is not clear exactly what the numbers are, and there are several studies trying to get a sense of what the numbers are precisely, but the trends are clearly very dangerous. Russia and Ukraine are both heading in that direction.

Unfortunately, one of the Soviet legacies is our problem with addressing that issue. There are problems about sex education, responsiveness to the needs of taking protective measures to protect oneself against these kinds of infectious diseases and also concerns within the Russian economic and political elite about allowing competitive pharmaceutical companies to deal with this, so they are being managed by the World Bank and by the Soros Foundation. People are trying to work on these issues.

The problem we have is that people are aware of the problem and they know what needs to be done, but it is a race because the increase in the infection rates is getting to the point where you could see a crisis in the next couple of years. And, we need some sustained attention coming out of Washington as well to get focus on the issue.

Ms. LEE. Thank you. Thank you very much, Mr. Chairman.

Mr. GALLEGLY. Dr. McFaul, I have a question, and I do not know if you can really answer it as quickly as we need under the circumstances, but let us give it a shot.

In a recent edition of *Current History*, Steven Holmes writes about power in Russia under Putin. He suggests two possibilities.

“Putin is a liberal in authoritarian clothing seeking a practical reform agenda by reestablishing political stability and legal certainty under a temporary consolidation of power, and, two,

Putin is an authoritarian in liberal clothing, a KGB strongman who has merely rented a few liberal advisors who is overly reliant on secrecy and super sensitive to criticism.”

How should we in the U.S. assess Putin at this point in his Presidency?

Mr. McFAUL. You are right. That is a big question for a few minutes, but I am glad you raised it because I think it is a fundamental question. Let me just give you some counter factuals, if you will.

If Putin is an authoritarian disguised as a liberal now, then our worst nightmare, in my opinion, is a raging economy growing at five or 6 percent per annum with a dictator who is anti-American in the Kremlin. I think the notion that economic growth always promotes democracy is just empirically incorrect. Much of my academic work looks at that.

Especially in a post Communist world, one of the things that is very striking about the last decade, that we did not as social scientists predict a decade ago, was the positive correlation between democracy and economic growth. That is, the fastest democratizers are also those doing the best in economic reform.

The Soviet experience to me is a great example of what you get with authoritarianism. You know, we have already done that. Why repeat it again? Therefore, you know, I have lots of friends in the business community. I had a 3-hour argument with Andre Illarionov—he is an economic advisor—just on Friday about this very issue. He said, you know, this is just pie in the sky. We know your bleeding heart democracy stuff, but, you know, Russia needs a strong hand now, and Putin is the guy to do it. Then we will be sorry about this stuff later.

I think that is a fundamentally flawed model. Imagine doing business in this country without Bloomberg. Imagine doing business if you are a businessman, doing business with this institution if there was only one party. Can you imagine how good that would be, you know, if you knew that every year there was going to be the same party guy sitting in that chair? That would be a disaster for business, I think, in this country, and I think it is the same in Russia.

Having said that, we need to be concerned. You asked a more specific question, though, about Putin himself. I think Putin has both of those impulses in him at the same time. I know that is a bad answer, right, but I think one can have that. My own son says I have it—democratic proclivities and authoritarian proclivities—depending on how he is behaving, right?

I think Putin, on the one hand, has two decades of experience in the KGB. He distrusts people that oppose him. He is suspicious of controls on his power, and at the same time, this guy served 5 years working for Anotoli Sobchak in St. Petersburg, which is an uncharacteristic thing to do as a KGB person.

I think he is trying to find his way. Therefore, if I knew he was a dictator then I would say, you know, let us not deal with him. If I knew he was a democrat, I would say let us sit back, and I will worry. Because I think he is in between, I think it is at a moment now where we as a country can help to push him along the

right path. Therefore, I would urge you, whenever you can, to do that in ways that you can.

Mr. GALLEGLY. Successes might influence him?

Mr. MCFAUL. Yes.

Mr. GALLEGLY. I thank the panel very much, and I apologize for the timing with the vote and so on. Unfortunately, there are higher authorities around here than me. I could see this dialogue going on all afternoon into the evening. Perhaps we will have another time.

I thank you very much. The Subcommittee will stand adjourned. [Whereupon, at 2:53 p.m. the Subcommittee was adjourned.]

