

The Role of Foreign Investment Activity
in Russia's Entry into the World Economy:
A Comparative Study of Two Periods:
before 1917 and after 1992

by

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Introduction

After more than half a century of central planning, Russia, the Soviet successor state, is returning to a market based economy. The “shock therapy” that came to define the Russian transition was fostered in the conflict between two groups of thought: one favoring a gradual transition focused on nurturing competition, and another proposing rapid liberalization reforms in the hope of “kicking” Russia into the capitalist world.¹ To support the profound changes that are taking place within its economic environment, Russia needs large capital resources. However, the small pool of private savings limits domestic investments.² Furthermore, Russia is losing money through capital flight, which started as early as 1994 and continued at high levels throughout the decade. Although estimates vary, widely accepted statistics demonstrate that during the 1990s, Russia exported over \$100 billion.³ Therefore, foreign capital will be essential to the restructuring and growth of the Russian economy.

Among the factors that attract foreign investors to Russia, are the size of the local market, the abundance of natural resources, the highly educated and cheap labor force, and the access to other developing markets.⁴ However, the absence or inadequacy of conceptual, legislative, institutional, and material premises for foreign investment has played a role in deterring foreign capital.⁵ Before Russia can start acquiring the necessary characteristics of a capitalist market, it has to “unlearn” the logic of socialist planning to which it was subordinated for three-quarters of a century. Foreign involvement within Russia will be of crucial help in assisting the nation to overturn its legacy of controlled economy.⁶ To better understand the dynamics of the current

¹ J. Stiglitz, p.76

² J. Slater, pp.10-11.

³ J. Johnson, p.129

⁴ H. Lankes, pp.557-9

⁵ A. Kuznetsov, p.x

⁶ *Ibid.*, 13

transition, it may be useful to re-examine the economic environment of Russia during the last thirty years of the Tsarist rule. At that time, Russia exhibited impressive economic growth, fueled, at least in part, by foreign investment. The Russian industrialization of the late 19th and early 20th century was in large part driven by foreign capital entry to various types of investments: government and railway bonds, municipal enterprises, and industrial ventures.⁷ Around 1916, foreign capital constituted 40% of industrial investment and 15-20% of total investment in Russia.⁸

Three important parallels exist, which invite the comparative analysis of the role of foreign capital in the two eras. Both periods possessed influential but conflicted banking sectors, which were among the first beneficiaries of foreign investment in each time. Foreign capital in both Tsarist and post-Soviet Russia united foreign resources with Russia's natural wealth. And lastly, foreign investors brought with them technical skills and entrepreneurial expertise that influenced the growth rate and structure of the Russian economy in both periods. The paper looks at these three valuable elements of foreign activity in Russia in each of the two periods: the banking system, the natural resources, and the managerial and technical innovations.

TSARIST ERA BANKING

Tsarist State Bank

During the later half of the nineteenth century the State Bank of the Russian Empire was largely a supporting institution of the Finance Ministry. The bank was more concerned with treasury operations than with the issuance of bank notes or with the deposits by private persons.⁹ Throughout the entire pre-revolutionary period, the State Bank maintained a close and supportive

⁷ O. Crisp, p.159

⁸ B. Bonwetsch, p.416

⁹ P. Lyashchenko, pp.701-02.

relationship with commercial banks, extending subsidies or acquiring troubled institutions. At the turn of the twentieth century the State Bank began to acquire a role of a “bank’s bank,” and by the beginning of the First World War it had become one of the most influential lending institutions in Europe.¹⁰ At that time, the Bank held vast gold reserves to stabilize the currency and to encourage foreign loans and investment. The Bank regulated Russia’s currency circulation and foreign exchange settlements and, through commercial banks, actively participated in international crediting industry and trade.¹¹

Witte’s System

Throughout the second half of the 19th century, the Russian government was redefining its economic policy to reflect notions of free trade and laissez-fair. However, Russian capitalism was too weak to take advantage of this call for private initiative and accelerated economic development. Starting in 1882, the government adapted a policy which became known as the “Witte’s system,” an economic program named after its architect, a Tsarist statesman. The three main elements characterizing the system were (1) the belief in the importance of railroad construction, (2) an emphasis on state intervention as a driving force behind industrialization, and (3) an assumption that native capital resources could not satisfy the needs of rapid development.¹² Thus, foreign capital entered the picture to bring the necessary fuel to the fire of Russian industrial transformation. In large part a result of the Witte’s system, cumulative foreign capital in Russia increased from .5 billion rubles in 1861 to 4.7 in 1900 and to 7.6 in 1914 (in 1914 rubles).¹³ Witte stressed that foreign investment, if allowed to enter and develop in Russia, would give rise to billions of native capital. He expected foreign investment to stimulate

¹⁰ *The Central Bank of the Russian Federation*

¹¹ *Ibid.*

¹² A. Kuznetsov, p.54

¹³ *Ibid.*, p.55

competition and enterprise, to shake the native monopolies of the Russian merchants, and to enhance the productivity of native industries.¹⁴

Investment Environment

The rapid growth of capitalist production at the turn of the 20th century attracted foreign banks with the potential profits of industrial finance.¹⁵ Foreign investors responded to Russia's demand for capital because of highly profitable terms of investment and government guarantees: the adoption of the gold standard in 1897 had stabilized the ruble and promoted the inflow of capital.¹⁶ Furthermore, the protective import tariff policy culminated in the act of 1891, which virtually eliminated all foreign goods competition within Russia. Thus, a promising market of 100 million people could only be reached by establishing production operations in Russia.¹⁷ However, the poverty of the Russian consumer, wide spread anti-foreign sentiment, brutality and anti-Semitism of Russian officials, and the uncertainty of conditions in general, all discouraged potential foreign investors. If they did choose to invest, foreigners often preferred government bonds rather than direct or private investment, because the Russian government always paid its debts.¹⁸

Foreign Activity

By 1913, Russia was the world's largest debtor nation with the majority of foreign capital coming from England, France, and Belgium.¹⁹ (see Table 1a for exact distribution by country) In the early stages of the foreign capital inflow, much of it was used to finance military investments and operation.²⁰ Even during the Russo-Japanese War, French banks played a

¹⁴ T. Von Laue, p.180

¹⁵ R. Cameron and V.I. Bovykin, p.270

¹⁶ *Ibid.*, p.275

¹⁷ O. Crisp, p.160

¹⁸ T. Von Laue, p.176

¹⁹ P. Gregory, "Russia and Europe....," p.481

²⁰ W. Blackwell, p.xii

decisive role in financing Russia's military spending. At that time, the Russian State, through syndicate of a number of French banks, including the Banque de Paris et des Pays-Bas and Credit Lyonnais, provided to the Paris market 5% tax-exempt state treasury bonds for 300 million rubles.²¹ Despite the extent of the foreign banks' investments in Tsarist Russia, most did not have a physical presence there due to Russian and foreign legal and management policies. The only foreign bank to maintain branches in Russia before World War I was Credit Lyonnais, which possessed agencies in St. Petersburg, Moscow, and Odessa. The bank, however, was not in any way involved in industrial or commercial undertakings, but rather focused on relations with the Tsarist government.²²

International Banking Relations

Foreign banks played an important role in the industrial growth of the 1890s, not only due to their capital, but also due to the complex system of interrelations that they have established among themselves and the Russian banks. Foreign banking houses, notably the Mendelssohn family of Berlin, participated in the formation of several Russian banks.²³ Many of the Russian banks established in the 1880s and 1890s had little experience dealing with unfavorable economic conditions. Thus, the economic stagnation and adverse exchange rates of the early 1900s brought severe difficulties and often bankruptcies. At that time foreign credit institutions participated in financial reorganization and revitalization of many Russian banks. By 1914, 42% of the total capital stock in the 18 major corporate banks was foreign capital.²⁴ (see Table 2 for foreign participation in major Russian banks by 1917) This influence was carried further as many foreign representatives joined the boards of the institutions with which they

²¹ R. Cameron and V.I. Bovykin, p.263

²² *Ibid.*, p.267

²³ R. Cameron and V.I. Bovykin, p.270

²⁴ P. Lyashchenko, p.708

established connections.²⁵ It is essential to note that foreign industrialists brought to Russia not only capital, but also the Western techniques of banking and finance. Such ties to the German, French, and Belgian banks remained a characteristic feature of Russia's economy up until the revolution.²⁶

Anti-Foreign Sentiment

The political relations between Russia and the Western empires of England, Germany, France, Belgium, and Netherlands in large part defined and influenced the presence and activities of foreign banks in Russia.²⁷ Those governments attempted to use foreign credit as leverage mechanisms to influence Russian foreign policy.²⁸ Unwelcome dependencies increased under Witte's activities through the sale of Russian state bonds abroad, as did the power that foreign investors, and the governments they represented, held over private enterprises.²⁹ The sentiment against the creation of foreign enterprises was strongest in the central industrial provinces of Russia.

At that time, foreigners became a major force in the extraction and distribution of Russian oil and some other natural resources. Russian capitalists not only viewed foreigners as a competitive threat, but also resented having to depend on them for supplies of resources.³⁰ The negative response was evident not only within the general population, but among many of the high ranking officials opposing the Witte's system. Several ministers, among them Muraev, minister of foreign affairs, warned that foreign capital created unreasonable dependencies and exploitation of Russia's mineral riches.³¹ To the large public, the foreign capitalist became the

²⁵ R. Cameron and V.I. Bovykin, p.274

²⁶ T. Von Laue, p.176

²⁷ R. Cameron and V.I. Bovykin, p.257

²⁸ T. Von Laue, p.176

²⁹ *Ibid.*, p.296

³⁰ T. Von Laue, p.177

³¹ *Ibid.*, p.185

epitome of all evil, destroying Russian agriculture, seizing natural resources, exploiting the population, and transferring colossal profits abroad. Economic backwardness helped encourage a national inferiority complex, which at times manifested itself in furious anti-foreign campaigns. Many foreign entrepreneurs in Russia responded to this xenophobia by taking over established Russian firms instead of starting new ventures.³²

TRANSITIONAL BANKING OF 1990s

Central Bank of Russia

The banking infrastructure of Russia, the successor state, is just as different from those in the Western nations, as was the Tsarist banking system. The period of early 1990s brought significant liberation of the banking sector from direct state control. The newly established Central Bank of Russia (CBR) received much more formal autonomy of status and political autonomy from external pressure than its predecessor Gosbank. Furthermore, a number of specialized commercial banks were established. However, Russian bankers both at CBR and other banks lacked technical expertise and instruments to effectively act out the newly found market-oriented policies.³³ The liberalization of the banking system instituted flexible interest rates and lack of borrowing or investment limits, but it did not carry sufficient control mechanisms. Because the central bank extended discount loans to troubled lower-tier banks and industries, it fueled monetary expansion and increased uncertainty over inflation rates and interest rates.³⁴

³² A. Kuznetsov, pp.60-61

³³ J. Johnson, p.67

³⁴ S. Lewarne, pp.105-06

Transition in Russian Banks

What made the transition of the banking sector particularly cumbersome was the necessity to learn the theoretical and practical banking roles right on the job. Although many bankers took classes in the newly established schools of commerce, they found it difficult to relate foreign experience to Russia's unique need to "unlearn" 80 years of state controlled system. The resulting learning curve and on-the-job experimentation created some unpredictability and inconsistency in the banking sector in general and within the CBR in particular.³⁵ (see Table 3 for index of banking reform in Russia and other European transitional economies) The shock therapy of rapid privatization and market liberalization encouraged among Russian bankers short-term thinking culminating in speculative transactions and capital flight, rather than more profound investment. In fact, capital flight afflicted almost all industries in form of unrepatriated export earnings, payments under fictitious import contracts, price manipulations under barter transactions, and under-pricing of exports.³⁶

Money within the new Russian banking system was made by relying on central bank credits at negative real interest rates, conducting foreign exchange operations, and handling governmental funds.³⁷ The Russian government replaced the gap created by capital flight through foreign and domestic debt. Such environment spawned increased use of monetary surrogates such as veksels, barter, and accumulation of inter-enterprise debt.³⁸ These developments instilled doubt in the minds of foreigners regarding the soundness of investments in Russia. After all, if Russians won't invest in their own country why should foreigners?

³⁵ J. Johnson, p.80

³⁶ A. Lushin, p.285

³⁷ J. Johnson, pp.4-8

³⁸ *Ibid.*, p.97

Foreigners in the Securities Market

Until 1998, both the Russian and the foreign-owned banks concentrated mainly on the GKO (high-yield Treasury bill) market. The GKO, introduced in 1993 to finance the government's budget deficit, yielded consistently high annual returns (an average of 136.8% in 1994).³⁹ The market was essential to help finance the substantial deficit that Russia was carrying on its overall balance of trade. The deficit was created by extensive domestic capital flight, the foreign currency debt inherited from the final years of the Soviet Union, and the state's inability to collect the debt credits previously granted by the USSR.⁴⁰ Given the Russian state's difficulty of attracting domestic capital to finance its expenses, it would seem that foreign capital would be welcomed and encouraged. However, the Central Bank was for some time reluctant to allow foreign participation in the securities market.⁴¹ The first relaxation of restrictions came in August 1996 in form of special 'S' accounts, which foreigners could open in authorized Russian banks. The funds would then be transferred and invested in the GKO market within Moscow Interbank Currency Exchange (MICEX). 'S' accounts allowed foreigners to participate freely in the secondary market for securities. Despite the fact that these accounts carried not only government default risk but also idiosyncratic bank risk, they attracted considerable inflows – by late 1997, foreign investors constituted 30% of a \$60billion market.⁴²

Crisis of 1998

The high profitability of the GKO market, aided by limitations on direct foreign investment, attracted much international short-term capital.⁴³ The dominance of speculative operations, together with lack of appropriate skills, discouraged the Russian banks from

³⁹ J. Johnson, p.123

⁴⁰ A. Lushin, p.283

⁴¹ B. Granville, p.115

⁴² *Ibid.*, p.118

⁴³ J. Johnson, p.220

evaluating borrowers, granting long-term loans, or restructuring enterprises. This handicap became apparent with the GKO default and ruble devaluation of 1998.⁴⁴ The crisis dealt a severe blow to the reputations of the CBR and the Russian banking system in the international financial community. The Bank's subsequent efforts to improve the performance and liquidity of institutions within the sector struggled to override the consequences of the crisis. Of significant importance to the recovery was the creation of the Agency for Restructuring Credit Institutions (ARCO) and the Inter-Agency Coordinating Committee for Banking Sector Development in Russia (ICC).⁴⁵ However, in 2000 the role of ARCO was still limited by weak financial and enforcement powers. The crisis had also encouraged foreign-owned banks to diversify their services to include more activities of regular commercial banks, such as opening of accounts, transfers, currency operations, crediting, etc.⁴⁶ Although foreign banks increased presence to about 11% of total capital in the banking sector by end of 2000, the sector remains vulnerable to new crises.⁴⁷ The amount of foreign capital in Russia's banking system is still relatively small, due to a climate of political, economic, and legal uncertainty. (see Table 4 for foreign bank participation in Russia)

Soviet Era Legacies

The emancipated financial institutions of Russia lacked in the past decade not only internal capabilities such as computer technology, and rating instruments, but also the necessary external infrastructure such as enforced legal business statutes and enterprises with budget constraints. Among the Soviet legacies were lack of private property doctrines and a system of

⁴⁴ *The Russia Journal* 15 Feb. 1999

⁴⁵ *The Central Bank of the Russian Federation* (2001)

⁴⁶ O. Sarkisov

⁴⁷ *European Bank for Reconstruction and Development* (2000)

soft credits.⁴⁸ The behavior of Vneshekonombank, the Foreign trade hand of the Soviet state's banking system, contributed to the apprehensions of foreign investors. The bank was so hurt during the Gorbachev reforms that its massive negative trade balance was covered by an equally massive foreign debt. By 1992, Soviet enterprises holding their foreign currency reserves in the bank found it nearly impossible to get their money back, leading to the massive default of joint venture enterprises and high levels of capital flight.⁴⁹ This handed a heavy blow to the economic relationships with the world's financial community.

Bank-State Relations

Foreign investors often have been discouraged by the incestuous relationship between the Russian government and the financial sector (as mentioned earlier a notable characteristic of the Tsarist era as well). The traditional revenue sources of the state had diminished significantly due to privatization, upheaval in the tax system, exchange rate liberalization, and the falling value of household deposits in Sberbank.⁵⁰ Thus, the lack of an efficient treasury system encouraged the state to invest its capital within the commercial banking sector. In 1994, the CBR financed 67% (44 trillion rubles) of the government's budget deficit.⁵¹ Since the banks continue to rely on the state for sustenance, barriers to entry into the banking sector are largely political and not financial. Furthermore, the relationships between the government and a number of large enterprises allow many firms to take advantage of tax exemptions and flaws in the tax system.⁵² All these structural consequences deter independent foreign participation in the banking sector. Another side effect of these relations is the concentration of the financial industry in Moscow and St.Petersburg. By 1998, 35-40% of all Russian banking institutions were headquartered in

⁴⁸ J. Johnson, pp.25-29

⁴⁹ *The Economist*, March 21, 1992

⁵⁰ J. Johnson, 81

⁵¹ *Ibid.*

⁵² M. Camdessus (speech), April 1, 1998

Moscow.⁵³ At the same time, two-thirds of the total foreign investment, about \$4.3 billion, went there.⁵⁴ The foreign banks are also largely limited to the Moscow and St. Petersburg locations, thus curtailing opportunities for foreign expansion into the more remote regions.⁵⁵ In fact, Moscow officials reported that in 2001 foreign investment in Moscow reached \$6 billion or 60% of the total investment in Russia.⁵⁶

Legislative Limitations

The close interdependence of the Russian government and the financial industry allowed the big Russian banks to advance legislation limiting the number and scope of foreign banks in Russia. The campaign against foreign banks began in 1992 despite the fact that there was little foreign presence in Russia at that time. According to a poll of bankers in 32 regions, 55% opposed allowing foreign banks to operate under the same conditions as domestic ones in Russia, while only 35% were in favor, and 10% were neutral.⁵⁷ In 1993, Yeltsin issued a decree severely limiting the operations of foreign banks, which was only fully repealed in 1995. Since then, many restriction remained regarding the allowances of foreign financial institutions operating in Russia.⁵⁸

Lawlessness

Russia lacks a market-oriented legal framework because its banking regulations were devised for the monobank system and are cumbersome to adjust. The climate of lawlessness spans far within the financial sector. The Russian general prosecutor's office revealed in 1999 that the CBR, over a 6-year period, funneled more than \$50 billion of Russia's hard currency

⁵³ J. Rostowski, p.173

⁵⁴ *The Economist*, Sep 4, 1997

⁵⁵ O. Sarkisov

⁵⁶ *Moscow Times*, March 4, 2002

⁵⁷ *Russian Economic Barometer* 2 no.1, Winter 1993

⁵⁸ J. Johnson, p.120

reserves through a tiny offshore bank called FIMACO. The Bank attempted to hide the funds from foreign creditors during its debt negotiations with the London and Paris clubs.⁵⁹ The rather recent implementation of legal guarantees protecting foreign property, and the rights to expatriate profits, have had some positive effect on the attainment of foreign capital. However, Russian businesses still appear to maintain their excessive red-tape climates and fickle contract habits.⁶⁰ (see Table 5 for ranking of business environments in the European nations competing for foreign investments)

The IMF

An analysis of the financial sector activities in Russia would not be complete without looking at the operation of the IMF and its effects on the Russian market. The IMF, along with other international financial organizations, took part in the restructuring of the Russian banking sector. And along with others, it faced a severe handicap of having no experience in supporting a transition from communism to capitalism. However, its involvement limited the independence of the CBR, which was forced to create an appearance of acting, if not really acting, according to the fund's demands in order to receive capital assistance. The IMF also increased the technical capacity of the CBR, and subsequently of the Russian financial sector, by implementing training programs and assistance with developing market instruments such as credit auctions, treasury bill markets, and better payments system.⁶¹ A mission from the IMF visited Moscow in December 2001 to discuss the macroeconomic outlook and the plans for structural reforms. The mission's representatives concluded that the current levels of account and fiscal surpluses, as well as foreign reserves, position Russia well to deal with even a less favorable environment in 2002. The mission also found that "the Government's plans and priorities suggest that the impressive

⁵⁹ *Ibid.*, p.64

⁶⁰ A. Kuznetsov, p.106

⁶¹ J. Johnson, p.93

momentum that has emerged in the structural reform area in 2001 is likely to be maintained next year.”⁶²

THE NATURAL RESOURCES AT THE TURN OF THE 20TH CENTURY

The Distribution of Foreign Investment

Russia’s wealth in raw materials has historically attracted vast amounts of foreign capital. By the end of the 19th century, trade was still largely built on grains and timber. However, Russian and foreign initiatives in the development of coal and ore basins began to attract large capital investments.⁶³ Nearly 55% of pre-war foreign capital was invested in the mining and machinery industries. (see Table 6 for distribution of foreign companies by industry in 1911) Those included, in the order of their importance, steel works, petroleum industry, coal mining, copper mining and smelting, gold mining and refining, silver-lead-zinc industry, platinum industry, and iron-ore mining. In the mining and metallurgy sector, the majority of foreign investments came from Britain, France, and Belgium (respectively 40%, 37%, and 15%).⁶⁴ American investments in Russia were, with but two exceptions, in enterprises of trade, finance or insurance.⁶⁵ The majority of the companies were consolidated into several large combines, which in turn were interlinked with one another by a system of interests. The influences of foreign entrepreneurs in various industries were not confined to production but rather encompassed all stages of marketing of the output.⁶⁶ The opponents of increasing foreign investment claimed that the uncontrolled influx of capital was making Russia excessively

⁶² *IMF*, December 2001

⁶³ T. Von Laue, p.13

⁶⁴ L. Lewery, p.6

⁶⁵ *Ibid.*, p.27

⁶⁶ *Ibid.*, p.10

dependent on foreigners. The supporters replied that foreign investment employed resources and labor that would otherwise have been idle.

Metallurgy and Manufacturing

The Russian government has historically been concerned with its military might. Thus it is no surprise that among the first areas where Russians sought foreign assistance was its armament industry. Russian officers delegated to explore American armory production, were highly impressed with the precision and quality of work, and with help of American entrepreneurs implemented the innovations in the Russian government armories.⁶⁷ At the same time, foreign capital almost exclusively fueled the expansion in the mining of non-ferrous resources of Russia. The areas of central Kazakhstan, which in the early 20th century produced a steady 12-15% of Russian copper, lead, and silver, were acquired and operated by English and French industrialists.⁶⁸ The ore and coal basins of South Russia were also developed in large part by French, Belgian, and English industrialists (in 1989 of the 17 operating large works in the area, and 12 more in construction, only 1 was entirely Russian).⁶⁹

The Extraction Sector

The mining and petroleum industries were, by law, open to foreigners in most of the Russian counties, except the maritime regions.⁷⁰ (see Table 7 for a list of applicable laws) The sector had to overcome ignorance, low technological capabilities, political strife within the state, and competition of highly organized distribution in the world's markets. Nevertheless, the petroleum industry of Russia had risen to the position of first in the world's production by the turn of the 20th century. Scandinavian capital was the first to enter the Russian petroleum

⁶⁷ J. Bradley, pp.3, 14-6, 78-93

⁶⁸ R. North, pp.78-9

⁶⁹ O. Crisp, p.164

⁷⁰ I. Kennard, p.46

industry in 1870s and was followed by French funds in 1880s, and English at the turn of the century. Foreign capital contributed a great deal to Russia's growing position in the international oil markets.⁷¹ (see Table 8 for foreign capital in petroleum industry in early 20th century) The six regions where oil was extracted and refined in Tsarist Russia were: Baku, Grozny, Kuban-Black Sea, Emba-Ural, Ferghana, and Sakhalin.⁷² There were other petroleum rich localities, but often they were inaccessible with the transportation of the time. The October revolution, and subsequent turbulent times, brought much damage to the oil properties, straining the future nationalized operation of the oil industry by lack of qualified labor, efficient equipment, and technical personnel.⁷³

The Nobels and Rothschilds

Russia's prominence in the international petroleum industry was achieved largely through accomplishments of two families - the Nobels of Sweden and the Rothschilds of France. Immanuel Nobel, who brought his family to Russia in 1830s, experienced first success in opening an armament factory. He was also the first to develop underwater mines, and to install central heating systems in Russian homes.⁷⁴ His sons Ludwig and Robert continued successful tradition of progressive manufacturing and business practices, employing many trained Scandinavian expatriates along with Russian workers. Among the many innovations to come out of the Nobel establishments were the first oil pipeline, a fleet of oil tankers and barges, new refinement techniques (producing high quality kerosene able to compete on the European markets), and unusual concern for workers.⁷⁵ In the early years of the 20th century Russia was supplying more than half the world's oil and the Nobel family owned, controlled or had

⁷¹ M. Miller, p.266

⁷² W. Otis, pp.3-4

⁷³ *Ibid.*, p.38

⁷⁴ R. Tolf, pp.8-13

⁷⁵ *Ibid.*, p.51-72

substantial interest in companies producing a third of Russia's oil. (see Tables 9 for Nobel company profits)

The second big influence in the Russian oil market was the international Rothschild family who further developed the resources of the Caspian-Caucasus region. The Rothschilds entered the industry in 1890s and focused their efforts on developing the Russian markets. Together with the Nobels, they built small tank steamers to carry petroleum across the Caspian Sea for transfer to Volga River barges, and they were largely responsible for the construction of a railroad from Baku to Batumi.⁷⁶ Through the *Caspian and Black Sea Petroleum and Trading Corporation*, the Rothschilds opened a multitude of European and Asian markets to Russian kerosene, and perfected the transportation and sale of it in these regions.⁷⁷ Royal-Dutch Shell Group subsequently acquired the company. (see Table 10 for major participants in the Russian petroleum sector at the turn of the 20th century)

The Transportation Sector

Along with investments in natural resources came investments in railroads, which were the necessary transportation vehicles. Technological modernization required for the establishment of an expansive railroad network needed capital, which in large part would have to be supplied by foreign investors. The Russian public was not willing to invest its limited capital in an undertaking so new and untried.⁷⁸ The railway sector saw its actual beginning in 1835, as an Austrian engineer Franz Anton von Gerstner, who admired the great natural and productive potential of Russia, offered to provide Russia with a system of railways. Supporters of foreign-induced mode of railway development pointed out that construction and operation of the railways will immensely benefit Russians through increased economic activity and employment.

⁷⁶ B. Gokay, p.7

⁷⁷ W. Otis, pp.3-4

⁷⁸ R. Cameron, p.253 and R. Haywood, p.107

Others opposed the idea of vast profits expatriated to foreign nations.⁷⁹ With the victory of the supporters, the Russian railroad age got started with significant foreign help.

The investments came in several forms and carried multiple benefits. Most foreigners chose to invest capital in bonds of private Russian railroad companies. Being guaranteed by the government, these appeared on the books under the heading of national debt, as did bonds issued for State railroads. In total, over 27 billion rubles were invested by foreigners in the stock of Russian railroad companies prior to the first world war. Of those an estimated 21.5 billions (nearly 80%) were French capital.⁸⁰ In the last decade of the Tsarist rule, the English investors also showed interest in the Russian railway market. The most noticeable foreign direct investment came in the form of an American firm of Harrison, Winans and Eastwick, who were responsible for construction of all locomotives, freight trucks, and passenger cars for the St. Petersburg-Moscow Railway. Their Aleksandrovks Main Mechanical Factory employed a number of foreign workers possessing skills superior to those of their Russian counterparts. Most workmen came from Sweden and Germany, and a number of supervisory positions were filled with American and English professionals.⁸¹

Lastly, the improvement within the transportation sector further encouraged foreign interest in Russian industries. Both coal and timber sectors attracted a greater number of investors as soon as better transport became available. The dairy industry, as well, began to attract Danish, German, and Finnish entrepreneurs when railways allowed for fast delivery of perishable goods. Thus, during the early years of 20th century, the dairy sector was revitalized

⁷⁹ R. Haywood, p.65-82

⁸⁰ L. Lewery, p.6

⁸¹ R. Haywood, pp.256-259

with new foreign technology and comparatively high levels of efficiency in production and marketing.⁸²

THE NATURAL RESOURCES ENTERING THE 21ST CENTURY

The Attractiveness

Even today, the resource industries remain the most important producers of value in the Russian economy. Foreign investment has grown throughout the decade but remains small compared to Russia's potential as a producer of raw materials. Its potential for development can be inferred from its current share in the world's industrial production: of oil it is 19%, of gas 32%, of coal 9%, of steel and mineral fertilizers 12%, and of cement 8%. In addition, Russia is particularly rich in forests (5 hectares of forest per head against .8 hectares in the US).⁸³ The natural resources sector was among the first to benefit from foreign direct investment. This is because first mover advantage for these investors is great in the form of acquiring strategic assets at low cost. The investors of other sectors or industries, who are more concerned with cost competitiveness than timing, will hopefully enter the Russian market when the risks go down sufficiently to make it more desirable than alternatives sites.⁸⁴ (see Table 11 and Figure 11a for comparative FDI flows to select transition economies in late 1990s)

At present time, even for the natural resource sector, the entering foreign capital falls far short of the needs for developing Russian industries and market infrastructure. A giant heavy-machine producer, *Uralmash Zavod*, alone needs \$500 million in investment to pull through the reconstruction stage. In the rust belt cities of Russia there are dozens of plants like *Uralmash*,

⁸² R. North, "The Oil Industry...", p.77

⁸³ A. Kuznetsov, p.48

⁸⁴ H. Lankes, p.564

the conversion of which will need billions.⁸⁵ The Russian Far East also remains full of “buried treasure.” Its reserves include over 120 different types of metallic, nonmetallic, and energy resources, as well as a multitude of minerals including: antimony, boron, brown coal, diamonds, fluorite, gold, platinum, silver, tin, and tungsten.⁸⁶ The region’s potential remains largely unused due to extraction infrastructure decay and economic recession of the region throughout the 1990s. The problems include lack of domestic capital, poor transportation system, failing production and processing plants, troubled worker relations, and bad management practices.⁸⁷

The Difficulties

Like in the banking sector, all production facilities of Russia need to erase the remnants of their Soviet time operations in order to proceed to the market based. Physical targets expressed from above drove the operations under the central-control. The enterprises rarely concerned themselves with such issues as pricing, market demand, operating costs, and profitability. Now to remain active they must take all those market indicators into account, and this transition has been traumatic for many businesses.⁸⁸ Among the challenges that face Russia, and especially the Russian Far East, stands competition with other CIS nations over foreign investment. Furthermore, since a good portion of foreign capital is expected to come from other developing nations, the inflow will be subject to fluctuations due to instability of those nations themselves. (For example, South Korea’s investments averaged \$18.3 million per year between 1993 and 1997 but declined sharply thereafter due to domestic problems.⁸⁹) It hasn’t helped to attract foreign investment, that Russia’s foreign policy towards the other Soviet successor states and towards the “near abroad” of Eastern Europe has been competitive and hindering (blocking

⁸⁵ A. Kuznetsov, p.126

⁸⁶ J. Dorian, p.90

⁸⁷ N. Lynn, p.19

⁸⁸ R. North, “The Oil Industry...,” pp.77-8

⁸⁹ C. Lee, pp.212-9

initiatives, stalling progress) rather than cooperative and strategic (creating new opening and developing new projects).⁹⁰

Oil and Gas

The heavyweights of the Soviet industrial might, the oil and gas sectors, had to undergo radical restructuring following the collapse of the Soviet Union. The shift led to a steep drop in production caused by depletion of deposits, inefficient practices, and under-investment.⁹¹ The movement from central control to market type economy involved considerable difficulties in revamping the industrial structure of ownership, control, pricing, and taxation. The administrative functions previously carried out by the designated ministries had to be taken over by private firms and associations. While the gas industry remained largely centralized, with Gazprom's single managements, the oil sector witnessed many conflicting developments in its deregulation.⁹² This opened the door for many private enterprises and created a potential for foreign participation. Foreign investment of 1990s consisted mainly of stock purchases of Russian oil, gas, and to a less degree chemical companies in the equity markets. The purchases in the extraction sector largely stemmed from the premise that Russian oil shares are undervalued when common industry valuation techniques are employed.⁹³ The 1991 Law on Foreign Investment explicitly allowed for foreign participation in the direct exploration of natural resources, granting a legal right for joint ventures with 30% or greater foreign participation to export 100% of their oil.⁹⁴ Among the most important foreign ventures in Russia in the 1990s were Polar Lights, Van'eganneft, White Nights, Nobel's Oil, KomiArktikOil, and AIK. In 1997

⁹⁰ P. Rutland, p.187

⁹¹ Y. Adjubei, p.132

⁹² D. Lane, pp.16-8

⁹³ P. Gregory and R. Stuart, p.425

⁹⁴ C. Bartlett, p.109

the extraction of these firms constituted 12% of all petroleum exports.⁹⁵ These FDI participants have been largely attempting to raise the output of depleted oil wells with the use of modern technology unavailable to local producers.⁹⁶

The foreign investment in the extraction sector allows to channel the released national Russian funds, and limited domestic capital, to the development of other sectors, such as transportation, municipal works, and consumer goods. Those sectors are essential for balanced development of the Russian economic position, but currently they cannot count on foreign interest. Thus, foreign investment within the natural resource industries is likely to stimulate a competitive environment on the Russian market in general.⁹⁷

Oily Problems

The investment in the petroleum sector remained relatively small due to uncertain legal status of capital, the difficulty of repatriating profits, the extent of crime and corruption, and the hostility of the government. Furthermore, numerous legislative restrictions have deterred foreign activity within the Russian oil industry. Foreigners were not allowed to participate in either the first (1992-4) or second (1995-7) stage of privatization. As a result many potential investors turned to other Soviet successor states. A 15% company cap, a restriction lifted only in 1997, limited foreign direct investment. Those intent on participating in the oil industry most often chose the form of joint-ventures or production-sharing agreements, which allow circumvention of many Russian legislative limitations and revenue taxes. Secondary markets were more permissive towards foreign participation, however, mostly at the subsidiary, rather than the holding level.⁹⁸ All in all, the Russian oil industry contains some of the worst malfunctions of

⁹⁵ D. Lane, p.20

⁹⁶ Y. Adjubei, p.132.

⁹⁷ A. Kuznetsov, p.131

⁹⁸ N. Moser, pp.319-20

the Russian developing market system including faulty share ownership, questionable bankruptcy proceedings, and lack of fiduciary responsibility of management to shareholders.⁹⁹

The poll conducted among foreign businessmen operating in Russia in 1995 revealed that among the factors holding back the development of foreign investment in Russia the strongest deterrent is confusing economic legislation. It is closely followed by instability of the political situation, high taxes, bureaucracy, and corruption among government officials.¹⁰⁰

In addition, just as transportation of resources from the heartland of Russia presented a problem in the Tsarist time, transportation of oil and gas is a difficulty in the post-transitional Russia. The pipeline system of the Soviet era forces Russia to rely on surrounding former republics for export of its oil. Russian oil must travel through Ukraine or Belarus to reach Europe, or the ports in the Baltic states must be used. In fact, only 15% of Russia's oil exports are currently shipped from Russian port terminals.¹⁰¹ And since domestic market is not developed enough to consume the abundance of available resources, foreigners are hesitant to invest in oil they can't export.

The Complicated Geography

With the collapse of the USSR, many natural resources that were formerly "Russian," now came to belong to other newly independent successor states. Thus, parts of the former Soviet Union are forced to compete with each other for both the role of suppliers and for foreign investments to help them develop these supplies. The Caspian Sea basin, which contains vast resources of oil, emerged as an important contestant. The Independent Republics of the region have welcomed foreign investment more than Russia, in part because they did not possess the

⁹⁹ *Ibid.*, p.322

¹⁰⁰ A. Barski, p.16

¹⁰¹ P. Rutland, p.166

resources to develop them on their own. However, foreign participation has been deterred by frequent ethnic and civil conflicts and by lack of development infrastructure.¹⁰²

The area of the Russian Far East also possesses immense potential for development, especially with assistance from the neighboring Asian nations. Although the cooperation is aided by growing demand for energy and minerals, potential deterrents included a number of military, political, and ideological considerations. In addition, the different specifications of the marketplace such as pricing and legal systems increase the difficulty of cooperation.¹⁰³ Thus, without active foreign participation, Russian Asia remains largely underutilized and lacking market to justify the development of the needed oil and gas infrastructure. Among the recent valuable developments has been the localization of decision making - more new economic initiatives now originate locally or abroad rather than in Moscow.¹⁰⁴

The Sentiment

Foreign investment is welcomed by some forces in Russia and despised by others, with both parties utilizing the same arguments as in the earlier century. The supporters insist that, due to Russia's current inability to generate domestic capital, it must rely upon foreigners to make the most of its natural potential. The transforming Russian industries need, not only the resources to be delivered and the markets to consume them, but global partners in the form of international banks and lending institutions to supply the necessary financing and access to technology. The opposition follows the path of traditional Russian isolationism and warns that that the great inflow of foreign capital in the prevailing erratic conditions may result in loss of control over the most important and competitive national industries.¹⁰⁵ Often the Russian

¹⁰² B. Gokay, p.13

¹⁰³ J. Dorian, p.107

¹⁰⁴ R. North, "Transport System...", p.77-8

¹⁰⁵ A. Kuznetsov, p.x

professionals are suspicious of not only the unknown methods being employed by foreign specialists, but of their intentions as well. Such attitudes have severely hindered the much-needed major investments throughout the 1990s.¹⁰⁶

Just like in Tsarist Russia, the exploitation of the reserves is limited and discouraged not only by domestic opposition but also by an arbitrary and unpredictable tax system. The taxes in the oil industry have at times included a value added tax, a tax on the value of property, and profit taxes levied by both the federal and regional governments.¹⁰⁷ A more permissive tax climate began to emerge in 1994-5. At that time the government lifted oil tariffs to cater to demands of the IMF. A number of bills followed providing greater independence to foreign firms operating in Russia, as well as more development rights and some tax relief. Although the effect of such measures was rather small, they showed an important change in governmental attitude towards appreciating the importance of the oil industry and the role that foreign investment will play in its development.¹⁰⁸

Recent Developments

The ruble devaluation after the 1998 crisis proved to be of great benefit to the Russian economy in general and to the oil industry in particular. The consistently high oil prices and favorable currency conditions of the past several years allowed Russia to return significant debt portions to its European investors. The future looks even brighter in light of Russia's early payment of \$1.7 billion to the IMF in October of 2001. However, foreign investment is still well below the desirable level due to continuing bureaucracy, corruption, illegality, and even violence in Russian businesses.¹⁰⁹

¹⁰⁶ R. Sinker, p.91

¹⁰⁷ P. R. Gregory and R. Stuart, p.423

¹⁰⁸ R. Sinker, p.93

¹⁰⁹ *The Economist*, Nov 23rd 2000 and Nov 29th 2001

The conflict within Afghanistan has had profound ramification in political and economic spheres around the world. Russia is no exception in that it can be expected to become more integrated within the international community as it joined the “good” side of this war. The changing political relations had two important implications: perception of Russia in the global arena has improved and perception of foreigners in Russia has improved. The conflict also emphasized the attractiveness of Russia as a substitute energy provider. Thus, although Russia has a long way to go in terms of needed economic reforms and environmental factors, its political and military role is likely to benefit its economic situation in terms of foreign investment.¹¹⁰

Among the latest news is the January 2002 announcement by the management of Lukoil, the biggest of the Russian oil producers, of the existence of a potential foreign buyer. The speculations name Capital Group as a possible investor, although traditionally investments in Russian oil production have been made by other foreign energy firms. Among the reasons that supposedly made Lukoil attractive to investors are the newly established compliance with GAAP, introduction of independent directors, and other improvements to management practices and corporate image.¹¹¹

FOREIGN CONTRIBUTIONS UNDER THE TSAR

Why did Russia Lag?

Technological growth was limited in the first half of the 19th century due to disorganized state of the Russian industry and the government’s unwillingness to divert resources to industrial

¹¹⁰ *WorldBank*, 2001

¹¹¹ *Vedomosti*, March 31, 2002

development.¹¹² The Russian marketplace lacked the financial motivations to encourage new technologies. The supply-side factors such as little pressure for profitability, and underdeveloped capital markets, along with demand-side shortage of funds spelled lack of development.¹¹³ Thus, Tsarist Russia lagged behind the European and North American nations in terms of technological and industrial progress. In 1913, while engineering products accounted for only 10% of manufacturing output in Russia, their share of manufacturing product in England, the United States, and Germany was on average 21%.¹¹⁴

Until mid 19th century, foreign capital was regarded as a threat to sovereignty, leading to severe limitation on foreign activity in Russia. This effectively prevented foreign professionals from introducing the production techniques that were spreading and evolving in Europe and America. As a result, Russia fell further and further behind the other industrial nations.¹¹⁵ The turnaround came in 1860s when foreign professionals were allowed to enter Russia and brought with them modernization of many industries. (see Table 12 for evolution of economic conditions in Russia between 1860 and 1914)

Industrial (Manufacturing) Contributions

The newly established foreign trade agreements of the mid 19th century placed pressure on increasing the quantity and quality of Russian industries. That, in turn, created a demand for qualified professionals to instill the necessary developments.¹¹⁶ Because Russia lacked capable domestic specialists to institute the necessary changes she had to rely on the West for many of her machines and engineers. At the turn of the 20th century, many of the factories in Russia were

¹¹² W. Blackwell, p.79

¹¹³ J. Bradley, p.8

¹¹⁴ P. R. Gregory, "Socialist and Non-Socialist...", pp.28-29, 34, 171-174

¹¹⁵ J. Bradley, p.8

¹¹⁶ W. Johnson, p.29

owned and operated by foreigners of mostly German, English, and French decent. Even in the traditionally Russian cotton industry, one-fifth of the plants were foreign.¹¹⁷

The transfer of technology, which modernized the Russian industries, accompanied the inflow of foreign capital. Foreign industrialists either created manufacturing enterprises from scratch, or significantly renovated the existing Russian plants, thus embedding a large quantity of technological innovations.¹¹⁸ The main beneficiary was metallurgy, receiving technology and products that were either unknown or superior to those traditionally employed. Especially successful was the introduction and dissemination of the foreign coke-steel technology in the metallurgical sector.¹¹⁹ The foreign managerial and technological expertise enabled the restructuring of the obsolete and unproductive coal and steel industries, and brought to life a new class of engineers and technicians. While in most cases, the foreigners entered the already industrialized cities of Russia, in some cases their contributions extended to the less developed regions. So in the 19th century, German scientists, geographers, and historians contributed an immense amount to the study of Siberia, including its natural resources.¹²⁰

Although in majority of cases the Russian state and industries made use of foreigners who entered Russia of their own will, occasionally “search parties” were sent abroad to recruit the needed professionals. In such a way, a Russian Major was sent to America in 1842 to enlist some workers for the State industries. He sought engineers and mechanics possessing the experience and skills lacking in Russia.¹²¹

¹¹⁷ W. Blackwell, p.87

¹¹⁸ O. Crisp, p.190

¹¹⁹ A. Kuznetsov, p.56

¹²⁰ I. Erofeeva, p.205

¹²¹ R. Haywood, “Russia Enters...,” p.126

State Support of Foreigners

The legacy of foreign teachers in Russia goes rather far back: the nation's first "applied" academy, the School of Mathematical and Navigation Sciences, was established by Peter I and employed a foreign director and a mostly foreign staff.¹²² Catherine II and subsequent monarchs continued Peter's tradition of inviting foreign specialists. The latter half of 19th century saw the greatest inflow of foreign professionals. By the turn of the century, Saint-Petersburg alone was home to over 50 thousand Germans, among whom there were doctors, scientists, industrialists, and teachers.¹²³ However, it must be noted that such benevolence on behalf of the monarchs was always with the main purpose of training Russians to become self-sufficient. They invited foreign technological innovation not to change the existing order of the Russian society, but rather to strengthen it.¹²⁴ Through the years foreigners maintained a volatile status within the Russian society: while they were welcomed and admired in some decades, they were viewed with extreme suspicion in others.

The Western Model of Research University

Mid 19th century witnessed an increase in demand for doctors, lawyers, clerks, administrators, teachers, and other professionals. This expansion of demand was driven in part by the expansion of local governments due to the emancipation of serfs.¹²⁵ However, because foreigners could not hold positions within the government, these professionals would have to be "bred" within Russia. Thus the pressure was formed to improve the underdeveloped system of education.

¹²² W. Johnson, p.28

¹²³ G. Smagina, p.161-2

¹²⁴ R. Haywood, "The beginning of..." p.65

¹²⁵ P. Alston, p.91

Russia's growing higher education structure was modeled after the European system and consisted of graduates from upper secondary schools pursuing four to five year programs at universities or institutes. Unfortunately, when adapting the European model the Russian ministers created institutions that were clearly more focused on areas of research, rather than applied sciences. While Western universities incorporated technical disciplines, the Russian Ministry of Education focused their institutions only on pure science. Russian officials believed that such universities of rigorous academic standards would add to Russia's prestige. While the resulting system indeed produced some remarkable individual scientists, its disregard of applied sciences severely handicapped Russian economic development.¹²⁶

More Balanced Education

What the model of pure research did not produce was a wide population of hardworking and skilled professionals. In fact, the educational system was so concentrated and elitist that in 1900 only two European countries (Serbia and Portugal) had a higher rate of illiteracy than Russia.¹²⁷ Only in the later half of the 19th century, the classical research universities were supplemented with a number of *realschulen* (based on the Prusso-German model), which provided a more technical and skill-oriented education to a wider student base. These schools offered a 6-year course of education in technical sciences, and sometimes in commercial studies. Foreigners, for the majority Germans, comprised 40% of teachers in *realschulen*.¹²⁸ Except for the traditional theological seminars, the institutions of secondary education in Russia were also heavily influenced by the German school structure. Two models predominated on this level: (1) the classical gymnasium, which had an exclusive right to prepare pupils for university study, and

¹²⁶ J. McClelland, "Autocrats and Academics...", p.22-3

¹²⁷ J. McClelland "Diversification...", p.183

¹²⁸ G. Smagina, p.165

(2) the *presitulschule*, which trained its student for the technical institutes.¹²⁹ These secondary institutions also employed an impressive number of foreign educators.

Furthermore, the system was influenced by foreign capitalists, who brought with them not only their skill and experience, but also a new entrepreneurial culture, new approaches to decision making in business, new relations among industry and banks, and new techniques in marketing.¹³⁰ All those had to be reflected in the educational system and during the 1890s the number of technical and commerce schools of all levels increased significantly, as did their quality.¹³¹

Unfortunately, even the evolving education system did not satisfy the growing need for middle-level specialists and some basic education for all industrial workers. The small elite of state officials in charge of the educational system perceived concepts of universal education as heretical and dangerous.¹³² The problem was further aggravated by the fact that despite the increased numbers of able candidates, the advancements within the state were often based on titles rather than educational achievements.¹³³

Russians Abroad

The Russian higher education system was noticeably underdeveloped compared to those of European nations: by 1907 Russia contained 9 universities, while Germany featured 21, Italy 21, France 16, Great Britain 15, and Austria-Hungary 11.¹³⁴ Russia could not offer its population the opportunity to obtain qualifications so necessary for its economic development. Thus, it is only logical that by the second half of the 19th century, studying abroad became a

¹²⁹ J. McClelland “Diversification...,” p.180

¹³⁰ A. Kuznetsov, p.66

¹³¹ A. Swetzer, p.36

¹³² J. McClelland, “Autocrats and Academics...,” p.20

¹³³ P. Alston, p.95

¹³⁴ A. Ivanov, p.343

popular program to increase the number of Russian qualified professionals. The most common destination was Germany, which enjoyed the best scientific and pedagogical reputation. By 1913 Russian students comprised over 60% of foreigners in the universities and institutes of Germany.¹³⁵ They were most interested in technical fields such as engineering, agrarian education, and mechanical and chemical sciences. Some were also educated at the European commercial schools. Most often, upon completing the educational period students returned to Russia, thus sharing the newly acquired skills.¹³⁶

In the 1870s and 1880s many Russian female students enrolled in European institutions due to a their inability to study professional fields, such as medicine, in Russia. However, as more private institution open to women appeared domestically, the female share of the student population abroad fell.¹³⁷ Among the men one of the greatest reasons for educating abroad was the Jewish quota maintained in Russian universities and institutes.¹³⁸

POST-SOVIET NEEDS

One Sided Education

Today Russia remains one of most educated countries in the developed world. Over 80% of adults have higher or secondary education.¹³⁹ The deterioration of the education system would place a severe blow on the fragile competitive environment of Russia. Currently the school system, largely abandoned by the state, is still turning out an educated population on the inertia of its perceived position in the society. However, due to high levels of corruption within higher education (specifically among university and college acceptance practices), both native

¹³⁵ *Ibid.*, pp.341,354

¹³⁶ *Ibid.*, pp.361-2

¹³⁷ C. Timberlake, p.333

¹³⁸ A. Ivanov, p.349

¹³⁹ Y. Adjubei, p.111

and foreign employers within Russia have witnessed a decline in the standards of the workforce, especially in technical fields.¹⁴⁰

Technological Lag

The vulnerability of technical expertise stems from Soviet era production growth patterns. While most modern economies grew through technology innovation, the Soviet production of the 1980s was on three quarters due to growth in inputs.¹⁴¹ Technological inferiority, and the resulting incompatibility of many Russian industries, crippled by lack of efficient development during the Soviet period and abandoned during the early years of transition, deter foreign investment. (See Table 13 for productivity comparisons of Russia and the United States, 1993) Developments in minicomputers have created a sizable and growing technological gap leaving domestic machinery generations behind the state-of-the-art counterparts in the West.¹⁴² If foreign capital is allowed entry, the investment policies of foreigners will hopefully elevate Russian industries to the technological level of world's forerunners.¹⁴³

Business Skills

Ideological constraints and censorship during the Soviet era have effectively prevented the development of fields of business studies and business history.¹⁴⁴ It is thus natural that Russian professionals of the new market era should turn to foreigners to acquire the necessary business proficiencies. Among other Soviet legacies are wide gaps in areas of economics, management, and administration. To successfully exploit the great potential of her natural resources, Russia will need to import essential skills of production engineering and enterprise

¹⁴⁰ *The Economist*, Jul 19th 2001

¹⁴¹ G. Ofer

¹⁴² A. Kuznetsov, pp.13-15

¹⁴³ *Ibid.*, p.5

¹⁴⁴ J. Grant, p.2-4

management. The transfer of technologies, managerial and labor skills, marketing channels, and a market-based business culture can maximize the speed of transition.¹⁴⁵

The government subsidies to unprofitable enterprise still prevent the full picture of severe need for foreign involvement from emerging. The share of unprofitable enterprises, though declining, was still above 40% in 2000. These companies survived with help of special regulatory favors and tax exemptions.¹⁴⁶ However, the emerging movement to enforce bankruptcy on loss-making firms will create an additional pressure to adapt Western style operational measurements.

The transfer of both technological and business skills is further hindered by the often unclear and contradictory resource ownership legislature. The preference for domestic over foreign control is visibly reflected in the Russian policy of 'reasonable protection.' Thus, resource development proposals with domestic majority control or commitment to purchase substantial amount of domestically produced equipment are favored. Such limitation make it more difficult to utilize foreign technological and managerial innovations.¹⁴⁷

New Schools

A number of private business schools have opened in Russia during the last decade in hope of providing a much needed understanding and appreciation of the newly developing market. Among the first schools was the International Business School of MGIMO in Moscow, which housed the first international conference on business education in Russia. As is typical of many such schools, it cooperates with several European and North American universities to establish common programs of study and attract foreign professors.¹⁴⁸

¹⁴⁵ H. Lankes, p.555

¹⁴⁶ *European Bank for Reconstruction and Development* (2000)

¹⁴⁷ J. Thornton, p.98

¹⁴⁸ *Institute of Business Studies*

Today there is a variety of programs and schools available both in Russian and English languages and utilizing a multitude of international educators. To mention just a few there is: The American Institute of Business and Economics, an independent business school in Moscow offering a full range of MBA level courses taught in English.¹⁴⁹ There is also the European University at St. Petersburg, which develops and maintains relations with nearly 50 foreign universities and organizations.¹⁵⁰ The Russian Academy of Entrepreneurship, has adapted many foreign courses of study as well as a Western structure.¹⁵¹ Of course, just like in the Tsarist era, a large contingent of Russian student population is studying abroad on all five continents. Although, at the earlier part of the decade, the goal of most Russian students was to find employment and to remain in the nation of his/her study, increasingly the trend has been for students to return to Russia upon completion of education. This movement brings valuable professionals back home, and has developed largely due to an increased number of employment opportunities at the domestic and foreign firms within the Russian market.

What can Russia offer?

It is important to note that foreign investors entering Russia, not only bring skills and expertise, but also obtain valuable knowledge that has accumulated within the Russian industries. Among the technical knowledge that may be of great attraction to foreigners is the experience of the Russian oil and gas sector, especially the expertise of developing oil under extreme natural conditions.¹⁵² Because joint ventures best allow to tap into the local knowledge and markets, it

¹⁴⁹ *AIBEc*

¹⁵⁰ *EUSP*

¹⁵¹ *The Russian Academy of Entrepreneurship*

¹⁵² A. Kuznetsov, p.132

is no surprise that JVs are the prime choice for foreign investment (they account for over 60% of all foreign excursions in Russia and other CIS nations).¹⁵³

Conclusion

Post-transition Russia faces a challenge of creating a workable market-based economy from the ruins of the centrally administered structure. The rapid development of other nations puts pressure on Russia to accelerate its integration into the world market. This paper has sought to compare some of the nation's contemporary struggles with challenges within Tsarist Russia.

But why should one bother with comparisons of two societies separated by a hundred years? Today there are a multitude of functioning market economies, which can stand as models for Russia to use to mold its new system. However, while market structures have evolved in many nations, none of them has been built from the shambles of a centrally controlled economy. Thus, no nation and no organization has experienced dealing with the dramatic economic transition that Russia has been going through. This means that foreign expertise on establishing a market economy is only marginally useful to Russia's case. The situation is further complicated by Russia's uniqueness. Historical and contemporary analyses of Russia are permeated by the word "backwardness," particularly in regard to the Russian economic climate, the political situation, the social and the psychological environments. Aside from the condescending aspect of the phrase, we must acknowledge that, conventionally, Russian development was taken to be a deviation from Western norms. The unique history of the political-economic climate and a heritage of social isolationism have led Russian businessmen of all eras to operate according to a different understanding from their Western counterparts. All

¹⁵³ H. Lankes, p.560

these conditions suggest that Russia may benefit more from an analysis of its own history rather than from the experiences of others.

By the middle of the 19th century Russia's "backwardness" was of legendary proportions. However, its industrial development during the late 19th and early 20th centuries was of such a pace that it quickly caught up to other industrial nations. In two decades Russia attained levels of development that took over a century in other nations. What lessons can be applied from that extraordinary historical experience to Russia's present trials? During the Tsarist era foreign and Russian entrepreneurs confronted challenges, similar to current ones, as they attempted to integrate private enterprise, foreign investment, and the latest foreign production techniques into the Russian environment. What helped them in this endeavor was that Tsarist Russia, despite its institutional shortcomings, featured a secure, though rudimentary, market economy with private enterprise. It also featured a stable and convertible currency, a functioning legal system, and it was able to integrate quickly foreign innovations. This combination of environmental factors offered the most important appeal to foreigners – stability.

An important difference between Tsarist and modern Russia was the nature of the foreign investors they attracted. The foreigners investing in Tsarist Russia weren't seeking a fast gain, but rather came to establish enterprises and to grow together with the Russian economy. Many brought their families, acquired Russian citizenships, and in other ways signaled their lasting interest in the Russian market. Of course, the international business and investment climate has drastically changed over the past hundred years. The developments in the telecommunication industries have in large part diminished the importance of physical presence in international dealings. However, even accounting for these changes, Russia's current business environment discourages long-term foreign interest. The existing financial system promotes short-term

lending which is less suited for long-term industrial development. To a large degree, investments are flowing into activities that yield quick returns. The experience of Tsarist Russia suggests that the influence of foreign capital is likely to be most effective if the investors bind their profit expectations to the growth of the Russian economy and the industries within it. Thus, to tap into potential foreign investment, Russia must implement better business practices and legal statutes, and develop stable economic and physical infrastructures.

The next step is determining the pace at which these essential changes are to take place. Many hope for a drastic transformation and expect the Russian government to institute a number of radical judicial, tax, and economic reforms. Indeed, Mr. Putin himself, in his most recent state of the nation address, complained about the need for greater and faster changes. Such actions would indeed be likely to increase both domestic and foreign confidence and yield the much needed long-term investment flow. But the history of Russia reminds us that drastic and forceful transformations can often come at great costs to the standards of living. Russian experience has been more benevolent towards spontaneous advances than towards devised upheavals. The “big bang” reforms of the 1990s are often perceived as spectacular failures, which gave rise to unpredictability, criminal behavior, and inflation. Although many needed developments have taken place since then, Russia is still lacking much of the infrastructure necessary for successful market operations. The nation is not ready for a forceful transformation into a Western-style market structure, but the reforms of the past several years have had a great positive effect. At this time a likely path of successful evolution within Russia will involve a large set of incremental developments, such as legal protection of private enterprise, long-term financial stability, and independence of the banking industry. Hopefully, if all those are encouraged and allowed to develop, Russia will form a unique market structure, just as it did in

the late 19th century. This economy is likely to differ from the Western market model to account for the singularities of the Russian background. However, the new structure can be expected to improve Russia's relationship with the international community and to allow for both internal and external stimulation of industrial development. Then Russia will finally go from being a nation of what could be to a nation of what is.

SUPPORTING TABLES

Table 1a

Growth of Foreign Investment Stock in Russia by Country of Origin, 1830-1917

Country of Origin	1890		1890		1916-17	
	Roubles (m)	%	Roubles (m)	%	Roubles (m)	%
France	66.6	32%	226.1	25%	731.7	33%
UK	35.3	17%	136.8	15%	507.4	23%
Germany	79.0	38%	219.3	25%	441.5	20%
Belgium*	24.6	12%	296.5	33%	321.6	14%
USA	2.3	1%	8	1%	117.7	5%
Other countries	0		0		122.5	5%
Total	207.8		886.7		2242.4	

* Much French capital has entered Russia under a Belgian cloak, partly due to the more liberal Belgian company law, partly because Belgian taxes were lower than French, and partly because Belgians traditionally pioneered new ventures which they subsequently passed on to others at a profit.

Source: Lyashchenko p.696

Table 1b

Major source countries of foreign investment in the Russian Federation, 1995

Country	# of Firms	Foreign Capital	% of total Capital
USA	451	1467	17.8%
Germany	482	736	8.9%
Austria	170	602	7.3%
Finland	245	521	6.3%
China	96	514	6.2%
Japan	119	484	5.9%
Italy	177	407	4.9%
UK	175	332	4.0%
Sweden	93	322	3.9%
Canada	67	302	3.7%
Total (w.other)	3373	8258	

Source: UN/ECE Secretariat

Table 2

Role of Foreign Capital in Commercial Russian Banks: January 1917

Bank	Base Capital (in mill. rub)	Foreign Part.	
		in mill. rub.	in %
Russko-Asiatskiy	55	43.5	79%
Petrograd Private	40	23.2	58%
United Bank	40	20.0	50%
Russian Trade-Industrial	35	15.0	43%
Petrograd International	60	24.0	40%
Russian External Trade	60	24.0	40%
Azovsko-Donskoi	60	22.0	37%
Sibirskiy Trade	30	8.0	27%

*Source: Ohl, pp.30-137***Table 3**

Index of Banking Reform (1991-1999)

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999
Czech Republic	2	3	3	3	3	3	3	3	3+
Estonia	1	2	3	3	3	3	3+	3+	4-
Hungary	2	2	3	3	3	3	4	4	4
Latvia	1	2	2	3	3	3	3	2-	3
Lithuania	1	1	2	2	3	3	3	3	3
Poland	2	2	3	3	3	3	3	3	3+
Russia	1	1	1	2	2	2	2+	2	2-
Slovenia	1	2	3	3	3	3	3	3	3+
Slovakia	2	3-	3-	3-	3-	3-	3-	3-	3-
Ukraine	1	1	1	1	2	2	2	2	2

Note 1: Index is a scale from 1 to 4+. 1 stands for little progress beyond establishment of two-tier system. 4+ stands for standards and performance norms of advanced industrial economies: full convergence of banking laws and regulations with Bank of International Settlements standards; provision of full set of competitive banking services.

Note 2: Among the transitional economies Russia's poor progress is only trailed by Ukraine's development.

Sources: EBRD Transition Reports

Table 4

Foreign Participation in the Transitional Russian Banking Sector

Year	# of Banks	
	Total	Foreign
1991	1306	-
1992	1747	-
1993	2009	-
1994	2456	-
1995	2295	21
1996	2576	25
1997	2526	29
1998	2451	32
1999	2376	33

Source: European Bank for Reconstruction and Development: Transition Report 2000

Table 5

Business Environment Scores and Ranks for Selected Transition Economies

Country	2001–05 (expected)		1996–2000		Change	
	Total score*	Rank	Total score*	Rank	In score	In rank
Estonia	7.40	1	6.86	1	0.54	0
Hungary	7.26	2	6.42	2	0.83	0
Poland	7.07	3	6.22	3	0.85	0
Czech Republic	7.01	4	6.18	4	0.83	0
Slovenia	6.96	5	6.08	5	0.87	0
Lithuania	6.95	6	5.74	7	1.21	1
Latvia	6.88	7	5.87	6	1.01	-1
Slovakia	6.57	8	5.46	8	1.11	0
Croatia	6.33	9	5.23	9	1.1	0
Bulgaria	5.94	10	4.03	17	1.91	7
Kazakhstan	5.59	11	4.3	13	1.29	2
Russia	5.49	12	4.12	14	1.36	2
Armenia	5.34	13	4.5	10	0.84	-3
Azerbaijan	5.28	14	4.35	12	0.92	-2
Romania	5.24	15	4.1	15	1.14	0
Yugoslavia, FR	5.23	16	2.79	27	2.44	11
Macedonia	5.21	17	4.47	11	0.73	-6
Albania	5.09	18	4.01	19	1.07	1
Ukraine	4.95	19	3.27	23	1.69	4
Georgia	4.87	20	4.01	18	0.86	-2
Moldova	4.78	21	4.04	16	0.74	-5
Kyrgyz Republic	4.77	22	3.75	22	1.02	0
Bosnia & Herzegovina	4.66	23	3.98	20	0.68	-3
Belarus	4.16	24	3.91	21	0.25	-3
Tajikistan	3.55	25	2.81	25	0.74	0
Turkmenistan	3.46	26	3.05	24	0.41	-2
Uzbekistan	3.18	27	2.8	26	0.38	-1

* 10 being the best and 1 the worst

Note: The Baltic States and Russia's Western neighbors have a more attractive business climate while the majority of other CIS members trail behind.

Source: The Economist Intelligence Unit

Table 6

Russian and Foreign Limited Liability Companies Operating in Russia in 1911 (sorted by %age of foreign participation)

No.	Description	Number of Russian Co.	Number of Foreign. Co.	
1	Metal works (except iron)	32	16	50%
2	Municipal Works	95	45	47%
3	Iron obtaining and production	56	22	39%
4	Storage and transport	15	5	33%
5	Metallurgical products	43	13	30%
6	Mineral products (except metals)	119	34	29%
7	construction of machinery	65	15	23%
8	Production of minerals	50	10	20%
9	Chemical products	79	11	14%
10	Commission agencies	24	3	13%
11	Insurance operations	19	2	11%
12	Timber and timber products	52	3	6%
13	Textile industry	261	13	5%
14	Animal products	31	1	3%
15	Foodstuffs and preserves	296	3	1%
		1237	196	16%

Source: *The Russian Year Book 1913*

Table 7

List of Selected Russian Laws Referring to Foreign Companies

Year	Code	Specification
1888	Enactments and Orders in Council, No.93	Procedure for the admission of certain foreign companies to carry on operation in Russia.
1893	Volume VII, Article 341	Procedure of applying His Imperial Majesty's order of 1887 to foreign mining companies in the Kingdom of Poland.
1899	Volume IX Article 830	Acquisition by foreign companies of real estate in certain Provinces of the western part of Russian and Caucasus.
1906	Volume X, Article 2319	Conditions under which foreign companies may exercise their rights, including their rights of Judicial protection, in Russia.
1906	Volume VII, Article 547	Procedure for the acquisition by foreign companies of naphtha (petroleum) bearing lands.
1906	Volume VII, Article 249	Mining operations by foreign companies in the Primorski Maritime province and also on the Island of Sakhalin.

Source: *The Russian Year Book 1913*

Table 8

Capital Entering the Petroleum Industry 1910 – 1913

Year	Foreign Capital (mil rub)	Russian Capital (mil rub)
1910	7.0	5.0
1911	8.0	1.5
1912	4.2	2.0
1913	54.0	1.1

*Source: The Russian Year Book 1913***Table 9**

Nobel Company Net Profits 1879-1914 (thousands rubles)

Year	Profits
1880	1005
1885	859
1890	2337
1895	2171
1900	6911
1905	2971
1910	352
1914	13142

*Source: R. Cameron, p.45***Table 10**

Crude Oil Production in Russia 1913-1914 (million of tons)

Enterprise	1913	1914
RGO*	2.1	1.9
Nobel Brothers	1.3	1.2
Royal Dutch-Shell Group	1.3	1.5
Others	4.4	4.3
Total	9.1	8.9

* Russian General Oil Corporation

Source: R. Cameron, p.87

Table 11

Foreign Direct Investment Inflows, Selected Transition Economies, 1996-2000 (actual) 2001-2005 (projected)
(\$ millions, annual averages)

Rank (actual)	Country	1996-2000			2001-05		
		Total	% of GDP	\$ per head	Total	% of GDP	\$ per head
1	Poland	6,528	4.3	169	6,900	3.2	178
2	Czech Republic	3,463	6.4	337	4,960	6.9	486
3	Russia	3,246	1.1	22	6,600	1.7	46
5	Hungary	2,029	4.4	201	2,030	3	205
6	Kazakhstan	1,289	6.7	86	1,300	5.2	88
8	Romania	1,115	3	50	1,350	2.9	60
9	Croatia	882	4.4	196	940	3.6	194
10	Slovakia	699	3.5	129	1,640	6.9	303
11	Azerbaijan	681	17.5	86	450	7.4	55
12	Ukraine	596	1.5	12	1,060	2.1	21
13	Bulgaria	594	5.1	74	950	5.6	121
14	Lithuania	460	4.4	124	450	3.1	121
15	Latvia	403	6.7	164	470	5.5	198
16	Estonia	310	6.3	214	350	4.7	243
17	Belarus	239	1.8	24	210	1.6	21
18	Slovenia	236	1.3	119	590	2.4	296
19	Yugoslavia, FR	222	1.3	21	580	3.7	54
20	Georgia	152	3	28	160	2.7	29
21	Uzbekistan	135	0.9	6	250	2.2	10
22	Armenia	112	6.1	30	130	6	34
23	Turkmenistan	94	3.1	20	130	2.2	26
24	Albania	73	2.4	19	180	3.7	44
25	Moldova	72	4.9	17	120	6.8	28
26	Macedonia	70	2.1	35	180	4.8	90
27	Bosnia & Herzegovina	67	1.5	18	340	5.7	82
28	Kyrgyz Republic	59	3.7	13	90	5	18
29	Tajikistan	25	2.3	4	30	2.2	5

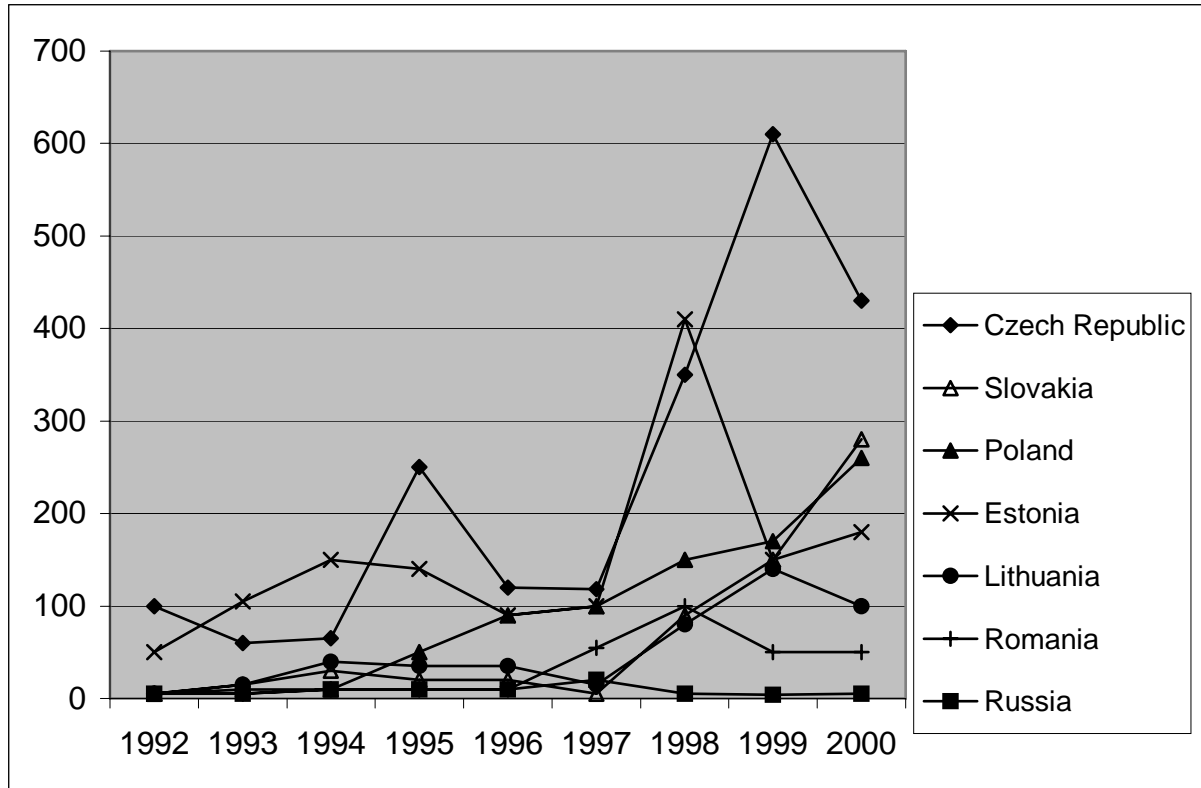
Note: Although Russia's total numbers place it among the top five recipients of foreign capital, it is important to note that its per capita amounts of foreign investment are among the lowest ten.

Source: The Economist Intelligence Unit

Figure 11a

Foreign Direct Investment Per Capita

(net inflows in U.S. dollars recorded in the balance of payments, per capita)



Note: Again it is evident that Russia's growth of FDI per capita was miniscule compared to the numbers for its Western and Baltic neighbors (in part due to the size of the population and in part due to delay in developing the necessary premises for foreign investment).

Sources: William Davidson Institute, based on EBRD Transition report 2001 Updated, World Bank Development Indicators 2001 and Davidson Institute staff calculations in J. Svejnar, p.17

Table 12

Main Indicators of Russia's Social and Economic Development, 1861-1914

Year	January of the Year			Per Year		
	Population (millions)	Length of Railways (th kilometers)	Liabilities of Joint-Stock Banks (mill rub)	Grain Output	Export	Import
1861	73.6	1.6			177	167
1875	90.2	18.2	595.3		382	531
1880	97.9	22.7	431.4	117	499	622
1887	113.1	27.3	568.5	1400	617	399
1893	121.5	31.2	728.7	1824	599	449
1900	132.9	49.8	1380.2	3086	716	626
1908	152.5	65.5	2007.3	4297	998	913
1913				6521	1520	1374
1914	175.1	70.2	6233			

Note: In the period of fifty years, Russia's economic indicators improved from nine hundred percent to five thousand percent.

Source: R. Cameron, p.197

Table 13

Productivity Comparisons*, Russia and the United States, 1993

	US=100
Russian/US GDP	12
Russian/US capital ¹	16
Russian/US capital ²	27
Russian/US labor force	56
Capital Productivity ¹	74
Capital Productivity ²	43
Labor Productivity	21
Total Productivity ¹	37
Total Productivity ²	23
Russian/US earnings ^a	4
Russian/US earnings ^b	16

* Capital and labor productivity averages using weights of .3 and .7 respectively.

Key: 1 Converts Russian Capital stock into dollars using the PPP rate for capital investment.

2 Converts Russian Capital stock into dollars using the average PPP exchange rate.

a Converts ruble wages into dollars using market exchange rate.

b Converts ruble wages into dollars using PPP exchange rate.

Sources: Natsional'nye scheta Rossii v 1989-1994 gg.69; Mezhdunarodnye Sopostovaleniia VNP za 1993; Sosial'nayia sfera Rossii 1995; U.S. figures from Statistical Abstract of the United States, (in Gregory and Stuart, p.348)

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