

# U.S. POLICY TOWARD RUSSIA

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## HEARING

BEFORE THE

### COMMITTEE ON FOREIGN RELATIONS UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

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JUNE 21, 2005  
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## CONTENTS

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	Page
Biden, Hon. Joseph R., Jr., U.S. Senator from Delaware, opening statement ...	29
Cloherty, Patricia, chairman and CEO, The U.S.-Russia Investment Fund and chairman and CEO, Delta Private Equity Partners, New York and Moscow .....	3
Prepared statement .....	6
Lugar, Hon. Richard G. Lugar, U.S. Senator from Indiana, opening state- ment .....	1
Verrastro, Frank A., senior fellow and director, Energy Program, Center for Strategic and International Studies, Washington, DC .....	13
Wallander, Celeste A., director, Russia and Eurasia Program and trustee fellow, Center for Strategic and International Studies, Washington, DC .....	15
Prepared statement .....	19
ADDITIONAL STATEMENT SUBMITTED FOR THE RECORD	
Ebel, Robert E., chairman, Energy Program, Center for Strategic and Inter- national Studies, Washington, DC .....	47



## **U.S. POLICY TOWARD RUSSIA**

**TUESDAY, JUNE 21, 2005**

U.S. SENATE,  
COMMITTEE ON FOREIGN RELATIONS,  
*Washington, DC.*

The committee met, pursuant to notice, at 9:32 a.m., in room SD-419, Dirksen Senate Office Building, Hon. Richard G. Lugar, chairman of the committee, presiding.

Present: Senators Lugar, Murkowski, Biden, and Obama.

### **OPENING STATEMENT OF HON. RICHARD G. LUGAR, U.S. SENATOR FROM INDIANA**

The CHAIRMAN. This hearing of the Senate Foreign Relations Committee is called to order.

In February of this year, the Senate Foreign Relations Committee held a hearing on the status of democracy in Russia. Today, the committee continues its examination of United States policy toward Russia by inviting the testimony of three distinguished experts: Ms. Patricia Cloherty, Chairman and CEO of The U.S.-Russia Investment Fund, in New York, also CEO of Delta Private Equity Partners; Dr. Celeste Wallander, Director of the Russia and Eurasia Program at the Center for Strategic and International Studies; and Mr. Frank A. Verrastro, Director and Senior Fellow of the Energy Program, also at the Center for Strategic and International Studies.

As I noted in our hearing 4 months ago, President Putin's increasingly authoritarian style, his control of the media, his retribution against political opponents have left the fate of democracy in Russia more ambiguous than at any time since the collapse of the Communist system. This has complicated the United States-Russian relationship and called into doubt some of the basic tenets of engagement pursued by both the Clinton and Bush administrations. Responding to these troubling developments by attempting to isolate Russia, however, is likely to be self-defeating and harmful to American interests. Consequently, the Bush administration has pursued a policy of forceful engagement.

At his February meeting with President Putin, in Bratislava, Slovakia, where the main agenda items were weapons proliferation and terrorism, President Bush was rightfully critical of Russia's backsliding on democracy, human rights, and the rule of law. The dilemma for American policymakers is how to strengthen Russia's respect for democracy while simultaneously advancing cooperation with Russia on issues that are vital to American security and prosperity.

Clearly, we must continue to work with Moscow on securing and destroying Russia's nuclear, chemical, and biological weapons. Beyond cooperative threat reduction, we have a mutual interest in joint action on many other security fronts, including nonproliferation efforts outside of Russia, the fight against terrorism, and law enforcement measures against international organized crime.

We also have a strong interest in cooperation on energy issues. Russia is the world's largest exporter of natural gas, and the second-largest oil exporter. While America's long-term energy security lies in domestically sourced renewable fuels, in the medium term we must pursue energy opportunities outside the Middle East. Today, only 4 percent of Russia's oil exports come to the United States. We need to improve our understanding of the obstacles to increasing that figure and determine whether it is in our interest to pursue additional energy imports from Russia.

Economic investment is an area that shows promise, as well as peril. Russia's economy, thanks to the boom in energy prices, has grown about 7 percent in each of the past 2 years. Behind this overall growth rate are pockets of prosperity and investment opportunities, such as retailing, but also sectors that suffer from corruption and too much government control. American investors have been cautious, given the government confiscation of some businesses and the harsh treatment afforded some of Russia's own businessmen. Our commercial relations are also encumbered by the continuing problem of copyright piracy in Russia.

We also should be working with the Russians to place prevention and treatment of HIV/AIDS higher on their national agenda. Many health experts consider Russia to be part of a second wave of countries—including India, China, Nigeria, and Ethiopia—that are on the verge of suffering an HIV/AIDS epidemic. Experts estimate that 700,000 to 1 million persons living in Russia have HIV/AIDS. There are indications that the disease is beginning to spread beyond sex workers and drug users to the general population, especially young people. A comprehensive response should be implemented now in order to stave off an HIV/AIDS crisis in Russia that could have grave human and political consequences.

Our panel today is particularly well suited to help the committee sort through the policy implications of these complex issues, and we look forward to their insights.

At the time that the ranking minority member, Senator Biden, appears, I will call upon him for an opening statement, which he may have, but, for the moment, we would like to proceed with the testimony of our distinguished witnesses.

Let me mention at the outset that your statements will be placed in the record in full, so you need not ask permission for that. You may proceed to either give the statements or to summarize. Please proceed in any way that you want to present the material. We will be here to hear you, so do not be too economical in your use of time, although we look forward to questions, following the presentations. And I would like for you to give the testimony in the order in which you are seated. That would be Ms. Cloherty first, then Mr. Verrastro, and then Dr. Wallander.

Ms. Cloherty, I'm delighted to see you here today. We appreciate your leadership, in so many ways, and we look forward to your testimony.

**STATEMENT OF PATRICIA CLOHERTY, CHAIRMAN AND CEO,  
THE U.S.-RUSSIA INVESTMENT FUND, AND CHAIRMAN AND  
CEO, DELTA PRIVATE EQUITY PARTNERS, NEW YORK AND  
MOSCOW**

Ms. CLOHERTY. Thank you, Mr. Chairman.

I am delighted to be here to talk about The U.S.-Russia Investment Fund, which has been known as TUSRIF since its inception in 1995. It is now managed by Delta Private Equity Partners, which is a private management company, which I own and run in Moscow. I am there permanently, and run the company from there.

I do believe I will be addressing one of the pockets of prosperity and investment opportunity to which you referred. I am not an oil person, we are not oil people, but we do work with entrepreneurs.

May I also compliment your staff, particularly Ken Myers and Ken Myers III, for their assistance and advice over the past 10 years. And I would like to compliment you, also, Senator Lugar, for your video keynote address that TUSRIF showed at our 10th anniversary celebration in Moscow in September. The Russian audience was deeply moved. They appreciated your words of encouragement to them as they go about the difficult task of rebuilding their economy, their society, and their polity.

The CHAIRMAN. Thank you.

Ms. CLOHERTY. It was very, very important.

Like our elder enterprise-fund sibling in Poland, TUSRIF's mission was, and is, to assist the new Russian Federation in its transition from a centrally planned economy to a market economy—not by giving away grants, but by making investments in entrepreneurial companies. We started with a board of directors of men and women, including myself, who served pro bono, men and women who have made money during their careers, thanks to the opportunities afforded them in the U.S. economy. Now all of us want, quite simply, to give back to their country by assisting Russia in a way that the U.S. Government, USG, simply cannot.

Now, about us. TUSRIF was formed in 1995 with USG as its sole financial sponsor, but under private management. The mission was to promote the development of a free market economy in Russia by providing investment capital, equity, and debt to emerging potentially high-growth entrepreneurial companies. This was to be combined with technical assistance to management teams seeking to grow productive, transparent, and valuable companies. Once such a program was established and working well—I refer to that as at the moment when the market began to talk back—TUSRIF's Board of Directors was to form a privately financed successor fund to continue the investment program. And, finally, the board was to propose to USG a plan for future use of the capital reflows from TUSRIF's successful investments that would seek to further accelerate entrepreneurship and economic growth in Russia. In other words, if we got the job done right, we would be able to reflow back to USG every penny it put to work, and hopefully more.

TUSRIF, now, has invested about \$300 million in 44 Russian companies, the most recent six investments of which were made together with Delta Russia Fund, which is the private successor fund, with 120 in committed capital, on which we closed in May, just ended.

I am pleased to report that, in the 11 years since inception, the \$300-plus million the government has put to work has been re-earned, and then some. And I would say, additionally, that the private fund, successor fund, in its 1 year of life, has shown an audited 407-percent internal rate of return. So, we're doing great.

2004 was a watershed year. In that year TUSRIF accomplished its mission. It ended its investment cycle and moved into the cycle of realizing returns on sales of its investment positions. We also formed the private successor fund, so we are well on our way to embedding the practice of risk-capital intermediation into the Russian economy. We have formed a legacy committee of the board, and we are planning for what we can do under a philanthropic umbrella, moving forward, in Russia.

The chart on my right, which is gigantic, shows our organization. Delta Private Equity Partners, in the middle, is a management company. TUSRIF is up on the left. Legacy Committee is the "leave behind" in Russia, commencing in 2007, as shown here. Delta Russia Fund, which we are investing currently, is there. And now I'm starting to raise the next one, because you can't stand still.

Now, what have we done? We have backed companies. We have launched industries. We have introduced the art of equity investing. And, through exits, we have brought high-quality international investors into the Russian market.

Example. DeltaBank is a commercial bank we founded in 2000. It pioneered in credit cards, which, while common in the West, are virtually unknown in Russia. In 2004, we sold our interest in DeltaBank to GE Consumer Finance, the global financial unit of the General Electric Company, for 4.3 times book value, the third-highest multiple on sale of a financial institution in the world last year. We were pleased to bring in such a high-quality company. We believe that, because TUSRIF has focused obsessively on the issue of transparency in its lifetime, that we get a transparency premium on resale of our investments that offsets the Russian discount.

Second example. We formed DeltaCredit, pioneer in residential mortgages, Russia's first mortgage bank, in 2001. It is the leader in its field, with 50 percent market share. But to put that in perspective from an opportunity standpoint, there are only, in toto, about 10,000 mortgages out in Russia, in a nation of 145 million people; and 10-million-plus in Moscow, alone.

We have been active in media investments. We own two television networks, and we own the largest cable operator in the city of St. Petersburg, with 1½ million subscribers.

Last year, we sold one of the networks to Fidelity Europe, at four times our cost, in a very highly successful transaction.

People are behind all of this. We support entrepreneurs individually, and we support entrepreneurship broadly. Example. Andrey Korkunov is the former rocket scientist who has become the chocolate king of Russia. We have visited his manufacturing plant. We have seen his state-of-the-art quality-control processes, met his em-



ployees, and, of course, eaten his products. In fact, I can't keep my staff from visiting that particular company. When he accepted his Entrepreneur of the Year award last year in Russia, Andrey said he wanted to, quote, "make life sweeter," end of quote, for his country. He is doing that by creating jobs and generating wealth for his employees and for his community.

Second example, Olga Sloutsker. She was told she could never succeed, but she did anyway. She built a remarkable company, a chain of health and fitness centers that grew to employ hundreds of people, and reshaped Russia's approach to health and fitness.

On broad support of entrepreneurship in 2001, we formed the U.S.-Russia Center for Entrepreneurship. It has become the leading entrepreneurial support organization in Russia today. Through it, we launched the Entrepreneur of the Year Award Program. We are currently mounting an Entrepreneurial Invention Contest among secondary-school students, and Junior Achievement in the city of Nizhny Novgorod. The center provides a novel combination of education, training policy analysis, and is driving the development of a culture of entrepreneurship that never existed in Russia.

The—back to people—there has been a reverse diaspora of talented Russians who have been educated and have worked in other geographies, in the United States, Europe, and Japan. They are coming, in increasing numbers, to take advantage of economic opportunity in Russia and bringing with them finely honed skills.

This has been a great benefit to me, with our TUSRIF staff. And I will give you an example. One of my partners, Kirill Dmitriev, from Ukraine, was honors graduate of Stanford University, Baker Scholar at Harvard. He worked for Goldman Sachs, in investment banking, and for McKinsey & Company in Los Angeles, Moscow, and Prague. He has been with us for 4 years, and he is a valued partner. At the age of 30, he is comfortable in two cultures and two languages, as well as the language of finance, and he is poised to be an international leader in private equity.

I will wrap up here by mentioning the fact that, of course, there are negatives in Russia. The business in which we are seeks higher than average returns on invested capital, and that, frankly, is never found without risk. If it were a perfect world, our returns would look like the ones that I'm getting in the United States.

So, in our view, Mr. Putin has a job no one should want. He faces an extraordinarily challenging set of circumstances, and—to transform a society that has been noncapitalistic and nondemocratic for 70 years. He faces the primary issue of confidence, confidence of the Russian people in their growing institutions. Russians, in general, have a well-grounded and abiding fear that all will be stolen. Yukos was a prime example where bribing people on an unprecedented scale, including those in the West, was about to work. The Russian population overwhelmingly supported efforts to put a stop to it.

The weakness of the banking system is serious, is being addressed, though slowly. The court system is chaotic, but improving. It is notable that the arbitration courts' figures last year showed that 73 percent of the tax challenges to companies were, indeed, won by those companies.

So, progress is being made in Russia. The magnitude of challenge the Russian citizens face is hard for most Americans to understand, for the Russian people must write whole new scripts for themselves. Every person with whom we work either used to be something else—a mathematician, a biochemist, and now they're selling apparel, or whatever—or they expected to be something else. It is a question of utter realignment of an entire society's incentives.

At TUSRIF we have sought, over the years working with these Russians, to write entrepreneurship into their individual and to their national scripts as a key driver of economic democracy and growth. It is my view that, with continued support, it will work. Thank you.

[The prepared statement of Ms. Cloherty follows:]

PREPARED STATEMENT OF PATRICIA M. CLOHERTY, CHAIRMAN AND CEO, THE U.S.-RUSSIA INVESTMENT FUND, AND CHAIRMAN AND CEO, DELTA PRIVATE EQUITY PARTNERS, NEW YORK AND MOSCOW

Chairman Lugar, Senator Biden, and members of this committee, I appreciate the opportunity to testify today regarding The U.S. Russia Investment Fund, known as "TUSRIF" since its inception in 1995, though it is now managed by Delta Private Equity Partners, a private management company. Many observers believe that TUSRIF may be the most successful foreign assistance program in Russia since the Soviet Union ceased to exist in 1991.

I also want to compliment your staff, particularly Ken Myers and Ken Myers III, for their assistance and advice over the past 10 years, and you, Senator Lugar, for your video keynote address at our 10th anniversary meeting in Moscow last September. The Russian audience deeply appreciated your words of encouragement to them as they go about the difficult task of rebuilding their economy, their society, and their polity.

Like our elder enterprise fund sibling in Poland, TUSRIF's mission was—and is—to assist the new Russian Federation in its transition from a centrally planned command economy to a market economy, not by giving away grants, but by making investments in entrepreneurial companies. We started with a board of directors of men and women who serve pro bono, men and women who have made money during their careers owing to opportunities afforded them in the U.S. economy. Now they want, quite simply, to "give back" to their country by assisting Russia in a way that the United States Government (USG) cannot.

#### ABOUT US

TUSRIF was formed in 1995 with the USG as its sole financial sponsor, but under private management. TUSRIF's mission was to promote the development of a free market economy in Russia by providing investment capital—equity and debt—to emerging, potentially high-growth entrepreneurial companies. This was to be combined with technical assistance to management teams seeking to grow productive, transparent, and valuable companies. Once such a program was established and working well, TUSRIF's Board of Directors was to form a privately financed successor fund to continue the investment program. Finally, the board was to propose to the USG a plan for future use of the capital reflows from TUSRIF's successful investments that would seek to further accelerate entrepreneurship and economic growth in Russia.

TUSRIF now has invested about \$300 million in 44 Russian companies, the most recent of which were made together with Delta Russia Fund, the privately financed successor fund that held its final closing last month with approximately \$120 million in committed capital. That fund has backed another half dozen companies already.

2004 was a watershed year. In that year, TUSRIF accomplished its mission. It ended its investment cycle and moved into the cycle of realizing returns through sales of its investment positions. Additionally, it formed Delta Russia Fund, the private successor fund. The board then organized a legacy committee and began planning for what it would propose to do with the proceeds from the sale of its investments.

So what exactly have we done?

We have backed new companies. We have launched new industries. We have introduced the art of equity investing in Russia and trained young Russians in that art. And, through exits, we have brought high quality international investors into the Russian market.

DeltaBank, a commercial bank we founded in 2000, pioneered in credit cards, which, while common in the West, are new to Russia. In 2004, TUSRIF sold its interest in DeltaBank to GE Consumer Finance, the global financial unit of the General Electric Company, for 4.37 times book value. This was the third highest multiple for a sale of a financial institution in the world for that year.

We were pleased that a company such as GE paid \$100 million, over four times book value, for a credit card business that began with a USG grant.

Second example. We formed DeltaCredit, a pioneer in residential mortgages and Russia's first mortgage bank, in 2001, to provide residential mortgages to Russia's emerging middle class. Like credit cards, mortgages never existed before in Russia. Now, with nearly 50 percent market share, the company is growing at 100 percent annually and is poised to remain a leading player in Russia's expanding mortgage market for the foreseeable future. DeltaCredit established a residential mortgage origination network of 15 Russian and foreign banks. In 2004, Standard & Poor's Rating Services rated the bank stable, reflecting the improved capitalization and diversification of its funding base.

We also have been active in media investments. In February 2005, TUSRIF sold its stake in CTC Media, a television network, to Fidelity Investments, a leading European mutual fund. The sale of CTC Media at four times its original cost is TUSRIF's sixth successful sale of a company from its private equity portfolio, and it is the second deal with a large international strategic investor in the 15 months through December 31, 2004.

We support young, talented, dynamic, ethical, and inspiring entrepreneurs, and we go to great lengths to stimulate entrepreneurship broadly. There are entrepreneurs such as Andrey Korkunov, a former rocket scientist who started his chocolate manufacturing company with his own money and has built the leading confectionary firm in Russia today. We have visited his manufacturing plant, seen his state-of-the-art quality control processes, met his employees, and, of course, tasted his products. When he accepted his Entrepreneur of the Year award, in Russia last year, Andrey said that he wanted to "make life sweeter" for his country. He is doing this by creating jobs and generating wealth for his employees and for his community.

Olga Slutsker is another example. Told that she could never succeed, she did anyway. Olga built a remarkable company: A chain of health and fitness centers that grew to employ hundreds of people and literally reshaped the nation's approach to health and fitness.

We have come to know these entrepreneurs and hundreds like them since we founded The U.S.-Russia Center for Entrepreneurship (the "Center") in 2001. Since then, the Center has become the leading entrepreneurial support organization in Russia today. Its novel combination of education, training, policy analysis, networking events, and research and publications is driving an entirely new and effective culture of entrepreneurship in Russia. It truly is the centerpiece of TUSRIF's legacy to Russia, as contemplated in the original foreign policy objectives of TUSRIF.

Moreover, the success of our Center has become a model for innovative, "bottom-up" economic development elsewhere, including in countries of Central and Eastern Europe, North Africa, and the Middle East. The State Department and USAID now are using our training modules in other geographies, much to our satisfaction.

The future of Russia's non-natural resource economy is dependent in great measure on these Russian entrepreneurs who are effecting economic reform, promoting financial transparency and good governance, and creating opportunity for themselves, for their employees, and for their communities.

#### RUSSIA'S ECONOMY

Russia's growth is attracting investors. Its GDP grew 7.1 percent, and industrial output increased steadily in 2004, spurred by increased domestic investment and an upturn in private consumption. Macroeconomic factors—including currency stabilization, tax reform, controlled inflation, an expanding service sector, and increasing exports—contributed to political and economic stability in Russia during this period. The cumulative effect of these positive trends resulted in an upgrading of Russia's sovereign credit ratings, with Fitch Ratings raising Russia to investment grade BBB – in November 2004.

The budget surplus and public finances in general held steady, the trade balance rose significantly, and currency reserves at the beginning of 2004 exceeded US\$77 billion, a record figure for the entire post-Soviet period. Sovereign debt decreased to 33 percent of GDP, and the government maintained a stable repayment record. The Russian stock market again came out among the top performing markets worldwide. In 2003, the Russian stock market grew by nearly 60 percent, which made Russia sixth among the world's capital markets in terms of capitalization growth. Public confidence in the national banking system and the ruble began to grow, and the role of the dollar in the Russian economy shrank.

It is argued that Russia's economy is too dependent upon oil exports. In fact, with an oil market precariously balanced between a slowly growing supply and surging demand, the price effect of marginal barrels is exacerbated. It is possible that by pumping fewer barrels, Russia could make more dollars.

On the macro side, the budget of the Russian Federation is in good shape. It is on track for a 6.5-percent surplus; foreign reserves are approximately twice the total sovereign debt load; after prepaying the IMF, the government is now prepaying the Paris Club; the trade surplus is increasing; and the reserve fund, now at almost twice its intended target of 500 billion rubles, has not been raided, despite many attempts. The greatest fear is ruble overvaluation such as occurred in the 1990s. Inflation is predicted to hold reasonably well at about 7 percent this year. The real (CPI-deflated) effective exchange rate is currently 6 percent below that of July 1998, despite the buildup of Russian reserves. Real incomes are increasing rapidly; the average Russian income increased by 12 percent last year. But with steady revaluation of the currency, and wages continuing to grow, a major improvement in economic efficiency has become imperative.

Given these positive developments, growth expectations in 2005 are being revised down somewhat, to about 6 percent. Notable, however, is that these are downward ratchets based on a conservative oil price scenario, and that every year since 2000, GDP growth has exceeded expectations. Furthermore, Russia is increasingly integrated into the European economies that are growing more slowly. For example, GDP growth in the reform-friendly Eastern European countries of Hungary, the Czech Republic, and Poland, is likely to fall to less than half of Russia's levels this year.

Inflation in Russia continues to exceed forecasts, so the government's reiterated CPI target for 2005 of 8.5 percent appears unattainable. Inflation reasonably can be expected to continue at about 2004's 11.7 percent. Given the need for a massive increase in charges from previously government-provided services, in energy prices, as well as creation of liquidity from purchase of hard currency inflows and the continued strong growth of the Russian economy, even attaining nonaccelerating inflation will be a major accomplishment.

#### CHANGING OF THE GUARD IN THE PRIVATE SECTOR

The positive changes in Russia's regulatory and tax frameworks complement the transformation occurring within many Russian businesses themselves. The 1998 fiscal crisis shook out many weak links in the economic chain. Surviving companies, are for the most part, those with coherent strategic visions, rational business plans, and professional management. The crisis ultimately produced a new generation of strong young entrepreneurs dedicated to building new industries rather than investing or speculating in old ones. These entrepreneurs develop their businesses from a clean slate, avoiding the financial baggage and practices left over from the Soviet era and the years prior to 1998.

Russian enterprises today generally are focused on corporate value-building, realizing that in a competitive business environment, the critical imperative is satisfying customers. Such companies increasingly understand that, in order to keep investment flowing, internationally accepted principles of accounting, due diligence and shareholder rights must be adhered to, and that performance in a manner consistent with business plans is required.

Another remarkable development has been a dramatic "reverse diaspora." Talented young Russians who left Russia to attend universities and to work in Western Europe, the United States, or Japan in the wake of the events of 1991 and 1998, are returning, bringing their educations and newly honed skills with them. They are joining the entrepreneurs who stayed. Together, they are forming a new class of sophisticated business managers.

Happily for me, these are the kind of young women and men who make up my investment team at TUSRIF. They, in turn, make their training and experience available for the new managerial elite. It forms a dynamic that makes identifying and partnering with innovative, responsible Russian management teams increas-

ingly possible, a process that is starkly different from the chaotic and speculative bets of the mid-1990s.

Here's an example from our own staff: Kirill Dmitriev. Born in Kiev in 1975, he came to the United States in 1992. He is an honors graduate of Stanford University, a Baker Scholar at the Harvard Business School, and has worked for Goldman Sachs in its investment banking division, and for McKinsey & Company in Los Angeles, Moscow, and Prague. Prior to joining us, Kirill was Deputy General Director of Information Business Systems (IBS) in Moscow, Russia's leading IT services company. Now he is a partner with me and others like him in Moscow. At the age of 30, he is comfortable in two cultures and two languages as well as the language of finance, and is poised to be an international leader in private equity.

The reverse diaspora serves to enrich the highly educated managerial base that it rejoins.

#### IMPROVING LIQUIDITY FOR INVESTORS

In private equity, which is TUSRIF's business, liquidity is key. Heretofore limited in Russia, the ability of investors to secure liquidity at appreciated values has improved apace with the growth of quality companies. The June 2000 Nasdaq IPO of Mobile TeleSystems, one of Moscow's two largest cellular service providers, as well as its rival Vimpelcom's earlier ADR float on the NYSE, exemplify one path to liquidity for investors. In February 2002, Russian food giant Wimm-Bill-Dann repeated these earlier successes with an IPO of American Depository Receipts (ADRs) on the New York Stock Exchange (NYSE). Furthermore, in April 2002, RosBusinessConsulting achieved a successful IPO on the Moscow Interbank Currency Exchange, and Seventh Continent, a Moscow-based supermarket chain, went public with an IPO on the Russian stock exchange in November, 2004. TUSRIF's successful exits over the last 2 years from investments as described earlier further demonstrate increased opportunities for liquidity in the Russian market—in this case, in the private market. Over the next several years, we expect increased demand from both capital market participants and strategic investors to buy into fast-growing local companies with Western-style management and robust transparency.

In fact, the number of IPOs on the Russian stock market in the last 18 months exceeded all of those for the past 8 years. This is significant. None of those companies even existed in Soviet times. They are diversified, in technology, retailing, and steel. Forty percent of the demand for shares is from Russian citizens. The companies offering shares accept the need for transparency, but, as important, are placing their confidence in the future. They are toning down the emerging markets' standard practice of "grab now, because there is no tomorrow."

Three other factors are enhancing financial liquidity. Western strategic investors are seeking to acquire a foothold in the expanding Russian market. Russian groups are diversifying and expanding regionally. And there is a growing interest among midmarket companies in tapping public securities markets through IPOs, both in Russia and abroad, to raise capital to fuel their growth. The Fund's 15 successful exits from investments in the last 3 years demonstrate that investing in well-managed growth businesses can generate strong returns.

#### INDUSTRIES OF NOTE

- *Consumer products and services*

With a population of approximately 145 million and an area spanning 17.1 million square kilometers, Russia is potentially a vast consumer market as consumer confidence increases and incomes rise. Many segments of the consumer goods market are positioned to grow rapidly over the medium term, driven by steady growth in personal incomes. As purchasing power among Russia's various consumer segments has increased, a preference for domestically produced items also has increased. Some foreign manufacturers have sought to become more competitive in the market by building "national" brands out of locally produced Russian goods that have gained popularity among Russian consumers. Meanwhile, as incomes grow, some consumers have started to turn back to international brands, while keeping intact their positive attitude toward local brands.

Consumer spending increased 22.4 percent above its 2002 value and it is expected to continue to increase. Real income grew by 14.5 percent in 2003, compared with 10.1 percent in 2002. Real disposable income growth accelerated to a record 20.2 percent in the year to December.

- *Technology*

Russia has a large talent pool of internationally recognized scientists and engineers. Some 50 percent of the country's higher education students concentrate on

science, mathematics, and engineering, a higher percentage than in any country in the world. Russia's scientific and technological talent pool is a relatively untapped commercial asset in such rapidly evolving fields as optical and laser technology, software, coatings, and materials.

The Russian IT sector grew 23 percent to US\$6 billion in 2003, and is expected to grow to US\$10 billion by 2007. The market is expected to maintain a growth rate in excess of 20 percent per annum through 2005.

The growth is fueled by the need of large Russian industrial companies to enhance productivity using IT; by the emergence of rapidly growing medium-size companies that rely on IT systems to manage growth; by an increasing number of foreign companies establishing operations in Russia and utilizing IT heavily; and by various levels of the Russian Government which are retrofitting their processes with electronic solutions. The Russian Government has launched a massive IT spending program, "Electronic Russia 2000–2010," that is expected to generate a total of over US\$2 billion in IT contracts. The program is aimed at eliminating the gap in IT use between Russia and more developed countries in an effort to increase transparency as well as productivity in Russian companies and state institutions.

The Russian IT market is strategically important for global technology players because of the significant growth potential it represents. Several global technology providers, such as Intel, Cisco, Microsoft, and Hewlett Packard, have undertaken extensive marketing efforts to grow the IT market in Russia and to capture market share.

- *Media*

Some 300 million Russian speakers (about half of whom reside outside of Russia) constitute the fourth largest language group worldwide. As of 2003, 58.6 million Russian households (98.6 percent of general public) are equipped with TV sets. Russia is the largest television market in Europe by number of TV households and has one of the highest TV-usage rates in the world (over 3 hours a day on average). At the same time, pay-TV penetration is only 9.2 percent compared to 50 percent in Hungary and 29 percent in Poland. Broadcast media is still dominated by the state, but the private sector is growing fast, both in distribution of content and, in particular, in the development of original Russian programming. Five private broadcasters—NTV, STS, REN TV, TNT, and TV3—now claim 36.2 percent of the national audience.

TV advertising, which commands some 47 percent of the total advertising market, has been growing at over 51 percent compound annual growth rate (CAGR) from 2001 to 2004, having more than tripled to reach US\$1.4 billion in 2004. Still, in absolute terms, per capita TV advertising expenditures in Russia remain low at US\$9 compared to the Eastern European average of US\$17 and Western European of US\$47.

Consumer spending on movies grew 70 percent per annum during 2002–2003 to reach US\$190 million in 2003, up from US\$18 million in 1999. Nevertheless, per capita spending is US\$1.4 in Russia as compared to the US\$20–\$30 range in Western Europe and US\$35 in the United States.

The Russian video games market is growing due to increasing personal computer and console sales. The market was approximately US\$120 million in 2003 and is expected to reach US\$200 million in 2005. The average game price is increasing, but it is still at a level of about US\$4 per licensed copy in comparison to the US\$20–\$60 range in the United States and the European Union.

The magazine publishing market in Russia grew at 46 percent CAGR in 2001–2003 to reach US\$300 million in 2003. Deal activity in this area has intensified recently, notably the acquisition by the Swiss group, Edipresse, of 52 percent of Kon-Liga Press (three Russian titles); the launch of Russian editions of National Geographic, Forbes, and Glamour; the purchase of a 35-percent stake in the leading glossy magazines publisher, Independent Media, by Prof-Media group, which is controlled by Interros, a local pool of capital; and the buyout by Hachette Filipacchi of a controlling stake in its Russian joint venture HFS.

- *Telecommunications*

Russia's telecommunications infrastructure is positioned for significant growth as economic prosperity extends out of Moscow and St. Petersburg and into the regions. The Russian telecommunications market grew rapidly in 2003 and is expected to continue at a healthy rate for the foreseeable future. Growth is driven by Russia's continuing strong economic performance and by the need to upgrade the inadequate telecommunications infrastructure. According to Russian Minister of Communications, Leonid Reiman, in 2003 investment in the telecom sector reached US\$2.8 billion, a 40-percent increase over 2002. For 2003, the Russian market for telecommunications services was US\$6.6 billion, more than 24 percent growth over

2002, while the number of cellular and Internet subscribers doubled. The voice-over-IP service volume increased by 2.8 times in 2003, reaching 1.95 billion minutes, or 10 percent of all voice telephony. The estimated annual growth for the period 2002–2004 is 15 percent, which could result in a telecommunications services market of around US\$10 billion annually by 2005.

Over the past decade, private providers have entered the market with newer, better, and cheaper technologies, including:

- The provision of high-quality domestic, long distance, and international telecom services by private sector fixed-line operators;
- The arrival of mobile network operators as the delivery mechanism of choice for voice and Internet services as subscriber rates grow exponentially; and
- The expectation that wireless and convergent technologies will offer cost-effective solutions to Russia's massive telecommunications deficit. As a result, investment opportunities are emerging at a rapid pace, most notably in the many cities with populations of 1 million or more.

#### KEY MARKET FACTORS FOR INVESTORS

A number of factors point to a significant near-term opportunity in the financial services, consumer goods, and technology, media, and telecommunications sectors, among others, of the emerging Russian market economy. These include the following:

- An expanding consumer market with a strong and growing demand for goods and services;
- A literate and technically skilled labor force;
- Scarcity of institutional investment capital;
- Attractive valuations; and
- Increasing opportunities for exit, particularly through trade sales to both domestic and international strategic investors.

#### EQUITY CAPITAL MARKET

From the public securities market standpoint, the second tier of companies is continuing to outperform the blue chips by a wide margin. Several new funds are being established in Moscow, most of them focused on the mid caps. Because of limited supply of the better second-tier assets, pricing is very competitive.

2003 and 2004 produced several landmark deals in Russia generally. In 2003, BP acquired a 50-percent stake in Tuymen Oil Company for US\$3 billion in cash and stock, making it the most significant transaction in post-1998 Russia. Templeton Fund invested in a leading retail chain, Perekryostok, which in turn, acquired SPA Middle Volga from TUSRIF in 2004. Glencore committed US\$100 million to acquisitions in the Russian agriculture sector. And toward the end of 2004, GE Capital International Finance bought DeltaBank from TUSRIF and other coinvestors for approximately US\$100 million. Such deals attest to substantial improvements in market attractiveness and liquidity.

#### WTO PERSPECTIVE

WTO is a mixed blessing from a Russian standpoint. The potential benefits may be limited, while the costs may be significant. Russia is mainly now an exporter of raw materials, including hydrocarbons, metals, weapons, chemicals, and capital goods, so the impact of tariffs on such exportation is limited. Oil prices are high, inviting further import duties. Military hardware is sold only to governments. Third-world buyers of Russian capital goods generally have no domestic machinery industry to protect, except for chemicals that are subject to tariffs. The Europeans seek to force up domestic gas prices, thereby eliminating Russia's competitive advantage. Russian steel manufacturers are penalized by European and United States tariffs, and no relief would be expected under WTO. These markets are protected by a wide variety of "anti-dumping" and other tariffs, so it is very doubtful that Russian steel exports would thus be allowed to rise substantially. The Europeans are not inclined to end agricultural subsidies, or to drop antidumping tariffs, or to cease protection of inefficient steel mills. That leaves consumer goods for Russia. But it seems unlikely that Russia will develop into a significant exporter in this area any time in the foreseeable future. Nor is the Russian financial services industry, in its nascent state, likely to challenge either the Europeans or the Americans on their own turf. In the debit column, though, there are some significant trade effects. Whole segments of the Russian economy, such as banking, telecommunications, insurance, and automobiles, could be threatened or destroyed. This might bring immediate advantages to Russian consumers, but it also would reinforce the position of

Russia as a wholly commodity-dependent economy, arresting development of a diversified economy, which is in the longer term interest of the country. European manufacturers are unlikely to set up export-oriented industries in Russia as long as wages remain low in the accession countries. Indeed, it seems most likely that they would supply the Russian market from their Eastern European plants.

Similarly, the main effect of more rigorous enforcement of intellectual property rights relating to copyrights and trademarks would be an outflow of large sums per year to Western software and movie companies. The fact is that, despite rampant piracy, Russian film and music are enjoying a major renaissance. Whether WTO trade tribunals would bring fairness in the process for Russian producers is open to debate. Nevertheless, an equally great failure is the current liberal orthodoxy which holds that countries must encourage the flow of economic activity to wherever the comparative advantages are to be found, regardless of the consequences for domestic economic activity. This view ignores the need for countries to maintain, at least, some industrial base and to diversify their economies.

The Russian Government is now successfully applying a growth strategy to the automobile industry. Russian cars, which clearly are two to three generations behind current international engineering standards, should be made extinct. But the Russian automotive industry definitely should not be. To do so would be to destroy a million industrial jobs, rendering Russia all the more dependent upon the Saudi oil-based model of development. Instead, by reducing tariffs on automobile parts while maintaining high taxation of new car imports, the government has sparked the establishment of several joint ventures with foreign automobile manufacturers, Renault, Toyota, and GM among them, all of which are building domestic plants. Russians will soon have a taste of both worlds: Safe, clean, and reliable automobiles, without sacrificing their industry.

Of course there are negatives. For businesspeople and financiers, high returns do not occur in a perfect environment. This environment is not perfect, but it is in the process of defining itself, not unlike the days of the American Revolution or of other countries during their infancies. In our view, Mr. Putin has a job no one should want. He faces an extraordinarily challenging set of circumstances. And the primary issue is confidence; confidence of the Russian people in their growing institutions. There is an abiding fear among Russians that all will be stolen. Yukos was a prime example, where bribing people on an unprecedented scale, including in the West, was about to work. The Russian population, by-and-large, supported efforts to stop that.

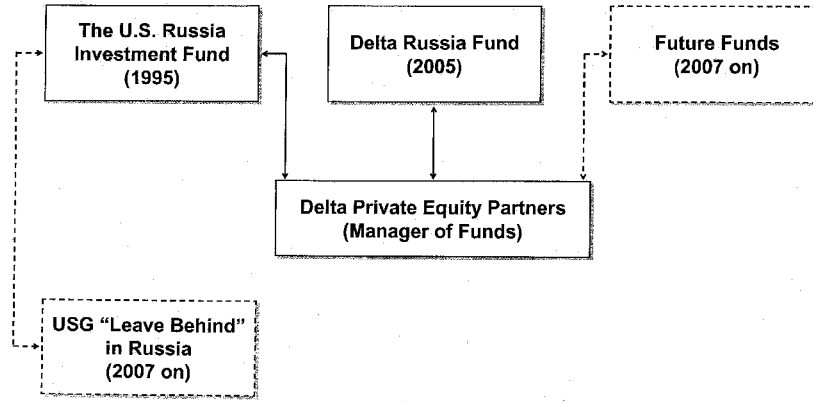
There is an underlying and basic distrust of government, which Mr. Putin must overcome. The weakness of the banking system is serious, and is being addressed, though slowly. It is needed to fill the long-term infrastructure needs of the economy, as well as those of the consumer. The court system is chaotic, but improving. Some 70 percent of the individual and corporate disputes on taxes currently are being won against the state, Yukos notwithstanding.

So, progress is being made in Russia. The magnitude of the challenge Russians face is hard for most Americans to understand, for the Russian people must write a whole new script for themselves. At TUSRIF, we seek with them to write entrepreneurship into this national script, as a key driver of economic democracy and growth. With support, it will work.

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I have attached to this written statement a chart to which I will refer in my oral testimony which assists in an understanding of the organizations I am privileged to manage.





The CHAIRMAN. Thank you very much, Ms. Cloherty.  
Mr. Verrastro, would you give your testimony?

**STATEMENT OF FRANK A. VERRASTRO, SENIOR FELLOW AND  
DIRECTOR, ENERGY PROGRAM, CENTER FOR STRATEGIC  
AND INTERNATIONAL STUDIES, WASHINGTON, DC**

Mr. VERRASTRO. Mr. Chairman, I, too, appreciate the opportunity to appear before you today. And, given the expertise on this panel, I'll focus my remarks on Russian energy policy and the implications for the United States and the rest of the world.

Let me begin by saying that, with the current tightness in global oil markets and the acceleration in energy demand, all producers are important to world oil supply. But, as you indicated, Mr. Chairman, given Russia's enormous potential, in terms of total energy resources, they have the largest proven resources of natural gas, the second-largest coal reserves in the world, and the eighth-largest oil reserves. And Russians global energy role is particularly significant.

In 2004, Russia was the world's largest non-OPEC oil producer and exporter, with production of approximately 9.2 million barrels a day, and exports on the order of 6.7 million barrels a day, ranking it second only behind Saudi Arabia. Sustaining or increasing that production is critical to oil market stability. But, given the enormous challenges facing Russia, the sustainability of recent performance is by no means a certainty.

In 1988, Russian oil production peaked at around 11 million barrels a day. Following the dissolution of the Soviet Union, production plummeted to around six less than 10 years later, in part, the result of depletion of several of the largest fields, due to state-mandated production practices, but also due to the collapse of the Soviet Central Planning System. Recovering from that decline has been extraordinary, to say the least, as production has rebounded to present levels as a result of the introduction of new technology, improved field practices, new investment, and step-out drilling, contributions that are unlikely to be repeated on a continuing basis.

With internal demand fairly stable, incremental increases in output have resulted in increased volumes of exports. And that's good for the world. But what about the future?

Beginning last August, the rate of growth for Russian production had begun to slow down, revealing some of the same symptoms that preceded earlier declines, namely, a decided lack of investment in new oil-field exploration, and the overproduction of fields currently in line, in order to take advantage of prevailing high prices.

2005 production levels are expected to be about 3 or 4 percent above 2004 output, but probably not much more than that. An additional 2-to-3-percent growth is projected for 2006, an increment which is helpful, but only a fraction of the average growth experienced between 2000 and 2004. And it's insignificant when compared against projections for rising demand.

And prospects for further improvements face a series of formidable challenges, including the need for new investment, improvements in infrastructure, including pipelines, the expertise and technology to develop the offshore fields, and a regulatory regime that provides potential investors with adequate incentives and predictability, in terms of transparency, rule of law, contract sanctity, and the opportunity to achieve returns on investment commensurate with the risks taken.

Sir John Browne, the CEO of BP, has aptly characterized Russian risk, noting that for many potential investors, quote, "Russia remains a dark and hostile place, a source of risk rather than opportunity," end quote.

In recent months, Russia has done little to allay such concerns. The Yukos affair has been characterized, on the one hand, as a thinly disguised effort to silence a well-heeled political rival, but, at the same time, is clearly recognized as part of a broader effort to restore and solidify greater state control over Russia's energy assets.

The problem, in terms of global oil and energy supplies, is that, at precisely the time when the world appears to need incremental new production from virtually all sources, Russian policy and field practices may be headed in just the opposite direction. The adoption of Russia's oil export duty, the equivalent of a windfall profit tax, captures roughly 90 percent of the current upside value in oil prices above \$25 a barrel. And the proposal to require 51 percent Russian ownership in new projects only further discourages new investment and stakeholders. When coupled with the increasing number of idle wells, which we estimate as high as one in four, the inability to replace reserves, and projections for a significant depletion in all existing major fields by 2015, the 5-to-7-year lead times required to bring on new production only reinforces the significance of the challenges facing Russian production in the years ahead.

When taken in context, the decline of major non-OPEC producer in the current market only serves to further concentrate future supply availability in the hands of a select few OPEC member nations. A somewhat more optimistic picture emerges for the longer term, but it's a picture that very much depends on the timely discovery and development of new oil-producing fields.

The most recent projections prepared by the Russian Ministry of Industry and Energy, covering the 10-year period between 2005

and 2015, estimates that Russia will be able to produce between 10.6 and 11 million barrels a day by 2015. But that same analysis suggests that reaching that level of production will require some \$270 billion in new investment.

Analysis prepared by CSIS and others projects a decided shift in global oil markets within the next 10 years. With an increase in concentration for both producing and consuming regions alike, we project that the main producing areas will be the Middle East, Russia and the Caspian, Africa, and the nonconventional fuels in Canada and Venezuela. When you look at the major consumption regions, it's North America, Europe, and Asia. These are areas that are geographically segmented, and it puts additional strain on transportation, security, and infrastructure, as well as investment. Also on the environment.

In particular, the projected rise of Asian demand, especially in China and India, will place increased logistical burdens on inter-regional movements of both oil and natural gas. Russia and the Caspian are counted on to play a significant role in that developing system, and the failure to realize that potential will have serious consequences for consumers, worldwide.

Thank you, Mr. Chairman.

The CHAIRMAN. Well, thank you very much, Mr. Verrastro.

Dr. Wallander.

**STATEMENT OF CELESTE A. WALLANDER, DIRECTOR, RUSSIA AND EURASIA PROGRAM AND TRUSTEE FELLOW, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, WASHINGTON, DC**

Ms. WALLANDER. Mr. Chairman and members of the committee, thank you so much for this opportunity to speak with you about developments in Russia and the implications for United States policy.

For my contribution to the discussion, I want to cover four topics: Political developments in Russia, the specific issue of HIV/AIDS, main tendencies in Russian foreign policy, and implications for United States policies and engagement. Since I can only touch on the high points of each of those topics, I've submitted written testimony that addresses each in more detail.

On Russian politics—the key to Russian politics today is that they are not really about Russian politics today; they are about the Presidential elections in 2008 and maneuvering over who will be chosen to succeed President Vladimir Putin with near certainty in a political process that is neither free nor fair.

This means two things. First, politics in Russia is not about public contestation and competition, it's about elite insider relationships. Second, no outside forces, whether those are social or civil groups, businessmen, human rights organizations, alternative political parties, independent intellectuals, or journalists, are permitted to affect the process. It is controlled, managed, and orchestrated. Without societal oversight, Russia's leaders answer to no one.

The Putin leadership argues that it has sought control for good reasons—for stability and for an effective state. The problem is that the Putin leadership has created a state that may be strong in silencing independent voices and in preventing independent activities, but it is a state that cannot effectively govern a modern

country. A state must have the enforcement power of a strong fist—and the Russian state has that, in very good measure—but a state cannot be only a fist if it is to govern; a state has to be a hand, as well, with the dexterity and flexibility of fingers and thumbs to manage social and economic challenges, and to implement policies, as well as decree them.

The Russian state is very good at stamping out dissent and defeating independent political, social, and economic forces, but it has been helpless in advancing economic reforms that would create a promising investment climate. The state has not had the dexterity to use the oil prices windfall of the past 6 years to spark growth and innovation in new sectors.

The Russian state, as fist, has failed where fingers and dexterity are required. It has failed to broker a compromise on domestic energy prices, a necessary condition for joining the World Trade Organization. It has failed to develop an effective reform of the country's social benefits program, a reform vital to Russia's future fiscal health, social equity, and economic competitiveness.

The Russian leadership has spent the last few years using the fist of state power to acquire control of the energy sector, to ensure that businessmen get the message that assets are theirs only as long as they do not act independently, and to eliminate oversight of the state's roll in redividing the spoils of the 1990s among current political leaders.

So, the problem with the Russian state is not only that it is too centralized, too impervious to society, and too unrestrained by constitutional checks and balances; the problem for Russia, and for the United States, is that, in the end, a fist cannot do very much, other than flatten things. Although the United States should be concerned about Russia's retreat from democracy, we need to be concerned because authoritarianism weakens Russia.

With that, let me turn to HIV/AIDS. For the basic numbers on HIV in Russia, I want to refer you to a handout we've provided. I just want to highlight one point about the numbers. The true number of HIV-infected Russians, as of 2005, is in the range of about a million Russian citizens. That means that about 1 percent of adult population is HIV-infected, a standard benchmark for an HIV pandemic poised to become a generalized national health crisis.

The signs are becoming clear that the disease is spreading from high-risk groups to the general population. In 2001, 93 percent of new infections were among intravenous drug users; in 2003, 63 percent of newly infected Russians were IDUs. In 2001, heterosexual transmission was reported in just under 5 percent of new cases; in 2003, it was 20 percent of new cases.

This also leads to the feminization of HIV/AIDS in Russia. In 2000, one in five of newly infected Russians were women; in 2002, one in four; and, in 2003, one in three.

Russia's HIV/AIDS problem must also be understood in the context of its broader demographic problems. Russia's population is shrinking. The combination of falling birth rates and rising death rates from chronic and infectious disease mean that, by 2025, Russia's population will fall from about 144 million to 125 million. Add to that anywhere between 5 million to 15 million excess deaths

from AIDS, and the country may have lost 20 percent of its citizens in the next 20 years. AIDS will have a destabilizing effect on a Russia that is already not healthy, and will strike at Russia's labor force and at women in their childbearing years, undermining the country's future.

Now, preventing HIV and coping with AIDS is a challenge for any country, and Russia is, by no means, unique in responding slowly. However, after several years of interviews and research, I am convinced that Russia is particularly vulnerable to a generalized HIV/AIDS epidemic because of the nature of its political system—the excessive centralization of government relative to regional and local authorities, the failure of federal ministries to coordinate for a comprehensive public-policy response, and the vulnerable position of NGOs, nongovernmental organizations, that are struggling to provide prevention services to stem the tide.

More than anything, responsible officials in Russia are waiting for President Putin to signal that it's okay to act. On a trip to Russia earlier this year, on this topic, I was told, time and again, that, given how socially sensitive HIV/AIDS is, no one wants to risk finding themselves the target of the Kremlin fist for charting an unwelcome independent policy course on AIDS. By creating a state in which independent initiative can land you in jail, the Putin leadership has increased Russia's vulnerability to HIV/AIDS.

Now, quickly, a few points on Russian foreign policy.

Russian foreign policy under President Vladimir Putin is motivated by economic growth, not only for the purposes of growth, itself, but for the sake of power, autonomy, and global position. Economic interests stand alongside strategic interests in how Russia defines its security and status. That is, Russia as an influential, autonomous, and accepted great power. The Russian leadership seeks global engagement, but only in the context of state control at home and a great power status abroad.

One effect of the great power focus of Putin's internationalist foreign policy has been the rise of geopolitics in Russian strategies and priorities. Russia's approach to the foreign-policy challenges of terrorism and proliferation is geopolitical, and filtered through the leadership's great power objectives. This means that, while Russia's concern about transnational terrorism is genuine, it also wants to act with a high degree of autonomy in regions around its borders. It means that, while Russia has little to gain from China's rise as a military power, with possible designs on Russian territory, it does have a very strong interest in selling its energy and arms and enjoining with China to try and balance United States influence.

In this context, the Russian leadership, unfortunately, sees United States policies as part of the problem it faces in its objective to establish itself as a great power with geopolitical advantages in an environment that looks highly threatening. This was the filter in which the Russian leadership viewed the Ukrainian elections and President Bush's visits to Latvia and Georgia. Russian leaders assume a great power and geopolitical framework for United States policy, so they see the net of United States relationships and activities in Eurasia as a form of neocontainment meant to restrict Russian power and influence.

Now, what are the implications for United States policies and engagement with Russia? Nothing—I want to emphasize this—nothing in what I have outlined contradicts the need for United States engagement with Russia. Russia remains one of the most important countries for the United States, as both a potential partner and as a potential challenge. The reasons for engagement with Russia are very well understood by the members of this committee and by the U.S. Government: Nonproliferation, energy diversification, counterterrorism, and Eurasian security. None of this has changed. And with the ups and downs in United States-Russian relations, it is too easy to lose sight of these fundamentals.

A responsible United States policy will be best served by a commitment to a long-term strategy of engaging Russia in order to secure American security and economic interests. Given Russia's importance in the region, and its impact on vital global issues, Russia must continue to be among the United States most important foreign partners. The analysis I offer above, or earlier, matters for the implications on how to engage Russia and for an assessment of how well Russia will be able to engage with the United States, not "whether" to engage Russia.

In the short term, the United States is confronted with engaging a Russian leadership that is quite internally preoccupied. The United States faces a leadership increasingly in crisis-management mode because of the weaknesses of its government institutions in managing public-policy challenges and the buildup of unsolved social and economic challenges. I've outlined the HIV/AIDS challenge, but it is only one among many serious problems that have not been dealt with effectively, and which cannot be avoided for much longer.

The challenge for the United States is to recognize the limitations on Russia's capacity as an effective state, and maintain its principled and practical stand on the importance of democracy and human rights as a way to strengthen the effectiveness of Russia as a country.

Under these circumstances, probably the best the United States can do is to continue to work on practical programs and policies with a proven record of successful engagement, and, among those, the first we would recognize is the programs on Cooperative Threat Reduction.

However, because of the limited capacity of the Russian State, and because, over the long run, Russia will be a successful, secure, and prosperous country only if Russian society contributes to the country's policies and programs, the United States should not shy away from engaging Russian society and independent civic and business institutions.

Trends in the past year are not promising, but Russia is not the Soviet Union of the height of the cold war. It is more open to the world, it has a sense of the benefits of engaging globally. Through a consistent and principled policy, the United States can cope with challenging Russia in the short term, while building on the strengths, both in the relationship and the strengths in Russia itself, for the long-term view.

Thank you, Mr. Chairman.

[The prepared statement of Ms. Wallander follows:]

PREPARED STATEMENT BY CELESTE A. WALLANDER, DIRECTOR, RUSSIA AND EURASIA PROGRAM AND TRUSTEE FELLOW, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, WASHINGTON, DC

Mr. Chairman, and members of the Committee, thank you for this opportunity to speak with you about developments in Russia and the implications for United States policy.

For my contribution to this discussion, I will cover four topics today. First, I consider political developments in Russia as a basis for understanding the country's medium-term policies and interests. Second, I address the specific issue of HIV/AIDS in Russia as both a factor in the country's potential, and as an indicator of the challenges that its society and government face as the country copes with this global pandemic. Third, I outline the main tendencies in Russian foreign policy. Finally, I offer some thoughts about the implications for United States policies and engagement with Russia.

#### RUSSIAN POLITICS

The key to Russian politics today is that they are not really about politics today; they are about the Presidential elections in 2008. That politics in the present are about the next election is not unique to Russia, and, in fact, is usually a sign of a well-functioning democracy, because elections are the core mechanism for holding elected officials accountable to society.

But in Russia today, the maneuvering about the 2008 elections is not about who will stand to compete in free and fair elections; it is about whom will be chosen to succeed President Vladimir Putin, with near certainty, in a political process that is neither free nor fair. It is about choosing the figure that will advance to effectively uncontested elections through a campaign process that has none of the features of a well-functioning democracy; that is, competing national political parties, civil society oversight and monitoring of campaigns and elections procedures, and reporting by independent media.

This means two things. First, politics in Russia is not about public contestation and competition; it is about elite insider relationships and associations. The constituency you need to satisfy and serve is a constituency of your elite peers and associates. The public is not completely irrelevant, and the fact of President Putin's relatively strong (though weakening) approval ratings helps. It means the leadership can stop short of true authoritarian control and simply satisfice with what it calls "managed democracy."

Second, that means the contenders prize control above all. No outside forces—whether those are social or civic groups, human rights organizations, alternative political parties, independent intellectuals or scholars or journalists—can have the right or resources to affect the process of politics from the outside. Everything needs to be controlled, managed, and orchestrated. This is what makes "managed democracy" work. Russia lacks the effective checks and balances of political competition and investigative journalism which—while perhaps annoying to all leaderships in power—keep governments accountable and honest. Without societal oversight, Russia's leaders answer to no one. It can pursue its policies, for good or ill, with relative impunity.

In the past few years, the Russian leadership has achieved a greater degree of control in Russian political, social, and economic life. In addition to the erosion of competing political parties, it has made the upper House of Parliament, the Federation Council, subordinate to the Presidential administration through the power of appointment, and this method of eliminating political independence has now been extended to the Governors of Russia's 89 regions. The chances for the development of independent political parties to challenge the leadership's hold on power has been further crippled with the passage of new regulations on parties that make it virtually impossible for new parties to register, let alone to attract enough of a national following to win seats in the lower House of Parliament, the Duma.

The Putin leadership argues that it has sought control for good reasons: For stability and an effective state. In contrast to the chaos of the 1990s and the hijacking of the Russian state to the interests of greedy oligarchs, Russia is now run by security professionals with the goal and capacity to pursue economic growth, improvement in social conditions, and Russia's status as a respected great power in the world.

Thus, the argument of Russia's leadership—and even many in United States policy and business circles—is that Russia's retreat from liberal democracy is necessary for stability, and that developments in Russia away from the institutions of democracy (independent, political parties, independent judiciary, independent civil society, independent media, independent legislature, and independent regional and local

governments) have been necessary to correct for the excesses of the 1990s, in which the state was effectively captured by narrow selfish interests which weakened it and stole national assets.

This is the context in which to best understand the Khodorkovsky case which has attracted so much attention and commentary since he was arrested in October 2003 and now convicted in May 2005. Whether because he was developing his own political ambitions and political party ties, or because he was criticizing and trying to influence government policy (notably, whether a Russian oil pipeline would go to China or to the far eastern coast), or because he had created his own foundation supporting nongovernmental organizations, or because he was negotiating foreign ownership of Yukos and thus putting part of the country's strategic assets outside of the government's control, Mikhail Khodorkovsky failed to heed the key to Russian politics today: State control and the impermissibility of independent influence or interests.

This is not to argue that Yukos had not been acquired and built during the 1990s through insider practices and possible illegal practices that warranted investigation and legal redress (although the question arises why other massive, wealthy Russian companies acquired and created in the same way have not been the target of Russian justice). It is to argue that the case ought to be understood in light of other political uses of the legal system to punish or prevent independent forces in politics and society. Or another way to put it: Analysts of Russia are often asked why we should feel sorry for Mikhail Khodorkovsky, a man who became wealthy through illegal schemes. Perhaps we should not. But there are plenty of victims of the Russian leadership's use of the legal system to control and prevent dissent and competition: Igor Sutyagin, the international relations scholar sentenced to 15 years in prison for writing a research paper using nonclassified and open-source materials on Russian submarines; or the physicist, Valentin Danilov, who in November 2004 was convicted of spying for China (after being acquitted but then having his verdict overturned by Russia's Supreme Court) and sentenced to 14 years in prison. International governmental and nongovernmental organizations (Amnesty International, Freedom House, Human Rights Watch, and the Council of Europe's Commissioner for Human Rights among them) have documented a pattern of use of the Russian legal system to limit and imprison independent political, social, scientific, and media activities, not merely the high profile prosecution of a billionaire.

Other aspects of the Yukos case point to state control as the overwhelming motivating factor in Russian politics today. To pay the back taxes claim resulting from the investigation, the Russian state seized Yuganskneftegaz, a valuable subsidiary of Yukos, and announced an auction. When Gazprom, the privatized Russian natural gas monopoly (owned in part by the Russian state) could not raise the financing necessary to successfully bid on the auction, an unknown new company, Baikal Finance Group, won the government tender, and then was promptly bought by Rosneft, a Russian Government-owned oil company chaired by Igor Sechin, deputy head of the Presidential administration. With one of the most valuable assets of Yukos now owned by the Russian state, the wealth it produced cannot be used by an independent businessman, nor can an important energy company be sold to foreign investors.

Meanwhile, the Russian natural gas monopoly Gazprom (the chairman of which is Dmitry Medvedev, head of the Presidential administration) recently bought Russia's largest independent national newspaper, Izvestia. And then this week at its shareholders' meeting, Gazprom will agree to a Russian Government purchase of Gazprom shares which will give the Russian state 51 percent ownership and thus control of the single most important sector of the Russian economy.

The problem is that the Putin leadership has created a state that may be strong in silencing independent voices and in preventing independent activities, but it is a state that increasingly cannot effectively govern a modern 21st century Russia in a complex global environment. A state has to be strong to defend the country against external threats, and to insure domestic peace, security, and rule of law. A state has to have the strength and enforcement power of a strong fist, and the Russian state has that in good measure.

But a state cannot be all fist if it is to govern a country effectively. A state has to be a hand as well as a fist, with the dexterity and flexibility of fingers and thumbs to manage social and economic challenges, to implement policies as well as decree them.

The Russian state is very good at stamping out dissent and defeating independent political, social, and economic forces. But it is virtually helpless in advancing economic reforms that would create a promising investment climate on a national scale outside of the energy sector (and the state has even failed to attract serious investment in the energy sector, as evidenced in problems with stalling production in



2005). The state has not had the dexterity to use the oil prices windfall of the past 6 years to spark growth and innovation for small and medium enterprises, and in modern industrial sectors where Russia's enormous human capital of highly educated scientists and engineers could make the country a global competitor.

Instead, the Russian leadership has spent the past few years using the fist of state power to acquire unquestioned control of the energy sector, to insure that businessmen get the message that their assets are theirs only as long as they do not act independently, and to stamp out any outside oversight that might question the state's role in redividing the spoils of the 1990s among current political leaders.

The Russia state-as-fist has failed where you would expect; where fingers and dexterity are required. It has failed to broker a compromise of domestic energy prices, a necessary condition for joining the World Trade Organization. It failed to develop an effective reform of the country's social benefits programs, a reform vital to Russia's future fiscal health, social equity, and economic competitiveness. By failing to engage local leaders, social groups, and nongovernmental experts in its plan for overhaul of the social benefits programs, the government failed to anticipate the mass protests across the country which resulted from its unilateral announcement of a reform that was perceived by society as unfair and a threat to the poor and vulnerable.

So, the problem with the Russian state is not only that it is too centralized, too impervious to society, too unrestrained by constitutional checks and balances. The problem for Russia—and for the United States—is that in the end a fist cannot do very much other than flatten both genuine threats, and also genuine dissent. Although the United States should be concerned about the excessive strength of the Russian state relative to Russian society, media, and independent political forces, the United States needs to be very much as concerned. Russia needs a state that can grasp problems or challenges. It needs a political system to craft policies that meet the challenges and solve the problems. And Russia needs to be able to use the fingers of an effective bureaucracy—regional and local government, civil society groups, a professional media, and an engaged business community—to implement and manage rules of the game that create a healthy market economy that can compete in the real 21st century global environment.

#### HIV/AIDS IN RUSSIA

Russia's HIV/AIDS is a perfect example of such a challenge for which a strong state is not enough, and in which Russia is vulnerable precisely because of its centralized, insulated political system.

Russia does not have the world's highest prevalence rate, nor the largest number of people living with AIDS. Compared to large population countries such as China or India, Russia (with a population of 145 million) is unlikely to contribute dramatically to the global burden of tens or even hundreds of millions of victims living with, and dying of, AIDS.

But for the past few years, Russia has had the sad distinction of having one of the highest rates of growth of HIV infection in the world. At the end of 1999, there were 31,000 officially registered HIV-infected Russians. By February 2005, Russia's Federal AIDS Center reported 305,000 officially registered HIV-infected persons. Arguably, while the growth rates could be viewed as a statistical artifact (any increase from a low number will result in a high-growth rate), the spread of the disease in Russia over the last decade has been explosive. Although reliable numbers are impossible to come by, credible professional estimates are that the true number of HIV-infected Russians is in the range of 1 million. That means that about 1 percent of the adult population is HIV infected, a standard benchmark for an HIV pandemic poised to be a generalized national health crisis, not one concentrated merely in high-risk groups such as injection drug users (IDUs) or men who have sex with men (MSM).

And the signs are becoming clear that the disease is spreading from limited high-risk groups to the general population. In 2001, 93 percent of new infections were IDU-related. In 2003, the figure had fallen to 63 percent. In 2001, non-IDU related heterosexual transmission was reported in 4.7 percent of new cases; in 2003 it was 20.3 percent. In addition to clear trends to non-IDU related heterosexual transmission, the spread of the disease from limited high-risk groups to the general population is suggested by evidence of increasing numbers of HIV-infected women giving birth. In 2000, there were 374 new cases of HIV-infected children born to HIV-infected mothers. In 2003, the number of new cases was 3,111.

The trend toward heterosexual transmission also means the feminization of HIV/AIDS in Russia. In 2000, one in five of newly infected Russians were women; in 2002, one in four; and in 2003, one in three. Given that Russia's HIV demographics

also are characterized by a high concentration in younger age cohorts (80 percent of registered HIV-infected Russians are between 15 and 29), the potential societal impact of a growing rate of HIV infection among young Russian women is substantial.

Russian and international experts understand the HIV/AIDS situation and threat it poses to Russia's future quite well. Russian scientists, activists, and health officials have been working to prevent the spread of HIV within high-risk groups and from such groups to the general population for years. Select regional and local governments, the appropriate U.N. agencies, and international foundations and NGOs have launched pilot programs for the study and prevention of HIV's spread. Many devoted and brilliant people have labored for years in their determination to spare Russia the experience of denial and inattention that plagued countries like the United States some 20 years earlier.

However, in the context of Russia's post-Soviet transition, HIV/AIDS is just one of many pressing political, economic, social, and health problems. It is not easy to convince national leaders that HIV requires more attention and resources when other health crises, such as a shrinking population due to cardiovascular disease and alcoholism, appear to be a more immediate and tangible threat to the country's future. It requires truly visionary leadership to devote political and financial resources to a disease that is perceived to be a problem of socially "maladapted" and marginal people when Russia's children attend crumbling schools and are taught by underpaid teachers. And while it is true that Russia's economy has been growing the past few years, it is important to note that the explosive growth in HIV infection began in the 1990s, when the economy was still suffering from a 50-percent reduction in GDP, near-hyperinflation, and low real incomes.

As a result, Russia, like so many—too many—countries before it, has been terribly slow to confront the problem of HIV and take effective action to prevent its spread to the general population. Although President Vladimir Putin has made reference in several speeches to the problem of Russia's demographic and health decline, he has publicly mentioned HIV/AIDS in this context only once, in May 2003. Russia faces many challenges in mounting an effective response to the problem of HIV, but none is more important than the failure of the country's national leadership to fully grasp the essence of the problem, which is the first step to mounting a national policy to prevent Russia from becoming a high prevalence country. The key to a national response lies in the Kremlin, which has been silent.

Because of the vertical nature of the HIV/AIDS health services structure in Russia and the ambiguous connection between the regional and city AIDS centers and the remainder of the Ministry of Health and Social Development, there is an internal debate about the accuracy and significance of the national HIV/AIDS numbers. The uncertainty and unreliability of government figures hampers effective efforts to characterize the scope and shape of the challenge facing Russia in the coming years. These structural and statistical ambiguities command a lot of attention of Russians and foreigners alike and—while they may not be a direct obstacle to an effective national response, they certainly do not contribute to its framing. The credibility of outside experts, who points to higher projected numbers in the coming years, is undermined by the unreliability of the basic numbers that the projections are based upon. By the same token, more sanguine assessments are no more credible since they are based upon official numbers which are the result of an inadequate public health surveillance system.

Russia's HIV/AIDS problem must also be understood in the context of its broader demographic problems. Russia's population is shrinking; the combination of falling birth rates and rising death rates from chronic and infectious disease means that Russia is losing approximately 400,000 to 840,000 people each year. By 2025, Russia's population is projected to fall from about 145 million to between 125 to 135 million. Some studies project that by 2050 Russia's population could fall to less than 100 million.

These projections are based on Russia's low fertility rate and high rates of cardiovascular and alcohol-related disease. These projections do not include the effects of a generalized AIDS pandemic. Taking into account AIDS is difficult given the unreliability of current numbers, one can project that by 2020 Russia will have anywhere between 5 million to 15 million excess deaths from AIDS. Specific numbers are less important than the trends. With Russia already suffering a fertility rate too low to replace the current population, and suffering from high levels of other diseases that will increase the burdens on the health system, AIDS will have a destabilizing effect on a weak, not a healthy, Russia. In particular, AIDS will strike at Russia's labor force and at women in their childbearing years, undermining the country's future.

A widely reported World Bank study projects that in the absence of an effective HIV prevention campaign, the effects of HIV/AIDS on Russia's economy will be substantial. Because of a smaller and less productive labor force and because of the diversion of societal resources to cope with a generalized pandemic, Russian GDP would be up to 4.15 percent lower by 2010, and 10.5 percent lower by 2020, than it would be in the absence of HIV infections and AIDS deaths in Russia. More fundamentally, if trends in the spread of HIV in Russia continue without effective public policy intervention, the effects of the disease will be to reduce Russia's annual growth rate by 1 percentage point by 2020.

These are the kinds of projections that should grab the attention of national leaders, but they have not in Russia. There are several possible reasons: The perception that those sick and likely to die are undesirable "socially maladapted" drug users whose loss is not perceived as a national problem; the low priority of HIV as a social or health problem given more immediate crises such as poverty, crumbling infrastructure, and health problems that already afflict the general population. But among the reasons cited was also the uncertainty of the numbers used in such projections. That is, the projections lack credibility because officials focus on the aforementioned officially registered numbers of 305,000 with declining rates of incidence reported in the past few years.

It is difficult to escape the conclusion that the problem of unreliable numbers and a nonfunctioning surveillance system is key to the challenge of an effective Russian public policy to prevent a generalized HIV/AIDS pandemic. Much of the effectiveness of any national response to HIV/AIDS—in any country—depends on political and other factors usually well beyond the control of health policymakers and technical experts. And, of course, having accurate information on the spread and impact of HIV/AIDS is not sufficient to ensure an effective response in the absence of addressing related societal issues. However, there is little doubt that accurately measuring aspects of the spread and impact of HIV/AIDS can contribute immensely to the effectiveness of a society's control efforts once the decision to mount such a response has been made. In the current situation, important information necessary to craft an effective comprehensive response is out of date or otherwise lacking. The ability of Russians and foreigners alike to act effectively will be handicapped until, at least, some of these issues are addressed.

The Government of Russia has been reluctant to discuss, let alone confront, the fact of its HIV epidemic. The predominant mindset has been that HIV is a problem of developing countries, not industrial powers like Russia, and that Russia is properly seen as an international donor helping to solve the global AIDS problem rather than as a country suffering from it. It is emblematic that President Putin has mentioned HIV/AIDS to a domestic Russian audience on only a very few occasions, even while he has engaged United States President Bush as a partner on the issue many times on the international stage. Russia has pledged USD \$20 million to the Global Fund while allocating only USD \$4–\$5 million per year from its federal budget to its own targeted fight against HIV/AIDS. A handful of government agencies, particularly some related to law enforcement, remain hostile to established international norms in the fight against HIV. Russia still has no dedicated national strategy to tackle its epidemic. No public figure has emerged as the kind of spokesperson who might destigmatize the virus and catalyze the formation of a coordinated national effort.

Preventing HIV and coping with AIDS is a challenge for any country and political system, and Russia is by no means unique in responding slowly and ineffectively. However, after several years of interviewing and working with Russian and international experts on the disease in Russia, I am convinced that Russia is particularly vulnerable to a generalized HIV/AIDS crisis because of the nature of the political system I outlined earlier. Russia suffers many vulnerabilities common to other countries dealing with AIDS (including the United States) such as limited financial resources, a failure to embrace programs with proven effectiveness for prevention (including health education and needle exchange). But Russia's greatest vulnerabilities to HIV/AIDS today are political. The excessive centralization of government relative to regional and local authorities and the failure of federal ministries to coordinate and cooperate for a comprehensive public policy response that involves the health, justice, interior, defense, education, finance, and economic ministries. And more than anything, responsible officials in Russia are waiting for President Putin to signal it is OK to act. On a trip earlier this year I was told time and again that given how socially sensitive HIV/AIDS is as an issue, no one wants to risk taking the initiative only to find themselves the target of the Presidential administration's fist for charting an unwelcome independent policy course, however important or well conceived.

By creating a state in which independent initiative can land you in jail, the Putin leadership has increased Russia's vulnerability to HIV/AIDS.

#### RUSSIAN FOREIGN POLICY

Russian foreign policy under President Vladimir Putin, like Russian foreign policy under President Boris Yeltsin before it, involves participation in the global economy in order to stimulate growth. Unlike Yeltsin's foreign policy, however, which sought global economic integration for leverage in reforming the domestic political economic system, the role of economic growth in Putin's foreign policy has a different immediate primary objective. Economic growth and international integration as a means to Russian development and national security and well-being remains the core of foreign policy, but the Russian Government is no longer as vulnerable as it had been. However, economic interests do not stand alone in defining Russian foreign and security policy; they stand alongside strategic interests how Russia defines its security and status, that is, Russia as an influential, autonomous, and accepted great power.

The enmeshing of this core economic and strategic national interest is perfectly expressed in phrases from Putin's May 26, 2004 "State of the Union" address to the Russian Federal Assembly:

Now, for the first time in a long time, Russia is politically and economically stable. It is also independent, both financially and in international affairs, and this is a good result in itself. We want high living standards and a safe, free and comfortable life for the country . . . We want to strengthen Russia's place in the world. We must grow faster than the rest of the world if we want to take the lead within today's complex rules of global competition. We must be ahead of other countries in our growth rate, in the quality of our goods and services and level of our education, science, and culture. This is a question of our economic survival. It is a question of ensuring that Russia takes its deserved place in these changing international conditions.

That is, Russia's is not a foreign policy driven by economic growth for economic growth's sake. This is a foreign policy driven by economic growth for the sake of power, autonomy, and global position. Economic interests do not drive Russian foreign policy, although they are important to Russian foreign policy. Russian interests in expanding its energy exports explains its relations with Europe, its increasing interest in CIS neighbors, its attention to Japan and China, its commercial relations with Iran, its concerted efforts to nurture and increase commercial arms sales (which amounted to over \$5.5 billion in 2003). Foreign trade, particularly in the energy sector, is very much in the commercial and economic interests of its business people, and through general growth in the economy, its citizens.

What this meant for foreign policy was a change in tone, direction, mode, and tactics. The United States remains important, but it is not all encompassing. More importantly, U.S. preferences and criticism matter far less to a Putin government that can pay its own bills and count on domestic support. The reduced focus on the United States, and the increased appreciation of the power and economic value of energy assets and transit corridors, contributed to a greater, and more strategic, focus on Europe, Asia, and the newly independent countries on Russia's borders. Russia's interest in international trade and business is not limited to interest and activity in the West, but applies as much to relations with the countries of what Russia continues to conceptualize as the Commonwealth of Independent States.

Russia's foreign policy strategy by 2005, therefore, is internationalist, but it is also statist, and most certainly not liberal. Rising trade is fine; foreign ownership of Russian oil or gas is not, because the globalization of international business brings transparency and the primacy of commercial interests to policy. International summits and modern global media technologies are useful benefits of the globalization of technology and communication; but only if their message is controlled by the Russian state. Opportunities for great power partnership to address global security and political challenges such as transnational terrorism, proliferation, and trafficking are part of Russia's proper status as a great power member of the U.N. Security Council and the G-8, but the international community is not welcome to offer its views on whether Russia's elections are free and fair, or to play any role in the resolution of conflicts in the countries of the former Soviet Union. High profile international conferences involving leading Western scholars and policy figures are welcome in Russia, but Russian NGOs and civil society groups are suspect if they receive funding from international foundations.

The result is a foreign policy that is active but not expansionist, sensitive to asserting prerogatives but cautious in exerting Russia's still quite limited power. Most

importantly, it is a foreign policy based on a strategy of growth through international trade, but with the increasing role of the state in controlling the economy, society, and globalization's influences.

One effect of the great power focus of Putin's internationalist foreign policy has been the rise of geopolitics in Russian strategy and priorities. As essentially a 19th century European great power approach to security and diplomacy, Putin's foreign policy is more attuned to the value of regional bilateral relationships for their security, political, and economic value. While trade with any country is important if it increases Russian economic well-being, trade with regional powers such as China and Iran is all the more important for the political relationships it helps to build. While good relations with the United States is important as part of the Russian goal for membership in the World Trade Organization and the economic benefits membership brings, economic growth cannot trump Russian understanding of its need for strategic stability and security in Eurasia. Expecting Russia, for example, to trade close economic and political ties with Central Asia or Ukraine for WTO membership is fruitless, because both are high priority components of Russia's strategy for rebuilding and reinforcing itself as a great power.

Therefore, to understand Russian foreign policy in 2005, it is necessary to understand both the great power concerns and methods that form the overall objectives and strategy, as well as Russia's tangible experience with what is truly not merely a 21st century emerging-threat environment, but a real world immediate-threat environment. The Russian leadership understands and responds to 21st century threats in a great power and geopolitical framework in which the reestablishment of Russian power through economic growth and political relationships is paramount.

Specifically, Russia's approach to the foreign policy challenges of terrorism, proliferation, international criminal networks, and other aspects of the "emerging-threats" environment is geopolitical and filtered through the leadership's great power objective. This means that while Russia's concern about transnational terrorism is genuine, the concern is not only to prevent 9/11-type or Beslan-type attacks, but also to maintain its prerogatives to act with a high degree of autonomy in regions around its borders, not to mention with full autonomy within its borders. It means that while the Russian leadership has no interest in seeing countries like North Korea or Iran obtain or expand their WMD capabilities, it does have a very strong interest in both profiting from sales of technology to Iran and maintaining strong political relations with its leadership given the multiple political and security challenges in the region. It means that while Russia has little to gain from China's rise as a military power with potential designs on Russian territory or with the capacity to counterbalance Russian influence in Asia, it does have a very strong interest in selling energy and arms to the Chinese leadership, and in joining with China to try to balance United States influence in Asia and to insist that the United States live within the rules and constraints of international law.

In this context, the Russian leadership has unfortunately increasingly seen United States policies as part of the problem it faces in its objectives to establish itself as a great power with geopolitical advantages in an environment that looks highly threatening. Instead of viewing United States perspectives on the nontraditional nature of the "emerging threats" of transnational terrorism in Eurasia and the problem of proliferation as a genuine 21st century perspective, the Putin leadership views it through a geopolitical and traditional 19th century great power perspective and imputes that perspective to what, in the Russian view, must be the true basis for United States policies and actions. In this perspective, the establishment of United States political-military relationships in Eurasia, for example, is rooted not in an effort to respond to transnational terrorist and criminal networks that can intersect as well with proliferation vulnerabilities. Russian leaders assume a great power and geopolitical framework in United States policy, so instead they see the net of United States relationships in Eurasia as a form of neocontainment meant to restrict Russian power and influence.

Similarly, Russia's response to United States involvement in transatlantic efforts to support free and fair Presidential elections in Ukraine, in fall 2004, was related to its assumption that the stakes were geopolitical and related to its relative status as a great power, rather than accepting that United States policy was genuinely motivated by the United States belief that the establishment of democracies throughout Europe and Eurasia serves the long-term goal of undermining the sources of emerging threats—weak, corrupt, and failed states. There are other important reasons for Russia's self-defeating and failed policy on Ukraine in late 2004—not least the closed and nondemocratic nature of its political system—but in thinking about future United States-Russian interactions in Europe and Eurasia it is most important to understand (if not to agree with or condone) the Russian leadership's sus-

pictions that the United States is primarily motivated by a great power strategy meant to enfeeble and constraint Russia in its own backyard.

#### UNITED STATES POLICIES AND ENGAGEMENT WITH RUSSIA

Nothing in what I have outlined contradicts the importance of United States engagement with Russia. Russia remains one of the most important countries for the United States, as both a potential partner and as a potential challenge. The reasons for engagement with Russia are very well understood by the members of this committee, and by the United States Government. Securing Russia's active cooperation in coping with the multiple threats of WMD proliferation remains as vital as it was when the United States Congress created the Cooperative Threat Reduction Program with the leadership of Senator Sam Nunn and Senator Richard Lugar. Expanding Russia's energy production and participation in global energy markets will help to improve and diversify energy supplies. Cooperating for security and development in Russia as well as Ukraine, Georgia, Kyrgyzstan, and the other countries of the region is necessary for long-term global security. In the short to medium term, Russia's geopolitical location and its own interests mean that effective cooperation in counterterrorism continues to hold great promise for meeting what has become a prime security challenge of the 21st century.

None of this has changed, and with the ups and downs in United States-Russian relations it is too easy to lose sight of these fundamentals. National interests and geopolitical realities do not change that quickly, and a responsible United States policy will be best served by a commitment to a long-term strategy of engaging Russia in order to secure American security and economic interests in Eurasia and the region's global importance. Given Russia's importance in the region and its impact of vital global issues such as energy, proliferation, and terrorism, Russia must continue to be among the United States most important foreign partners.

The analysis, I offered above, matters for its implications on how to engage Russia, and for an assessment on how well Russia will be able to engage with the United States.

In the short term, the United States is confronted with engaging a Russian leadership that is quite internally preoccupied. A visit to Moscow results in long conversations with Russian experts focused on speculation about various scenarios by which President Putin may stand for a third term (considered by most not very likely), or the process by which his hand-picked successor will be identified and positioned to win in 2008. Speculation also centers on whether the results of the Khodorkovsky trial will create some stability in state-business relations, or whether the ongoing maneuvering for control of assets by key political figures will continue, further complicating the investment climate.

The United States is also confronted with a leadership that is likely going to be increasingly in a crisis management mode, because of the weaknesses of its government institutions for effectively managing public policy challenges, and the buildup of unsolved social and economic challenges. I have outlined the HIV/AIDS challenge, but it is only one among many serious problems that have not been dealt with effectively and which cannot be avoided for much longer. Others include Russia's crumbling infrastructure (roads, utilities, and public works systems), the unresolved reforms and modernization of the Russian defense forces, and the effects of underinvestment in education and the scientific-research institutions that were a backbone of Russia's relative economic capabilities, even through the difficult years of the post-socialist transition.

As a result, Russia's leadership is likely to be focused on internal challenges and short-term objectives in the coming years. That matters for the United States, because a longer term strategy and commitment is necessary in nearly every area the United States could and should seek cooperation and engagement with the Putin leadership. Accepting painful and controversial requirements for WTO accession, for example, requires a strategic focus on the long-term benefits of freer trade and global integration. That will be difficult for a Russian state that has proven itself ineffective in social reform. Cooperation in controlling WMD technology requires a long-term commitment in the face of short-term commercial interests in maximizing sales.

The challenge for the United States is to recognize the limitations on Russia's capacity as an effective state, maintain its principled and practical stand on the importance of democracy and human rights as a way to strengthen the effectiveness of Russia as a country, and to solve practical problems in the short term with a Russian leadership that views such a stand as a pretext for weakening Russia.

Under these circumstances, probably the best the United States can do is to continue to work on practical programs and policies with a proven record of successful

engagement, which means primarily cooperative threat reduction and related programs for professional exchange and training. It means engaging, and working with, those ministries and departments of the Russian Government that are interested in, and capable of, effective policy, including in counterterrorism, military exercises, and scientific research.

However, because of the limited capacity of the Russian state and because over the long run Russia will be successful, secure, and prosperous only if Russian society contributes to its country's programs and policy, the United States should not shy away from engaging Russian society and independent civic institutions. Although support for NGOs may be a sensitive issue for the Russian leadership, this is one area where it is important for the United States to take a long-term approach to engagement. The United States would do Russia no favors in bowing to the Putin leadership's views on centralization and the illegitimacy of independent thought and activities on the part of its citizens, because as I have argued that is exactly what is weakening Russia's capacity for effective policy and development. Russian NGOs, scientists, students, and businesspeople are eager for engagement and cooperation with the United States, on both official and nonofficial levels, and that kind of engagement, as we saw in Ukraine, has long-term beneficial consequences.

In sum, the United States needs to find a balance in its policies of holding to principles of the importance of democracy in Europe and Eurasia with the practical engagement in global economic growth and security cooperation with the Putin leadership. The United States needs to think in terms of a long-term commitment and strategy in its Russia policy, and avoid the cycles of excessive optimism through rose-colored glasses to lows of bitter recrimination and failure to appreciate Russia's challenges and limitations. The next 3 years will probably define the kind of Russia that the United States will be dealing with over the next few decades. Decisions on investment, health and demographics, and economic reform will define Russia's ability and willingness to cooperate reliably on the global stage. Trends in the past year are not promising, but Russia is not the Soviet Union of the height of the cold war. It is more open to the world, and has a sense of the benefits of global engagement, if not always the right answers on how to do so. Through a, consistent and principle policy, the United States can cope with a challenging Russia in the short-term while building on strengths in the relationship and within Russia itself for the long term.

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## THE BROOKINGS INSTITUTE-CSIS NEWS RELEASE

### RUSSIA & HIV/AIDS: STARK REALITIES; REASON FOR HOPE

WASHINGTON, June 7, 2005.—The HIV/AIDS pandemic in Russia has reached serious proportions and is at risk of becoming generalized. But according to a new joint Brookings-CSIS report released today, the important work of researchers and NGOs gives reason for hope, if the Russian leadership mobilizes in time.

The report, "Russia and HIV/AIDS: Opportunities for Leadership and Cooperation," (<http://www.csis.org/hiv aids/russiahiv aidsreport.pdf>), recommends that the Russian Government:

- Elevate HIV/AIDS as a national priority;
- Establish a comprehensive HIV/AIDS control strategy;
- Upgrade Russia's public health systems, with HIV/AIDS as a critical priority;
- Increase the space for the operation of NGOs, who sometimes feel marginalized; and
- Improve access to effective antiretroviral treatment.

The report, written by J. Stephen Morrison, director of the CSIS Africa Program and executive director of the CSIS Task Force on HIV/AIDS, and Celeste Wallander, director of the CSIS Russia and Eurasia Program, examines the findings and recommendations from a CSIS delegation that traveled to Russia in February. The delegation was cochaired by CSIS President and CEO John Hamre, and Strobe Talbott, President of the Brookings Institution, and consisted of scholars and experts.

The delegation met with Russian national and local officials, persons living with HIV/AIDS, United States officials, representatives of U.N. agencies active in HIV/AIDS in Russia, representatives of Russian and international nongovernment agencies (NGOs), Russian media, university officials, scholars, and experts. The report makes recommendations in two key areas, to the Russian Government and to the international community, and stresses the necessity of committed, high-level leadership to effectively address the threat posed by HIV/AIDS.

The report recommends that the United States, international organizations, and other members of the G-8:

- Identify how to best support capacity building in Russia and how to help sustain it;
- Support the Russian Government as it expands its leadership and financial commitments on HIV/AIDS;
- Strengthen nongovernmental organizations, which often feel marginalized;
- Ensure multilateral cooperation to secure the success of UNAIDS, Global Fund, and World Bank programs; and
- Collaborate with Russian medical professionals to share best practices and accelerate training.

In response to the role of the Russian administration, the report states that “If activated, the leadership can further enlarge the possibilities for significant achievements both in meeting Russia’s economic, health, and social goals, and on a global plane, in promoting a healthier world.”

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#### HIV/AIDS IN RUSSIA: BASIC FACTS

Number of officially registered HIV infected as of April, 2005: 313,000

Range of estimates of actually infected: 420,000 to 1.4 million

Newly registered in 2004: 28,391

HIV/TB coinfection cases (registered): 7,678

Change in IDU-related infections as percentage of total: Decrease from 93 percent (in 2001) to 63 percent (in 2003)

Change in heterosexual transmission as percentage of total: Increase from 4.7 percent (in 2001) to 20.3 percent (in 2003), to 25–27 percent (2004)

Distribution of newly registered cases of HIV by sex (2003): 62 percent male, 38 percent female

80% of those registered with HIV are between the ages of 15 and 30

Prevalence in the adult population: 1.0 to 1.2 percent

Fatalities from AIDS and AIDS-related illnesses by 2004: 13,722

Russian population 2003: 145 million

Russian population 2004: 144.2 million

Population growth: –.6 percent

Experts estimate that 50,000 HIV-infected Russians need treatment in 2005: 1500–2000 currently receive ARV treatment

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[Note.—The Brookings-CSIS report “Russia and HIV/AIDS: Opportunity for Leadership and Cooperation” was too large in length to print in this hearing. It will be retained in the permanent record of the hearing in addition to being available on the CSIS Web site mentioned above.]

The CHAIRMAN. Well, thank you very much, Dr. Wallander. I appreciate, as I’m certain all viewing this hearing do, the extraordinary depth of the analysis of our three witnesses. These have been extraordinary papers, and they will be of great use, not only to Members of the Senate and our staffs, but, I would think, to the general public. And we’re hopeful that distribution can be made. It would be helpful.

Now, I want to recognize the distinguished ranking member, Senator Biden, for an opening statement and/or initiation of questions that he may have.



Senator BIDEN. Well, thank you very much, Mr. Chairman. I'll withhold my opening—I'll ask unanimous consent that it be placed in the record; much of it will have been redundant now. And I appreciate the testimony of the witnesses, apologize for being here a little late, and I'll follow you in your questioning.

[The opening statement of Senator Biden follows:]

OPENING STATEMENT OF HON. JOSEPH R. BIDEN, JR., U.S. SENATOR FROM  
DELAWARE

Mr. Chairman, thank you for convening this hearing. I, too, want to welcome our witnesses and thank them for sharing their expertise with us.

Fifteen years ago this summer, we all watched with awe—and a bit of uncertainty—as the Soviet empire receded into history. At the time, we hoped that a vibrant, democratic Russia could rise from the rubble of the old Soviet Union and, for a while, such hope seemed justified.

Unfortunately, recent developments have brought an unsettling conclusion to that era of high expectations. The consolidation of political power in the hands of Russia's President, the declining independence of the judiciary, and the Kremlin's increasing involvement in Russia's energy sector are all causes for serious concern.

In recent years, economic growth has been a rare bright spot for the country. However, I am worried that recent Kremlin actions will eventually undermine this positive trend as well.

At a Cabinet meeting on June 16, Russia's Economic Development and Trade Minister said that capital flight from the country may reach \$7 billion this year. He also indicated that foreign investment, oil production, and economic growth are all slowing. At a time when roughly one out of every six Russians still lives in extreme poverty, the nation and its citizens can ill afford such losses.

No recent event in Russia has exemplified these disturbing trends more clearly than last month's sentencing of businessman Mikhail Khodorkovsky.

While Mr. Khodorkovsky rose to wealth and prominence amid dubious circumstances, by the time Russian authorities arrested him in October 2003, the oil company he headed, Yukos, had an outstanding reputation for good corporate governance.

In addition to introducing Western business practices, Mr. Khodorkovsky sought Western business partners. He used his wealth to fund a broad range of civil society projects and also provided financial support to political opponents of Russian President Vladimir Putin.

Mr. Khodorkovsky's backing of President Putin's political rivals, his close ties with Western energy companies, and his success as a businessman all seem to have been major factors in the decision by Kremlin authorities to go after Yukos and its leadership.

In the wake of the Yukos affair, the Kremlin's influence in the country's energy sector grew again last week when the government took a controlling stake in Gazprom, Russia's lucrative gas monopoly.

I am concerned that the timing of Mr. Khodorkovsky's prosecution, the declining independence of Russia's judiciary evidenced at his trial, and the government's efforts to gain control of Russia's energy sector are all moving the country in the wrong direction.

President Putin has used his control of Russia's broadcast media to portray these developments as a victory for Russia's citizens. However, in doing so, I fear he is creating a Potemkin village on a national scale.

In addition to Russia's pressing political and economic challenges, health problems are devastating the population and threaten to throw the country into a demographic tailspin.

Russia's current population of 144 million is likely to decrease by more than a third in the next 50 years and much of this decline will be due to rampant alcoholism and the spread of HIV/AIDS. Unfortunately, the Russian Government has been slow to acknowledge the extent of these epidemics and reluctance to confront health issues has diverted attention and funding away from the country's problems.

I want to conclude where I began, by invoking the great optimism that attended Russia's transition to democracy. I am not drawing attention to these problems with the goal of weakening Russia. If anything, the reverse is true. Now, as in the summer of 1990, I hope for the emergence of a Russia that is respected and prosperous. I hope for a Russia that can address its health crisis and become a real partner for the United States in promoting global peace and security. However, experience

shows these goals are unrealistic without the protection of political liberties, the strong rule of law, and judicial and economic independence.

Few countries can match Russia's history of scientific, literary, and cultural achievement, but history also shows us that the people of Russia will never fulfill their potential in the absence of basic freedoms.

We have all lived through dark decades of authoritarian rule in Russia, and I remember that period too well to stand by and watch as the country's leadership reverts to old behaviors. For that reason, I hope our discussion today can focus on how to help bring Russia closer to a free, democratic future. I look forward to hearing your testimony and ideas for how we can reach that goal.

The CHAIRMAN. Well, thank you very much. We'll proceed with questioning.

And let me begin by pointing out a topical item in the Financial Times today. It has the headline, "Russian Economy Loses Steam Amid Falling Oil Output," as the testimony today has either indicated or prophesied. But the 6-or-7-percent growth that we've been discussing was more like 5.2, at least in the current estimate. And worse still, for reasons that you have discussed, there does not appear to be any particular promise as to why this would pick up. The Russian authorities have indicated, and Mr. Zhukov is quoted as saying, that perhaps tax changes and stimulants in fiscal policy in Russia might be helpful; which, indeed, they might. But I'm wondering whether the tail-off that was indicated by your testimony, Dr. Verrastro, is already occurring, or whether this is just one of the blips in the charts, as opposed to being a trend, at this point.

Mr. VERRASTRO. Mr. Chairman, it's probably too early to call it a trend, but a lot of the symptoms that we saw in the eighties have come back; lack of new investment—and part of that's policy-driven. It's also acreage that's available. Russia's future is probably in the Siberian fields, in Sakhalin Island, and in the offshore. And, quite honestly, they need new investment. They need technology, especially offshore drilling and enhanced recovery technology. And they need a regulatory system that actually works to protect investors.

The CHAIRMAN. Now, how does that regulatory system fit with what Dr. Wallander is describing, as this internal-driven governance, without too much talkback from the outside—you know, conceivably, as you say, firms allowed to run their affairs, manage their businesses? The considerations you were just giving are more systemic, with regard to governance in the country, some management of the total resources. So, how do these issues intersect?

Mr. VERRASTRO. We think the policy's heading in absolutely the wrong direction, as Celeste indicated. The Russian economy, for the last 5 years, has been driven. The engine that's driving it is by oil and gas and export sales. President Putin certainly has realized this, and he has stepped back to reassert control. There is no private pipelines, on the oil side, in Russia. Transneft controls the monopolies, Gazprom controls the gas side. They need to step back and allow foreign investment. And we think that a lot of the production increases in the recent past were the result of what we call "step-out drilling." It's development drilling. You're not bringing on new resources; you're putting more wells in the ground, and you're producing for rate. And that will allow you to increase production in the short term, and take advantage of the higher price, but, over the long term, it just depletes your fields faster. And, I believe, for

every dollar increase in the price of oil last year, it meant \$1,400,000,000 to the Russian treasury. So, it was very price sensitive, and production declines will hurt them significantly.

The CHAIRMAN. Just following up one more oil question: What effect does this have upon foreign investment? Are foreign investors already so embedded in the system that they just suffer the consequences of having fixed investments?

Mr. VERRASTRO. Mr. Chairman, that's an excellent question. I spent 20 years in the industry. I was the senior vice president at Pennzoil before coming to CSIS, and we were in the Caspian and in Russia. And, in a lot of companies, once you have sunk costs it's very difficult to walk away from that investment. It's increasingly difficult when you look at the fact that 70 percent of the world's resources are now in the control of national oil companies. So, it's a place of where you can go to develop new reserves, and whether the terms are commercially attractive or not, and what's the alternative if you're a major company trying to replace reserves. And we've seen that in the case of BP and in Chevron and in Exxon. Companies are very reluctant to walk away, so you kind of suffer through. The industry byword has always been "contract sanctity." But, as a practical matter, the best deal you ever get is the first one you negotiate, and it goes downhill from there.

My sense is, though, that Russia needs the United States, as well. One of the basic policies that the Russians are looking for is to increase oil exports to the United States, as well as LNG exports. They need market entry, they need technology, and they need capital investment. And they're looking to do that with companies like Shell and Conoco.

The CHAIRMAN. Ms. Cloherty, you presented a lot of good news from investments that have occurred, from enterprising Russians, aided and assisted, perhaps, by the funds that you have managed. And yet, in the midst of this situation, you also pointed out the reforms that the United States has suggested, strongly, from the time of Ambassador Strauss onward, when he talked about the need for bank reform, for banks that look like, perhaps, banks in the rest of Europe, quite apart from the United States; or rule of law in the courts, certainly to title minority shareholder interests. All of these things were part of his agenda, which he regularly indicated. He was quite forceful. However, that was then; this is now—say, 15 years later, more or less. And as you're pointing out, the court situation, I think you've characterized, is chaotic. And the banks, certainly with considerable deficiencies, in terms of intersection with world banking. What kind of an investment climate does this make, not only for Russians, but for Americans who might think about going into Russia? I ask this on the basis of visits to Russia, where I have talked to business people. I remember one situation, a very interesting one—a man who had made money on the Chicago Merc. He was a risk-taker and interested in Russia. And he told me he had over 100 different investments in quite a variety of situations. The basis for this was, he had fully anticipated that through fraud and abuse, he would lose some of his money. Some of his investments would simply dissipate or disappear; but he hoped that by having a broad enough number of chances, that some of them might come home.

Now, most American boards and corporations of publicly managed firms do not have the luxury of what amounts to almost a lottery system of investment, as he was describing. How would you describe the approach a normal American business, large or small, might take to this situation?

Ms. CLOHERTY. Well, Mr. Chairman, he probably lives in Las Vegas. I don't know. We do not pursue that particular program. The—I must say, I suffer cognitive dissonance from sitting on panels with—Celeste, forgive me—political scientists. I mean, it makes me want to withdraw my own personal little millions that I put in Russia. But the—I mean, I'm an actor there, and I see the change. I mean, I've been there since the early nineties. The mid-1990s were chaotic. Speculation was rampant. Carpetbaggers were everywhere. And the ruble had to be devalued, which it was, when the—the debt default occurred, in August of 1998. Since then, companies—import substitution has been occurring apace. I mentioned the new breed of managers that are coming on. I think it is terribly important for Russia to diversify its economy. We had the great advantage, in the United States, early in our history, of having people like Abraham Lincoln look across a vast wealth, the fertile land of the Nation, and saying, "There must—we cannot be a commodity country; we must provide an incentive to invent, whether it's for increased productivity in animal husbandry, farming, mining, or all kinds of inventions, from the—with the book, "From the Steam Engine to the Search Engine." Russia does not have that. And I think for them to become wholly dependent on oil would be inappropriate.

I also, as a—almost a detailed matter—do not believe a lot of the government statistics. I think they have no means of tracking the diversified economy. I think that is not in the numbers. It's, like me, in the venture capital business for the past 35 years, I never backed a company that had an SIC code, just didn't exist. Now, the fact that it became the world leader in HIV protease inhibitors, worth billions, is a whole other matter. It just couldn't be tracked.

And so, I think there is, in the investment program, let me say, the early years of our fund, the proposals for investment were all fruits of a military economy. They were rocket launchers, satellite launchers, deicing aircraft wings, what have you. I mean, now its chains of apparel stores, chains of supermarkets, which are new to Russia. These are all new.

From the standpoint of our investors—and I just closed a fund in—a private one—USG is in, also, as a seed investor in that fund. The investors are—it's led by General Electric Pension Trust, not foolish people. They are investing. It has people like George Russell, from Frank Russell Associates, money management, in Tacoma. And it has a Russian group. In any event, the—and the way that has gone from the first—this is a year-old fund. The investors of each dollar committed to the investment put up 52 cents, and, within the first year, got 96 cents back. That just is not terrible. I mean, they are almost off risk within 12 months.

So, I kind of look at—I mean, I—the macro is helpful. It so depresses me, I think I ought to withdraw my investment. But we're making—we're doing too well. There's not a company in our portfolio—there's 19 companies right now, in two portfolios—only two

companies of those are experiencing less over the last 3 years than high, double-digit rates of growth. The two that are not is one financial software company, whose primary market is the United States. It's growing at a rate of 2½ percent. And the second one is a hotel, where you have only so many boxes for people to sleep in. And so, that can't grow. But all of the other ones, it is astonishing.

And—Celeste and I were talking about this before—if there's one area of real opportunity in Russia, which is not being commercially developed now, that is in knowledge-based industries. And that is the absence of intellectual-property protection. But, in those areas, are—you know, buried in some of the Russian research labs is very important intellectual property, most notably in the life sciences. And it's extremely difficult to tease out and invest, when you cannot be assured of a chance at IP enforcement in world courts. And that happens to be my own particular area of specialization. We are mounting a scientific investment group, consisting of myself and two Russian scientists, and we are determined to break the back of that issue.

Just one final comment, because I am going—I'm in a business that is predicated on change. That is, the venture business. And the key is to use all of your wits to make the change work for you, undaunted by obstacles, or, preferably, getting rid of them. And, I mean, over the years, that is how small American companies took on IBM and ATT. And if they said it was just too difficult to start with, then you just hang it up. But if you say, "We know there's a way to do it"—and that's what we do with our small amounts of money, recognizing the negatives. But, to me, they're just, sort of, Everests to climb.

The CHAIRMAN. Let me just ask one more question of Dr. Wallander. The expertise of this panel, and the extraordinary depth of your experience, is truly remarkable. I'm fascinated by what you're saying, as I'm certain other Senators are. Let me just ask you, Doctor Wallander. You presented a very grim picture of the AIDS business, on top of a declining population trend. This is a very sizeable country, a very strong country, which you pointed out. But you suggest that it might be diminished by as much as 20 percent in its population in the course of 20 years or so, and with a central government that's not intersecting very well with others, but perpetuating itself, worried about authority.

Let me superimpose on this a question totally from the outside. What is the position of Russia with regard to the WTO? What should be the position of the rest of the world? And if not the WTO, how can this kind of country work with other countries in the so-called sharing? How do I obtain a good bit of transparency or trust or adjudication of disputes? In other words, will it be a factor in globalization, in a broader sense than simply the export of energy resources?

Ms. WALLANDER. Thank you, Mr. Chairman.

Yes, the Russian policy on WTO is that officially—and, I think, genuinely—WTO membership which was supposed to be this year; it's looking like it might be, at best, next year—is a priority goal of the Putin leadership. They have been engaged in—they succeeded in agreeing with European countries about the terms of its

accession, and they're now engaged primarily with the United States in those negotiations. And the key questions remain in the area of things like intellectual-property rights, and in the area of internal subsidies for different industries—not only energy; also steel and different industries. And I think that the delays, themselves, are indicative of the problem, which is: To be able to negotiate to world standards on those issues, someone's going to have to lose, inside Russia. And, increasingly, those who may lose inside Russia are those who are actually in the government, in the leadership, themselves. And so, the need for transparency, in particular, in gas—in the natural-gas industry, but also in other areas of the energy industry, is something that is a—it's tough to give something away that you're holding or you're acquiring at the moment.

I wouldn't necessarily argue that there won't be a successful negotiation of those terms in the next year, given how important WTO membership is to Russia's future. But I think that that points to the key aspect of your question, which is: What should the outside world do, or how should the outside world view this? And I think the outside world should view this as, Russia, like any other country, shouldn't get a free pass on membership. It's important for the United States to be a member—for Russia to be a member of the WTO, but it's important for the United States for Russia to be a qualified member of the WTO, one that meets the agreements, meets the standards. Because it's not being a member of the WTO that makes you prosperous and able to integrate in the international economy, it's negotiating those terms, it's creating the transparency, it's creating a better investment climate, it's learning how to operate on international markets, it's being willing to submit disputes to a World Trade Organization process to adjudicate those.

Those are the things that we can give Russia—expecting it to live up to great-power standards in being a member of the WTO, and that should be the focus of the United States, not ideas that, “Well, Russia's too important to let fail.” Russia is important, and it's important not to let Russia fail, so we have to help Russia meet those standards so that it can continue to move to a higher level of participation in the international economy.

The CHAIRMAN. Thank you.

Senator Biden.

Senator BIDEN. How do you do that? I listened to your testimony, and just listened to the answer to your question, and, speaking of cognitive dissonance, I don't get it. In the picture you painted, what possibly can the United States do in the next year that will, quote, “help Russia” meet the qualifications, the standards, necessary for WTO, unless they have a blind eye and pretend that things are happening that aren't? Both you and your colleague have indicated that this is a black hole. No pun intended. There's no transparency, or virtually no transparency in major industries and there's confiscation of assets. So, how do you get there?

And then, Ms. Cloherty, I'd like to know what your largest investment is. I don't mean—just the amount, not where or what company, but, I mean, what kind of dollars are you talking about, in terms of investments? It's one thing to walk into a lot of countries and invest in relatively small enterprises that are under the

radar of the government, that actually can make money and grow; it's a very different thing talking about the kinds of enterprises that your colleagues have been talking about.

So, my two questions are, number one: Doctor, how do you get from where you said Russia is to being able to, quote, "help them" in the next year, in light of every action Putin seems to be taking, which seems to be counterintuitive to what you're suggesting? That's the first question.

Ms. WALLANDER. I think the way to think about it is, right now the Russian leadership is too focused on dividing an existing pie, or redividing an existing pie, in both political terms and economic terms. There's a moving around of the assets. They need to be focused on—they need to be encouraged to recognize that there's more promise in—

Senator BIDEN. But, Doctor, how do you encourage them? I'm just a plain old politician. How do you—you're Secretary of State, and you're advising President Lugar, here, how to encourage it. How do you encourage that? I think you're brilliant, but you sound like you're from the State Department. It's very compelling what you say, but there's no meat. How do you do it? What is the recommendation to President Lugar as to how you do what you're suggesting? Give me something concrete.

Ms. WALLANDER. There is greater—although I've described the Russian political structure as nontransparent, and so on—there's diversity of interests and arguments within the leadership.

Senator BIDEN. Right.

Ms. WALLANDER. For example, it is interesting that Minister Gref and Minister Kudrin are both still in the leadership, and still primarily responsible for macroeconomic and financial policies. Those are the partners to speak to within Russia to create incentives and leverage within the Russian leadership, the marginal arguments for negotiating WTO membership, the reasons for negotiating the kinds of agreements necessary.

There are individuals within the Presidential administration, the Kremlin administration, as well, who seem to "get it." It's just not clear how influential they are and how often they get the ear of President Putin.

So, speaking to the individuals to "get it," reinforcing their arguments, and making their arguments credible, and appear to be successful, were they to be pursued, as well as speaking as frankly and as often to President Putin, himself, I think, is the only hope for waking up the Russian leadership to the opportunity that it's about to lose.

Senator BIDEN. But to wake up to the opportunity, they've got to give up part of their grip. They've got to open the fist and actually be a little more dexterous. And that seems counterintuitive, based on the way they're going.

Ma'am, what is your largest investment, in terms of dollar amount, in a particular company or—

Ms. CLOHERTY. Well, Senator Biden, in my business that is—forgive me—is not relevant. It's what it's worth at the end.

Senator BIDEN. I got what it's worth—

Ms. CLOHERTY. Five million in, and a hundred out, is better than a hundred in and a hundred—

Senator BIDEN. No, no, I'm not stupid, ma'am. I understand that part. I got that. You know what I mean?

Ms. CLOHERTY. Good.

Senator BIDEN. But, I'll tell you what, there's a difference between investing a hundred million in and investing five million in, in terms of your degree of confidence in what you're investing in, and the size of the enterprise. All I'm trying to figure out is, what are the size of the enterprises you're investing in, in your hope and expectation that they quadruple or, you know, ten times—increase tenfold. What is—what are the size of the enterprises?

Ms. CLOHERTY. The—

Senator BIDEN. Because my observation in the past, if I may continue just for a second, is, whether you are talking in some Asian countries, and smaller Asian countries in, you know, microinvestments that—

Ms. CLOHERTY. No.

Senator BIDEN [continuing]. Or whether you're talking—in Eastern Europe, in the beginning, when we started this process, in 1993, we were focusing on smaller investments in areas that, quite frankly, were under the government's radar. There wasn't a whole lot of focus. There's a whole lot of focus by Putin on Gazprom. There's a whole lot of focus by Putin on these mega-industries, only really one, that they seek to control, for a whole range of reasons. There may not be.

What I'm trying to get at is: Is your success related to the fact you're under the radar, or is your—and I know you're brilliant, and I know you make a lot of money, and I know all that—but my point is that if you're under the radar, as opposed to being engaged in investing in those enterprises that the former vice president of a large energy company found himself shackled with, when you make investments? That's the essence of my question.

Ms. CLOHERTY. I understand. The—we are under the radar scope, from a size standpoint. I think the—but the reason we are in the segment we are, is that the natural-resource base is too capital intensive. It is not—in fact, we've done financial institutions; they are not logical for the kind of capital that we represent.

Senator BIDEN. No, that make sense. I'm just trying to deal with the cognitive dissonance here.

Ms. CLOHERTY. No, no, I—

Senator BIDEN. That's all—

Ms. CLOHERTY. No, I—

Senator BIDEN [continuing]. I'm trying to figure out here.

Ms. CLOHERTY. Yes, I understand that. The—I guess we do a couple of things. First, it's interesting to me, from a policy standpoint, that the—in truth—the public servants in Russia do not know, nor do they have any reason, from their own experience, to know the entire policy fabric that goes into creating an entrepreneurial economy and risk-capital flows to it. They ask me for counsel on that, because it really involves everything from how they evolve their institutions for aggregating and deploying savings and pension assets. It has to do with rules in the financial markets and disclosures, has to do with transparency. It even has to do with bankruptcy laws. We work very closely with a group called OPORA, which is an association of growth companies, that basi-



cally—and it's very interesting—they have a hotline for business people to report predators in the bureaucracy, so that you can tabulate, every year, who's the biggest crook in the tax—and this is a rather courageous act—and this is reported back. And Mr. Gref takes a great deal of interest in these kinds of regulatorially related things.

So, we have been working with them in filling out that policy fabric, including this area I mentioned, on the intellectual property, because it is—has always been my view that the majors, notwithstanding oil, aluminum—because we do deals with the various oligarchic groups, in basic elements and others—but holding those aside, it is our objective to figure out the wealth-creating formula, whereby that which is resident in the Russian brain becomes a more valuable source of capitalizable value than an oil well.

Senator BIDEN. Thank you.

Last question, Mr. Chairman, if I may.

Doctor, I understand Dr. Feshbach is a colleague of yours—or you've worked with—and I found the statistic, I think produced by him, somewhat startling, looking out to the year 2050, in terms of population declines. I believe this is his work. He indicated that the current population of 144 million Russians will decrease to between 77 and 100 million by 2050, and a significant portion of that decline will be due to rampant alcoholism and the spread of HIV/AIDS. Russia and Ukraine have the fast-growing rates of new AIDS cases in the world. If current trends continue, between 5 and 14 million Russians will be living with HIV in the year 2020, and that infection rate would result between a quarter of a million and 600—or 250,000 to 650,000 annual deaths from the disease. Is that accurate, to the best of your knowledge? Or, do you agree with those statistics?

Ms. WALLANDER. I do. Dr. Feshbach is a recognized expert. And, not only that, he is a legitimate expert, because he was looking at this long before it became interesting to the broader population. So, I think that those are quite solid numbers.

Senator BIDEN. I thank you.

The CHAIRMAN. Senator Murkowski.

Senator MURKOWSKI. Thank you—I thank you for the hearing this morning.

Our Russian neighbors are about 3 miles from us in Alaska; so, we pay attention to what's going on, and the U.S. policy as it relates to our neighbors there.

I want to ask a few questions this morning about energy. As you know, we're focused on developing a national energy policy for this country, something that I feel has certainly been long overdue. So, it's interesting to understand your comments this morning, Mr. Verrastro, as it relates to Russia's production levels, your comment that sustained production is not a certainty, citing, apparently, to the lack of investment and the lack of predictability, essentially, for those that are looking to develop in Russia, and Russia's policy of not encouraging new production. I was not aware of this—of the Russian export duty and how that operates.

How does this export duty—or, how will this affect the oil pipeline that is being built from Russia to Japan, possibly a spur to

China, as well? How will this work as it relates to that specific project?

Mr. VERRASTRO. I think there's a question that—in terms of policy, there's two things going on. One is the desire, while you have the leverage and with higher prices, to gain economic rent, if you will, and take advantage of the higher prices. There's a second issue, in terms of Russian policy objectives with respect to energy. And, going back to Celeste's fist and five fingers, I would just argue that I think two components are to expand LNG sales to the United States in oil shipments, but also to look to the Asian market. And it's just critically important. You know, Bob is familiar with me saying that when we look north, we see Canada. Well, when China looks north, it sees Russia. So, there's a logical nexus between those two countries.

But, in terms of pipeline distances that have to be built, these are multibillion-dollar infrastructure projects, and they're railing some 200,000 barrels of oil a day now, which can't be economic. But, just to look at it as a growth market.

So, in terms of Russian policy, on the one hand it's to gain the advantage of price and increase the revenue for the state; on the other hand, if you look a little bit longer term, you have to look at LNG exports and oil exports to the United States, increased gas exports to Europe, and then also opening up corridors to Southeast Asia and to China.

Senator MURKOWSKI. So, what is Russia doing with regards to encouraging the predictability, encouraging that investment that will be so necessary? You know, Exxon had come in, not too long ago, negotiated a contract over in Sakhalin, and that has been canceled. What incentives are there for foreign companies to come in and provide this level of investment? What is Russia doing to encourage, or to help facilitate—

Mr. VERRASTRO. Yeah, I think, in terms of Russian policy, there is no positive at this point. Companies will invest there, (a) because they have no place else to go, or they have sunk costs already in country. And when they look to replace reserves, they can book reserves in Russia because of the substantial resource base. So, you don't want to not be there, but in terms of economic incentives, as I indicated, I think they're heading in the wrong direction. Now, it may be a short-term phenomena to just take advantage of the higher prices and increase revenue stream, but eventually it's going to catch up. A lot of the increase in production that we've seen in the last 3 or 4 years was literally a result of infield drilling or step-out drilling. It's not developing new fields. And their future really is in the offshore—in the Bering Sea, at Sakhalin Island, and in Siberia—and that will take massive new investments, new technology, and new partners. And—

Senator MURKOWSKI. And if—

Mr. VERRASTRO [continuing]. Unless they're willing—

Senator MURKOWSKI [continuing]. If companies—

Mr. VERRASTRO [continuing]. To free up, it won't happen.

Senator MURKOWSKI [continuing]. Though, are looking to make their investment matter—

Mr. VERRASTRO. Absolutely.

Senator MURKOWSKI [continuing]. They know that there's no predictability, no reliability, coming out of Russia, they're going to look elsewhere before they make that effort to put more into their project, whether it's in Sakhalin, or wherever.

Mr. VERRASTRO. That's absolutely true. The question is: What are your alternatives? I mean, we see people investing in Venezuela, currently; and they've increased the royalty rates, as well as gas taxation rates. In Kazakhstan, they've changed the terms of some contracts, but there's only a few select places in the world that have the potential for increased production—

Senator MURKOWSKI. So, do you think that—

Mr. VERRASTRO [continuing]. The amount of exports—

Senator MURKOWSKI [continuing]. That Russia is looking at it from that perspective, saying, "They don't really have many other options, so we don't necessarily have to do much here."

Mr. VERRASTRO. I think that's right.

Senator MURKOWSKI. "We don't have to do anything to encourage it, because there's really no place else for anybody to go"?

Mr. VERRASTRO. I think, Senator, at this point, there's a lot of host governments that think they have leverage right now, and they'll extract whatever they can, in terms of contract terms of ownership rights or additional taxes. And until that situation changes, quite honestly, they're in the driver's seat.

Senator MURKOWSKI. And you're not—are you willing to gaze into your crystal ball and give me a determination as to how long that might be?

Mr. VERRASTRO. I think if you look out the next 2 years and see how steep the decline rate is, and that needs to be corrected, that may be one of the things, whether it's with HIV/AIDS, that the problems get so immense and the revenue streams look like they're changing, that it forces you to do something different. But, in the current climate, I've got to tell you, at \$55 oil or \$60 oil, you can ride the upside just on price, and keep your production level, and still benefit year to year.

Senator MURKOWSKI. So, you think it's probably those other impacts—perhaps the social impacts to the economy, not necessarily what's happening in the energy sector, that can—

Mr. VERRASTRO. May drive it first.

Senator MURKOWSKI [continuing]. Ultimately drive it.

Mr. VERRASTRO. Yes.

Senator MURKOWSKI. Yeah. What about environmental standards? Is there any movement to upgrade or to really take steps toward environmental safeguards, when it comes to energy production?

Mr. VERRASTRO. I think the best option for Russia, as for most of the Caucasus in Central Asia, was investment by Western companies. And what they brought with them, even though there were no environmental standards to speak of, was Gulf of Mexico or North Sea standards. To the extent that you don't require that, you'll see pipelines that don't have the integrity, or production platforms that have less environmental restrictions.

Now, going back to the World Trade Organization, this idea of Kyoto, and Russia's participation in Kyoto, it'll be interesting to see how they play that. If you take the base year, given the decline in

consumption, they're already below it, so they have tradable credits. But if increased pollution occurs, they're going to find themselves in the same boat as everyone else.

Senator MURKOWSKI. But, once again, you think that their situation is such that, if you don't have anyplace else to go, they don't need to focus on the environmental safeguards or standards.

Mr. VERRASTRO. I think it's a—

Senator MURKOWSKI. It will be external forces—

Mr. VERRASTRO [continuing]. It's a lower priority for them right now, but it's got to be gaining, in terms of importance. We've seen the same thing in China. If you talked to the Chinese 5 years ago, it was economic development, employment, and security; environment wasn't even on the top-ten list. But if you've been in Beijing anytime recently, you know that it's got to be a stronger consideration. So, that's coming, as well.

Senator MURKOWSKI. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Well, thank you very much, Senator Murkowski. Senator Obama.

Senator OBAMA. Thank you very much, Mr. Chairman.

Thank you for—the members of this panel. I apologize for coming in late. So, I may end up asking questions that have already been asked. If so, I apologize.

I know that one area of interest for this panel is the issue of Russia's shift in—fits and starts toward a market economy. And I am interested in how the three of you see what appears to be contradictory trends. On the one hand, an aggressive move toward the market sector, in some areas; at the same time, President Putin seems to be cracking down where he thinks that the market is creating competition for his power base. And, obviously, we have—you know, we're not expecting the same levels of transparency or respect for private property that we might have attained over the course of 200 years here in the United States. Having said that, it does seem that the trends are—have been moving in the opposite direction.

I suspect this is something that's already been touched on, but if somebody wants to just give me a sense of how—where we're at right now, and how the United States could most usefully intervene, in encouraging a movement toward—continued movement toward transparency and rule of law in how the economy operates.

Ms. WALLANDER. Thank you, Senator. This also—it wasn't quite asked this way, but Senator Biden referred to “cognitive dissonance” he was experiencing between Patricia's discussion of investment opportunities and my discussion of a sobering political situation. And I think the cognitive dissonance is resolved by your question, exactly, which is that you—foreign investors and Russian investors can make money in the Russian economy. There's a lot of exciting stuff going on in the consumer—especially in the consumer sector, in different smaller sectors of the economy.

Where the problem comes, in terms of the role of the state and the activities of the Russian leadership, are in the big sectors, the strategic sectors, the sectors that are important for a large portion of the Russian economy, and also that have implications for Russia's foreign policy and for its power, and that's where energy

comes in. Energy is not just a growth sector; energy is a foreign policy—is foreign-policy leverage. Foreign—energy gets you attention from the United States, from China, from Japan, and so on.

Arms sales are not just about profits, although they're there for Russian industry, as well, it's about—it's maintaining a base in the Russian economy so that, when Russian military reform, someday, ever gets done, and the Russian military is able to rebuild itself into a modern military, it has a defense industrial base left to work with.

So, the dissonance comes between what is, as we talked about, under the radar screen—under the radar—small enterprises, enterprises that are not in what the Russians think of as strategic sectors, versus those that are larger, that have more importance, from a political point of view, and for an ambitious Russia that wants to play a role in the world as a great power.

Senator OBAMA. Does that mean that we can anticipate, sort of, a two-tiered economy in which—or a carve-out—where these strategic areas are going to be tightly controlled, essentially nationalized, and, beneath the surface, or outside of those carve-outs, you have a functioning free-market economy? Is that, sort of, what we should anticipate and strive for? Or do we—or do you think that we will never arrive at the kind of free market that we need, so long as those particular sectors, strategic sectors, are so tightly controlled that they end up infecting the rest of the economy with, sort of, old-style command-and-control approaches?

Ms. WALLANDER. Yeah, I think we're seeing the emergence right now, in the short to medium term, of that kind of two-tiered economy; and we're seeing a little bit of the emptying of the middle. One of the reasons—or the main reason for the decline in Russian growth rates in the last year is that Russian industry, heavy industry—the manufacturing industry—is failing because of the appreciation of the ruble, because of Russian exports. And so, the consumer sector is doing well. The energy sector is doing well. And all the stuff in between, other than defense, is disappearing. It can't compete, internationally, or within the former Soviet space.

But I think that it's not a stable equilibrium, that a two-tiered economy doesn't work in Russia, partly because the country is too well educated, people are too well educated, and you will get ambitious entrepreneurs, who work with Patricia and do extremely well in their sectors of the economy, and they want to do more. You know, they have this experience, and they want to do more. They want to grow the economy larger. They want to see an integrated Russia, not just merely, you know, their very successful factory in their town. And so, I think the political implications of the strategic sectors, and state control in the strategic sectors, doesn't work with a market economy that's working on a lower level, over the long run. And that's the challenge—more for Russia than for us. But it is part of the challenge for us, because I think the Putin leadership would like us to accept that kind of two-tier approach. And I don't think we're doing Russia any favors by letting them think it'll work.

Senator OBAMA. So, in terms of what we would—in terms of our foreign policy, what would be some of the steps we could take to encourage better integration across the board here? Another way of

asking it, I guess, is: Is Putin paranoid, or is his assessment accurate, that if he lets go of the reins on these strategic areas, that that potentially undermines his own power base, over the long term?

Ms. WALLANDER. I've already done this. I will just observe that I think—I don't know if he's paranoid, because I am a political scientist, not a psychologist, but—

Senator OBAMA. Well, do you—

Ms. WALLANDER. Yeah. No, I know.

Senator OBAMA [continuing]. Understand what I'm saying? I guess—you know, another way of putting it is, people who are paranoid may actually have enemies. [Laughter.]

Ms. CLOHERTY. Can I comment?

Ms. WALLANDER. But I do think, unfortunately, that the Russian leadership has overlearned the lessons of the late 1990s, the dangers of lack of control—that the late 1990s was important, and it was a tragic set of developments for the Russian people, but the solution to the crash of 1998 wasn't the degree of state control, that they had asserted. Sorry.

Senator OBAMA. Ms.—

Ms. CLOHERTY. Yes—Cloherty—I think he probably should be paranoid. This is a very Shakespearian situation over there, and the—but I think to portray it as two-tiered is too rigid. I think that there is a retrenchment going on, and it—in many ways, it is a—both an economic and politically tactical retrenchment. The first—Mr. Putin's first term, from the standpoint of the economy, was characterized by truly major reforms, steps to reform the banking system, the change in the tax rate, individual and corporate tax rates, and a whole series of those, plus regular statements regarding diversification of the economy—remember, the plan to achieve the GDP of Portugal in 10 years. And so—now, in the second term, with the events such as Ukraine intervening, and others, they got a bit derailed, and the administration—reform of the administration, of government, has gotten bogged down. And it is imperative—because I do think that a problem with the Russian Government is not that it is overarching and reaches everything; I think it is weak. It, many times, looks like the gang that really couldn't shoot straight. We had the—they don't hear markets and they have no reason, from the history to do so, but when there was a mini run on banks last fall, the deputy head of the Central Bank made statements that made it worse, so that offices, such as my own, were vacated by the employees, who were running to withdraw their money from the banks. So, they don't hear the markets. I mean, Mr. Greenspan can speak for 2 hours, and no one knows what he's saying; so, markets don't move. And so, they don't have that—yet—that capability, but what I do—I will say this, because I think they will retain some control on certain strategic areas, sure, and regain control—that was the Yukos thing—as an example to the other centers—in aluminum—and the other people.

But, in the meanwhile, what is happening is, the private market is developing. And I reiterate something I said earlier. After the fall of the Soviet Union, you had a country where every single person had to become an entrepreneur. I'm not talking disciplined entrepreneurship; I'm talking often crooked entrepreneurship. But

survival was at issue. People traded whatever was there to be traded—chocolate, cigarettes, whatever.

And so, now there's another generation coming along, and with—and they are, sort of, push—there's a push and a pull—they're pushing the process. There have been more IPOs in the Russian stock market in the last 18 months than there were in the previous 8 years, and—because companies are raising capital. And these are not ones that are going to be permanently small; they are going to be ones that have legs and can grow and achieve billions in values.

So, I think it is happening. I think that the policymakers are trying to shape the concept of the fabric of policies that can make that work. But everywhere you look, there's more to be done.

Senator OBAMA. Mr. Verrastro.

Mr. VERRASTRO. Senator, if I may make one comment and echo some of the sentiments that have been expressed here.

I think, in terms of energy, energy is a strategic commodity, and it's recognized as that. It's not only a revenue stream for the government, but it allows them to play a geopolitical role in the region, and especially at this time, when energy is in short supply, both oil and natural gas.

Second, to recharacterize the Yukos affair, I—part of it, I think, was political. I think it was a policy-driven issue. But one of the lessons learned was process. And, where Exxon might have gone, you know, to Khodorkovsky and talked about investment in Yukos, Conoco went to the Kremlin first, got it blessed, and then made their investment in LUKOIL. So, it didn't totally freeze investment at that point. You just approach it in a different manner.

Senator OBAMA. Right. Just on the energy issue, to pick this up—and, again, this may have been answered before—I am curious, given the scope of the energy sector in the Russian economy, and the degree to which hard currency is obtained as a consequence of the energy sector, is that money being used wisely in order to—is it being reinvested in, first of all, the energy infrastructure, itself; second, to branch out and diversify the economy in some fashion? I mean, is there any planning process, or is it basically being used just to subsidize the existing economy, and to prop it up?

Mr. VERRASTRO. I'd say the answers are no, no, no, and yes.

Senator OBAMA. Okay.

Mr. VERRASTRO. It's a situation where there's not a lot of investment being put back in the fields at this point; it's just extracting additional production. The government, in terms of centralized control, decides what to do, certainly with the tax revenue and the export tariffs. We have not seen any sense of going out and trying to encourage new investment, change taxes or royalty rates, bring on new partnerships. So, in that sense, at least at this point, I would say that it's revenue driven, and it's a strategic commodity.

Senator OBAMA. How sustainable is that in the long term?

Mr. VERRASTRO. I don't—

Senator OBAMA. Or, let me ask you a different—even just within the energy sector, itself, is that a sustainable model? Or are they just—are they going to strangle the goose?

Mr. VERRASTRO. I agree. I think it's short-term gain for long-term pain, unless you remedy the situation, not only in infrastructure on pipelines, but also on reworking some of the old fields.

Senator OBAMA. Are there technocrats within the economy that—

Mr. VERRASTRO. That understand that?

Senator OBAMA [continuing]. That recognize that?

Mr. VERRASTRO. Yes, I think so.

Senator OBAMA. But they just—their voices, right now, are not prominent.

Mr. VERRASTRO. I think their voices aren't prominent, and the way they're approaching it is somewhat piecemeal. It's been expressed that if you can bring in some minor investment and new partners with some technology on a limited basis, you can forestall a dramatic decline.

Senator OBAMA. Right.

Mr. VERRASTRO. And that, kind of, remains to be seen.

Senator OBAMA. Okay. And, on the energy sector, as well, the—

And I know we've got a vote coming up, but, Mr. Chairman, is it 11 o'clock? So, the—I'll wrap up in a second.

What arrangements are being—how is this impacting the Sino-Soviet relationship? Obviously, China's huge hunger for energy—the Soviets are a geographically—

Mr. VERRASTRO. Proximate?

Senator OBAMA [continuing]. Proximate source for that energy. How is that shaping up right now?

Mr. VERRASTRO. As I indicated earlier, Senator, I—we think that the global energy market on the map is shifting, and it's shifting east. In the past, when the United States, for example, as the largest consumer, needed heating-oil supplies or gasoline-blend stocks, we could get it from Europe, or we could get it from Latin America. Now we have another major competitor out there—and, soon, maybe two, when India steps up—that are willing to put money on the table, do deals, and maybe engage in bilateral discussions with governments offering arms sales—diplomatic benefits that companies, private-sector companies, can't offer. If you look at that region, the intent 5 years ago, even with the BTC pipeline, was to look West, to the Europe and United States markets. We had just come off the Asian recession, and China hadn't yet emerged, as a major energy consumer, with new development. And if these pipelines were to be built today, I see, increasingly, the options to go south, toward Iran, integrate and if these pipelines were to be built today, I see, increasingly, the options to go south, toward Iran, integrate supply and demand within a region, and, certainly, for the Russians or the Kazakhs to provided increased energy supplies to China.

Now, there's enormous infrastructure constraints when you start building a pipeline from the Russian border to a Chinese consumption center. That's thousands of kilometers. So, these are multibillion-dollar investments, and it won't happen overnight. But you can see the Chinese, whether it's in Canada or in Venezuela, looking at additional sources of production—or Sudan or Iran—and it's diversify their supply.



Senator OBAMA. A final question, and I'll direct this at Ms. Wallander, although if any of you want to chime in, please feel free.

You know, on this committee, the issue of proliferation is something that takes up a lot of our time. Our chairman, I think, is one of the foremost experts, and has done more constructively in this area than just about anybody. And, you know, Russia obviously has an important relationship with both Iran and North Korea, or at least has potential influence in those two areas. You know, Russia's been involved in Iran's nuclear program. And we know that. They're, potentially, part of the six-party talks with respect to North Korea, and could have some influence there. And, obviously, they're still on the Security Council.

Can you just talk a little bit about how we have used our relationship with Russia, in a constructive way, around those proliferation issues? And the—have we been as adept as we should be in using both carrots and sticks to advance our strategic interests in these areas of proliferation with Russia?

And I guess the last part of that question would be: Do we have to sacrifice our concern for human rights issues, democracy issues, if we're going to get progress on those fronts, or are there some other levers and buttons that we can push? Big question. Two minutes.

Ms. WALLANDER. No problem. [Laughter.]

Russia probably doesn't have an awful lot of leverage on North Korea. China's more important. So, we'll use Iran as our test case.

United States/Russian cooperation on Iran is probably—maybe this is a bad statement on United States/Russian relations, but I think it's been better than I would have expected. The willingness to seriously engage Russia on the issues of working out and addressing concerns about Iran's legitimate—at least under international law—interests in peaceful nuclear technology, which is the Russian position, has evolved toward a greater engagement with the United States to talk about the political incentives which might be leading an Iranian leadership towards seeking nuclear capabilities. The Russians have shown themselves willing to negotiate modifications in how the nonproliferation regime works—so, say, to require the return of spent fuel, and to make that part of their commercial deals with Iran—which I wouldn't have necessarily guessed, that they would have been willing to go down that road.

So, I think that the lesson, so far—and we're still in the middle of the story—the lesson, so far, is that engaging—Russia has its own interests on Iran, commercial interests and political interests. I don't think that Russia has any interest in proliferation. And Russia, in fact, has a strong interest in nonproliferation. But we have to manage those commercial and political interests, as well, and the nonproliferation regime doesn't do a very good job of that right now. So, by engaging Europe and Russia we made it a lot easier for Russia to cooperate with us, because it made it part of a larger package, of politics and economics in the region. And I would say that the course we're on right now, in engaging with Russia and Europe, is probably the right one and the best that can be done.

Senator OBAMA. Thank you, Mr. Chairman.

The CHAIRMAN. Let me just raise one question about farming—agriculture, land ownership, land reform. We haven't touched upon that, and I'm just curious as to the panel's view of how those issues are proceeding. Apparently, Russia now is self-supporting, from the standpoint of nutrition, and in some degree of trade with the rest of the outside world. There has been much popular writing on the evolution of farming. Who is doing it? How many people? What comments might any of you have about this?

Ms. CLOHERTY. Well, I will comment, simply because that is—we are starting an initiative there to—I am a former Agricultural Extension agent from Brazil, and I know everything there is to know about the conversion ratio of feed to meat and swine. Anyway—or poultry—so, we are planning to take a look at it. I will say, they began a process of privatizing agricultural land a couple of years ago, and there were fisticuffs in the Duma over the issue. It's a tough one.

But what has happened around the centers—whether it's Nizhny Novgorod, St. Petersburg, Moscow, whatever—is a lot of that farmland, as you could anticipate, is being bought up in vast hectares by real estate developers. So, I think that the agricultural areas are moving further out. But we are planning to take a look specifically at that, working with the Embassy, to see if we can begin to introduce productivity enhancements in crops and animal husbandry.

The CHAIRMAN. Yes.

Ms. WALLANDER. One—I don't know about the numbers of who's still engaged. I do know that they had some of this controversy over private property. But one of the success stories in the Russian economy has been agricultural production, the producing of products for the market, and that, in fact, there have been a number of companies that have—Russian companies that have been quite successful, and produce not only for the Russian market, but actually also export to neighbors, former Soviet countries, as well. And it seems to me that that's one of the sources of, sort of, growth that could regenerate—or rejuvenate agriculture in Russia, and is possibly a promising area, outside of the strategic view of the state, where there might be that kind of investment promise and growth.

The CHAIRMAN. Well, I raised the question because, obviously, the land mass of Russia, the huge dispersal of people, don't mean that people who are not in the cities are engaged in agriculture, but it is a focus which, perhaps, is less concentrated by many people looking at Russia, including all of us here. I'm just curious, because, in many cases in the world, a large part of the population is still engaged in agriculture, and some of them are not doing very well.

But let me just ask a quick question, likewise, about such things as student exchanges, tourism back and forth, quite apart from business people or labor unions. What sort of engagement is occurring? And is it increasing or decreasing, in terms of citizens in various walks of life, or people who might come from Russia? Perhaps they learn from us as we learn from them. This has usually been a healthy sign, when this type of thing increases, as opposed to decreasing. How would you characterize the Russian/American relationships in that respect?

Ms. WALLANDER. I would argue that these are important—we see the long-term benefits of these kinds of exchanges—that funding for these programs is important, but the real obstacle to a healthier relationship in this area has been problems of Russians, especially young Russians, in getting visas—

The CHAIRMAN. Visas.

Ms. WALLANDER [continuing]. To come to the United States, as you well know. My understanding, from my Russian friends—and every now and then I get an e-mail horror story of a Russian professor either sending students or coming themselves, and, at the last minute, the system has, kind of, gone awry. My understanding is that the system is now working better, that there's a more predictable and transparent system of the United States visa approval system, but that improvements still could be made, and that this is a sore spot, that Russians who encounter that visa system do tend to have a very bad view of the United States. And it's not something we want to let continue.

The CHAIRMAN. I mention it simply because it appears that we've talked about ways in which we might be influential with the Russians. This doesn't always occur from state to state. It occurs because Russian individuals enjoy something in our educational system, have special expertise, even affection, for the country, and return and do some things there as Russian citizens. I think the visa problem is one that we have been trying to tackle aggressively in this committee, with some success, incrementally, but we will keep at it.

Ms. Cloherty, did you have a thought to—

Ms. CLOHERTY. Just in—agree profoundly with the visa issue. And—but if you measure—just take indicators of hotel occupancy, in terms of tourists and conference schedules, there are a lot of Americans and American associations coming. I mean, I was in St. Petersburg, and we all were—in June, White Nights—you could not find a room. And the—you just—if you want a good indicator, just check out the Marriotts in Moscow. You have to book 6 months in advance, unless you've got some edge. So, this is a change from many years ago. So—and the other thing, I think the—I mentioned the reverse diaspora. There are many, many young Russians who are returning because they see the kinds of opportunities we do. And that's all a plus. Needs more encouragement.

The CHAIRMAN. Well, I thank you all very much. As the indicators on the clock show, we're in the second half of a rollcall vote—and so, we will bring the hearing to conclusion, with a lot of satisfaction. Very important ground has been covered by each of you, and we hope that the questions have illuminated the topic even more.

And, so saying, the hearing is adjourned.

[Whereupon, at 11:12 a.m., the hearing was adjourned.]

#### ADDITIONAL STATEMENT SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF ROBERT E. EBEL, CHAIRMAN, ENERGY PROGRAM, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, WASHINGTON, DC

Thank you, Mr. Chairman. My name is Robert Ebel and I chair the energy program of the Center for Strategic and International Studies. I welcome the oppor-

tunity to discuss with you, and members of the Senate Foreign Relations Committee, the current and likely future direction of Russian energy policy and how this policy is impacting its relationship with the United States and the rest of the world.

As background, I was a member of the first oil delegation the United States sent to the Soviet Union. The year was 1960. Since then I have visited every oil-producing region of the country. I must say that analysis of the Soviet oil and energy sector was much easier then, than it is today. For then, one could write and say almost anything about the subject and few could argue with your findings, because we knew so very little about what was going on.

Today is very much different. We are overwhelmed with information and data, and the task to separate the good from the bad is a difficult one, from the spin offered by a government official to a spin offered by a company representative.

For the past 18 months or so, the attention of oil producers and consumers worldwide has been captured by just one simple word. And that word is “sustainability.” Is growth in oil production and exports by Russia, second only to Saudi Arabia, sustainable?

Russia is very much in the news today. The volumes of oil Russia has been able to place into the world oil market have helped keep world supply and demand in balance. Because of that, it very much matters to all of us whether Russia’s oil sector continues to expand as it has the past number of years, whether it cools off, as it has been since late summer of 2004, or whether the Russian oil boom truly is over. That is, should we anticipate a decline in production and in exports?

If Russian oil export growth cannot keep up with world oil demand growth, for whatever the reason, then the burden on OPEC to balance oil supply and demand becomes even greater. Is this a responsibility that OPEC can readily assume? No, it is not. Is this scenario in the best national interests of the United States? No, it is not.

We have witnessed the loss, over time, of spare producing capacity worldwide, capacity that can be called on to respond to an expected gain in oil demand. Other than for Saudi Arabia, there is very little spare producing capacity available among OPEC-member countries. Russia, for example, has never developed spare producing capacity, and never will by choice. In their judgment, spare capacity is a frozen asset.

Adding to capacity takes time, and exporting countries always will want to be reassured that a market for that new capacity will be available. Today it is, but there can be no assurance for the future.

#### RUSSIAN OIL COLLAPSE, THEN RECOVERY

In mid-1988, Russia was producing at a rate of about 11.4 million barrels per day, well above Saudi Arabian production. Then the oil sector began an unprecedented collapse in production. Unprecedented because it was not caused by developments in the market place or by war, but rather by a lack of investment capital and mismanagement of the oil fields. The production collapse took the oil sector to a low of some 6 million barrels per day in 1998 before it began its slow recovery.

Last year, Russia produced about 9.2 million bbl/d, close to matching Saudi Arabia. Of that production, Russia was able to export around 70 percent, that is, both crude oil and petroleum products, because domestic requirements have held relatively stable. Indeed, virtually all of the increments in production the past years have been available for export.

Despite the successes of 2004, signs of trouble had begun to appear. Rates of growth in production began to slow, beginning in August 2004 and have continued through to today. The causes of this fall in growth rates—little investment in oil field exploration and overproduction of producing fields—match the causes behind the collapse that began in 1988.

Moreover, past successes in expanding oil output derived in large part from the massive application of advanced technology. This one-time gain is no longer available.

Yet, we are not anticipating an annual decline in production nor are we watching a decline in oil export levels. I would venture that oil production in 2005 will exceed the 2004 level by 3 to 4 percent, averaging about 9.5 million barrels per day, and matching the current Saudi level. Oil exports should also show a modest expansion.

#### BUT WHAT ABOUT THE FUTURE?

It is the Russian oil future that is of concern. Before the collapse of the Soviet Union in December 1991, the Caspian Sea had been viewed as representing the oil future of the country. But the collapse took that future away and gave it to Azerbaijan and Kazakhstan.

Given that, where does Russia see its oil future today? In East Siberia and offshore. But three obstacles stand in the way of converting this future to reality. These obstacles are the lack of experience in exploiting offshore oil resources, a lack of investment capital, and a lack of the kinds of technology required.

Where to turn? To international oil companies, of course. For national oil companies, the name of the game is access; access to new oil reserves. Russia has unquestioned oil potential, and the national oil companies can bring the needed experience, technology, and investment capital to the table.

But, will they? We should add a fourth obstacle to foreign investment in Russian oil. That is the failure of the country to offer the potential investor what he needs and expects: Transparency; rule of law; sanctity of contract; and equally important, opportunities where anticipated returns on investment reflect the risks that lie ahead. Or, do they need be only relatively better than alternatives? In sum, the rules of the game must be clear and secure.

In the words of Lord Browne, CEO of BP: "For many potential investors and for many commentators and observers, Russia remains a dark and hostile place, a source of risk rather than of opportunity."

A portion of investment risk derives from perceptions of the Yukos affair. Was the Yukos affair really about eliminating Khodorkovsky as a factor in the economic and political life of the country? Yes, it was. But was it also part of an effort to restore control over the country's oil resources? Yes, it was.

#### OIL SECTOR CONSTRAINTS

Current Russian oil sector prospects are troubling:

- A rather high number of idle wells, possibly one out of every four wells.
- Inability to replace oil reserves produced.
- Almost all existing major fields are likely to be depleted by 2015.

There is an oil export duty to be paid, a Russian version of a "windfall profits tax" that in effect discourages exploration and production. This tax, at present, is \$18.66 per barrel when the selling price is above \$25 per barrel.

Given that it usually takes 5 to 7 years or so from field discovery to development, means that time is not on Russia's side if it is to avoid a production decline.

#### PIPELINE CONSTRAINTS

Then, there is the more obvious constraint, that of pipeline capacity limitations.

Russian oil exporters complain that pipeline capacity limitations have in turn limited volumes that could be exported. That means a considerable share of exports must move by more expensive rail and water. All oil pipelines are currently under the control of Transneft. There are no privately owned pipelines. Khodorkovsky wanted to build a private line to China and there were plans to build a private line to the port of Murmansk, to facilitate oil exports to the United States. Both plans, for now at least, have been consigned to the trash can.

#### SHIFTING PIPELINE DIRECTIONS

Russian oil pipelines face the west. But that is not where the growth markets are. Oil demand growth is found to the east, in Southeast Asia and the Far East. How to respond to this market? Build a pipeline to the Pacific Ocean port of Nakhodka, in the Russian Far East, with a branch line going to China, a line that eventually would have a carrying capacity of 1.8 million barrels per day.

One small problem, though. Where would sufficient oil be found to fill this projected pipeline? Some volumes could be made available from West Siberian fields, but large new sources of supply would have to be discovered and developed in East Siberia, geologically attractive but completely lacking in supporting infrastructure, inhospitable terrain, and weather conditions.

Nonetheless, when a thirsty China looks north, it sees Russia and its tremendous oil and gas reserve base. Just as when a thirsty United States looks north, we see Canada, our leading supplier of foreign oil who also provides one-sixth of the gas we consume.

Russia-China is a natural linkage, especially in terms of geography. Current plans now anticipate construction of an oil pipeline eastward from a point near Irkutsk, in East Siberia, to a point some 1,700 kilometers eastward, and just 70 kilometers from the Russian-Chinese border. Then by rail to the border. And beyond, by rail to the port of Nakhodka, assuming available oil. When available volumes permit, the pipeline will then be extended to the Pacific.

Until this planned pipeline to China becomes a reality, oil will move to China by rail, some 200,000 barrels per day this year, rising to 300,000 barrels per day next

year. Rail shipments can expand to a limit of 600,000 barrels per day, at which point pipelines are more financially viable.

But East Siberia is more than oil, it is also a storehouse of natural gas. The largest known gas field is Kovykta, and TNK-BP holds an interest in this field. Indeed, Lord Brown of BP has called Kovykta “the tomorrow” for TNK-BP. But that tomorrow has been stalled by the efforts of Gazprom to see to it that development and planned export pipeline construction to China and South Korea do not proceed without their involvement.

Russia is very jealous of its prerogative as a transit country. That is, it would like to see all oil and gas exported from Central Asia, Azerbaijan, and Kazakhstan to be channeled through Russia. The recent completion of the oil pipeline from Baku through Georgia to the Turkish port of Ceyhan, on the Mediterranean, bypasses Russia, much to their displeasure.

#### NEAR TERM

Russian officials, public and private, have been comparatively open as to how they view the oil sector’s future. Their forecasts portray a Russia that, at least in oil, will essentially be marking time within the next several years.

Economic Development and Trade Minister, German Gref, recently outlined the near-term future of the Russian oil sector, and his views generally reflect a consensus.

- Oil production growth should be around 3.5 percent this year, declining further to 2 or 3 percent in 2006. That compares with an average growth of 8.5 percent during 2000–2004.
- In his opinion, oil exports would increase by 5 percent in 2005 and by 3 percent in 2006, down from an average of 14 percent during 2000–2004.

Again, it is important to note that production and exports are not expected to decline. Rather, it is the rates of growth that decline. Moreover, export increments continue to match production increments.

That approach is very much in line with Russian marketing philosophy. Oil is not withheld from the market as a way of supporting price. Any and all volumes surplus to domestic needs are exported, regardless of the current market price.

Nonetheless, as Russian oil growth rates fall while world oil demand increases, the market will increasingly look to OPEC to fill the gap. That, of course, brings increasing concentration on a select few, geographically separated countries. That in turn gives rise to inherent logistical, infrastructure, and security concerns.

#### LONGER TERM

A somewhat different picture emerges for the longer term; a picture that very much depends upon the timely discovery and development of new oil fields.

The most recent evaluation comes from the Ministry of Industry and Energy. An oil and gas sector development strategy reportedly was drawn up in 2004, and covers the 10-year period between 2005 and 2015. According to an official of the Ministry, “in 2015 Russia will be able to produce 10.6 million barrels per day . . .” To reach that level, he noted, would require up to \$270 billion investment in the sector.

He added later that in 2015 Russia may export 6.2 million barrels per day of crude oil alone. If so, crude oil exports will jump by 1 million barrels per day in 2015, compared to about 5.1 million barrels per day last year. Not much, considering the prospective growth in world oil demand.

#### A FINAL COMMENT

The head of LUKOIL, the largest oil company in Russia, recently was asked about the prospects for foreign investment in Russia’s petroleum sector. His answer was forthright: “You are doomed to invest in Russia.” But that can work both ways. Russia is “doomed” to seek that investment.

But, what if that investment is not forthcoming? Then consumers could well be faced not only with high prices but as well with physical constraints on volumes available for purchase.