



US-Russia economic relations

Room for improvement - but do not expect too much

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Geopolitical issues have historically dominated US-Russia relations and bilateral trade and investment levels are low. Nevertheless, trade has grown rapidly in recent years and there is room to further strengthen economic ties. Closer economic relations may also stabilise the political relationship between Russia and the US. To start a virtuous circle of improving economic and political relations between Russia and the US, a strong initial push by the respective administrations is needed.

US-Russia trade is dominated by inter-industry trade. The US mainly exports skill-intensive products to Russia while importing commodities from Russia. While Russia and the US each only account for minor fractions of the other's trade with the rest of the world, there are a few products for which bilateral trade is significant.

Bilateral direct investment has also been on a low level. US FDI in Russia has mainly taken place in the mining sector and to a lesser extent in manufacturing. Russian FDI in the US has been concentrated in the steel sector.

There are structural reasons why a priori not to expect flourishing economic relations. Current impediments range from technical reasons and trade disputes to Russia's scarcity of competitive export goods outside the energy sector. In addition, there are institutional impediments such as the fact that the US does not grant Russia permanent normal trade relations (NRT) status, as well as Russia's non-membership in the WTO and OECD, and the lack of a ratified bilateral investment treaty.

There is no general trend distinguishing US-Russian trade from US trade with other large emerging markets apart from China. As far as direct investment is concerned, the difference to other large emerging markets is even less pronounced than for trade.

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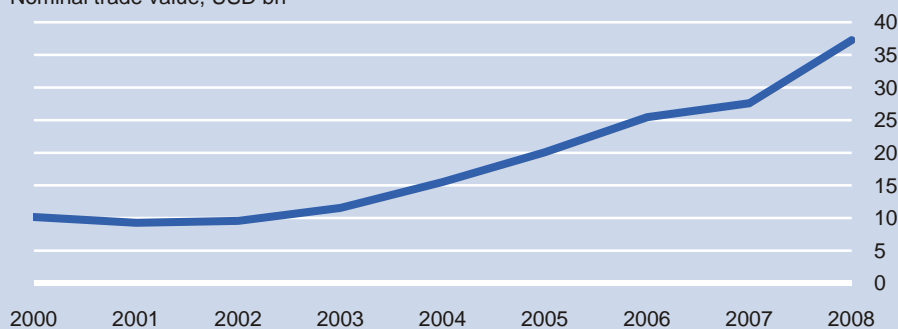
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US-Russia trade reaches new high
Nominal trade value, USD bn



Sources: IMF, DB Research

Introduction

The discussion about a “reset” of US-Russia relations has moved into the spotlight since the Obama administration took office in January. Among the main topics of interest are nuclear arms reduction and non-proliferation, missile defence shields, the war on terror and NATO enlargement. A topic which has seldom made headlines is economic relations. An exception was a recent statement by John Beyrle, US Ambassador to Russia, who claimed that “the volume of Russian-US trade can and must increase”.¹

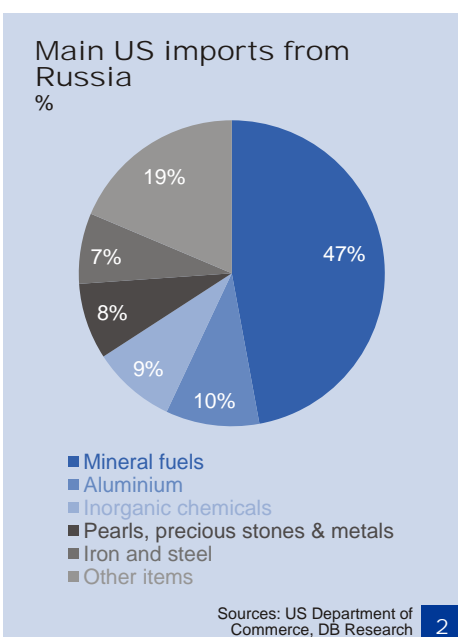
Economic ties are important in their own right but may in addition help to provide stability to the broader US-Russia bilateral relationship.² A more stable political relationship brought about by deeper economic integration has, for instance, characterised Germany’s policy vis-à-vis Russia.³ We therefore take a closer look at bilateral economic relations between Russia and the US focussing on trade and direct investment. It turns out that current trade and investment levels between Russia and the US are low but there is room for improving the status quo. At the same time there are many structural and institutional factors impeding flourishing US-Russia economic relations. Against the background that their economic relations are sometimes even perceived as exceptionally low it is noteworthy that on several measures they are not less significant than US economic relations with other major emerging markets such as Brazil, India and Turkey.

Status quo – trade

In recent years, trade between Russia and the US has grown fast but it is still on a low level. Since 2000, US exports to Russia have increased 22% per year on average while US imports from Russia have risen 19% annually. Still, Russia accounted for only 0.7% of US exports and 1.3% of US imports in 2008. Vice versa, the shares are slightly higher with the US accounting for 3.3% of Russia’s exports and 4.4% of Russia’s imports.

To analyse trade in more detail, we broadly distinguish between inter-industry trade, where exported and imported goods differ, and intra-industry trade, where exported and imported goods are of the same kind. Given the largely differing industrial structure and resource endowments of Russia and the US, it is not surprising that US-Russia trade is dominated by inter-industry trade. In fact, the 15 largest trade items, which accounted for 90% of total US-Russia trade in 2008, can all be considered as inter-industry trade. Taking an even closer look with regard to the dominant export and import items from a US perspective, the data reveal that the top three exports from the US to Russia were nuclear equipment, meat products and vehicles, while the three largest imports to the US from Russia were mineral fuels, aluminium, and inorganic chemicals and radioactive components (see charts).

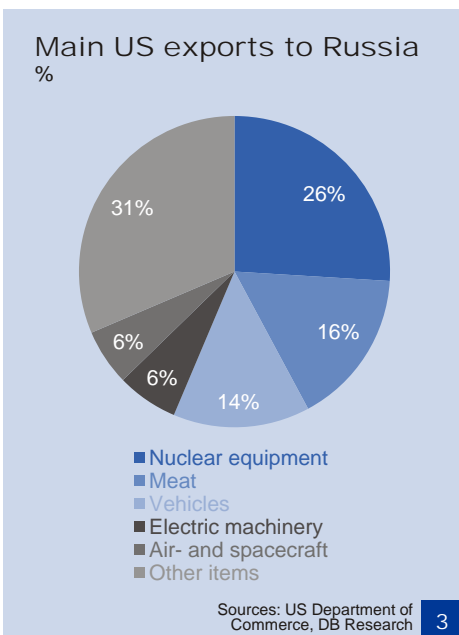
Despite the fact that the overall level of trade is low, there are some surprises hidden in the data. Notably, Russia is one of the largest export markets for chicken, with 39% of total US chicken exports going to Russia in 2008. On the import side, the importance of Russia is even somewhat more pronounced as there are several areas in which America imports sizeable volumes from Russia.



¹ See Johnson’s Russia List (2009, #26).

² See Charap & Kuchins (2009, pages 11 & 15).

³ In German, “Annäherung durch Verflechtung”.



Russia accounts for 32% of US fertiliser imports and 19% each for total base metal imports and nickel imports on average from 2000-2008. From the Russian perspective, there are also some items for which exports to and imports from the US are sizeable. The US accounted for significant shares of Russian aluminium exports (22%) on average from 2000-2008. On the import side, the US supplied close to 60% of total Russian aircraft and spacecraft imports and 18% of total meat imports.

Status quo – direct investment

Bilateral foreign direct investment (FDI) shows lower figures than trade: Russia accounted for only 0.3% (USD 6 bn) of the US FDI stock abroad on average from 2000 to 2008. FDI increased sharply from 2003 to 2007 but recorded a significant drop last year driven by FDI stock reduction in the mining sector. The large impact of the mining sector on the US FDI stock in Russia is not surprising given that US FDI has been concentrated in the mining sector (53%) over the period 2000-2008. During these years, another important sector was manufacturing (16%).



There are only two sectors where Russia occupies a prominent position with regard to the worldwide US FDI stock, namely the mining sector, where Russia accounted for 6% of total US FDI since 2005 and manufacturing in the food sector, where Russia accounted for 3% in recent years. For all other sectors, Russia's share was close to or even well below 1% of worldwide US FDI. Data on Russian FDI stock in the US is limited. Media reports and expert assessments reveal that Russian FDI stock in the US was dominated by the steel sector, accounting for 90-95% in recent years.

US-Russia economic relations in international comparison

To gauge whether US-Russia economic relations are exceptionally low, it is worthwhile comparing them to other bilateral relations. We do so with respect to US trade and investment relations with Brazil, China and India. Together with Russia, these are the four largest emerging markets and are often referred to as the BRIC countries. In addition, we compare US-Russia economic relations to US relations with Turkey, another sizeable emerging market and a close US ally. Finally, we consider US relations with Ukraine, which on the one hand shares Russia's Soviet history but on the other hand has moved closer to the West since the Orange revolution in 2004.⁴

Russia's peer group: Basic facts

	GDP in 2008, USD bn	Population, m
Brazil	1,573	192
China	4,402	1,328
India	1,210	1,190
Russia	1,677	142
Turkey	729	70
Ukraine	180	46

Sources: IMF, DB Research **5**

Trade – US-Russia trade in international comparison

US trade with Russia totalled USD 18 bn per year on average from 2000 to 2008. This was more than 13 times lower than total trading volume with China and about half of the trading volume with Brazil, but only slightly below trade with India and still larger than with Turkey or Ukraine. While absolute numbers are informative, they may be somewhat misleading as they do not take the economic size of the individual countries into account. US-Russia trade is thus 4 times rather than 13 times lower than US-China trade when measured as a percentage of GDP. While US trade with Brazil remains almost twice as high as US trade with Russia, US trade with Turkey and Ukraine are slightly below US-Russia trade in terms of GDP. Another way to express the size of FDI inflows is in per

⁴ We do not consider Mexico for comparison as membership of NAFTA and its border to the US make it a special case.

capita terms where US-China trade is only 1.5 times larger than US-Russia trade.

China is the closest trading partner of the US
Trade flows with US, average per year 2000-2008

	USD bn	% of GDP	Per capita	Growth rate
Brazil	39	4.7%	213	10.6%
China	247	10.9%	189	17.3%
India	25	3.3%	22	15.7%
Russia	18	2.6%	124	18.8%
Turkey	9	2.3%	135	11.3%
Ukraine	2	2.0%	36	28.8%

Sources: IMF, DB Research **6**

In terms of growth rates, US-Russia trade relations look very dynamic. US-Russia trade has grown even slightly faster than US-China trade and much faster than US-Brazil, US-Turkey and US-India trade. Only US-Ukraine trade has grown much faster, at almost 30% on average per annum. This may be politically explained by closer US-Ukraine ties following the Orange revolution in 2004, a view supported by the fact that the average annual growth of US-Ukraine trade was much higher from 2005 to 2008 than from 2000 to 2004.

Direct investment – US-Russia direct investment in international comparison

Comparing direct investment from the US to Russia with that of the US with other countries is slightly more difficult due to data constraints. With regard to the stock of US FDI, Russia ranked below Brazil and China, slightly below India and above Turkey on average from 2000-2008. Looking at US FDI as a percentage of GDP, Brazil leads with 4.4%, while the levels in India, China and Turkey are all close to 1% and hence on par with Russia. In per capita terms, Brazil received most US FDI followed by Russia and Turkey, which both obtained significantly more FDI per capita than China and India. These figures are also evidence against the claim that US-Russia economic relations are exceptionally low.

Brazil is most favoured destination for US FDI
US FDI abroad, average 2000-2008

	USD bn	% of GDP	Per capita
Brazil	35	4.4%	186
China	20	1.0%	12
India	8	0.9%	5
Russia	6	0.7%	38
Turkey	3	0.7%	39

Sources: BEA, DB Research **7**

How to enhance US-Russia economic relations

Several structural factors constrain relations between the US and Russia that are difficult to resolve. Among those are the large geographical distance, different languages, a relative lack of cultural ties and, not to be forgotten, the history of the cold war.

Despite these structural impediments, there are several concrete ways to raise trade flows. Starting with the oil trade, the low share of Russia in total US oil imports (3% on average from 2000-2008) is surprising given that Russia is the second largest oil producer worldwide. While there are likely historical reasons for this fact, there are also technical reasons limiting US oil imports from Russia, namely that US oil refineries are not suited to process the particular type of oil (Urals) that Russia produces.⁵ More direct investment by US oil companies in Russia might render US refineries for Urals oil more profitable. For this, barriers to foreign direct investment in the

Structural impediments to flourishing economic relations

Technological impediments to US-Russia trade

⁵ According to experts from the US Commerce Department.

Lack of cooperation and trade disputes	<p>Russian energy sector would need to be reduced. US natural gas imports from Russia are mainly limited by the fact that there are no gas pipelines connecting the two countries. An alternative to building pipelines would be to liquefy natural gas and then ship it to the US. However this process is still very expensive. Hence improvements in the liquefaction technology could spur further US natural gas imports from Russia. In the context of technological and energy cooperation, it would also help to restart the US-Russia energy dialogue, which has stagnated since 2005.⁶</p> <p>There is no strong Russia lobby in the US and cultural and business exchange is limited. Against this background, the US-Russia Business Council has recommended the creation of a new bilateral Economic and Technical Cooperation Commission along the lines of the Gore-Chernomyrdin Commission of the 1990s.⁷ Turning to the major US exports to Russia, namely nuclear equipment and meat exports, progress on the 123 Agreement on nuclear cooperation between the US and Russia could also help to boost further US nuclear equipment exports.⁸ With regard to US meat exports, resolving outstanding issues on sanitary measures may also help to increase US exports further. Hence there is room to raise trade even within the current inter-industry trade pattern.</p>
Russia has few competitive goods outside energy sector	<p>Concerning intra-industry trade, we already noted that there have been only low-level exchanges of goods of the same kind between the US and Russia. This is due to the fact that few Russian goods outside the energy sector are able to compete with US products. The Russian government is well aware of the lack of competitiveness in the non-energy sector and has explicitly included measures to raise competitiveness in its current anti-crisis programme. Intra-industry trade could start to rise once Russia has modernised its industrial structure.⁹ The international competitiveness of Russia's economy has also been hampered by its weak business climate and institutional environment. Improving Russia's environment for doing business, fighting corruption, and improving corporate governance and the rule of law may therefore help to encourage trade and investment relations.</p> <p>US-based Russia experts as well as the US-Russia Business Council highlight several other institutional impediments weighing on US-Russia economic relations.¹⁰ Reducing these would need a more active engagement of the new US administration.</p>
Russia does not enjoy permanent normal trade relations	<p>First, the US does not grant Russia the benefits of permanent normal trade relations (NTR) status, i.e. Russia does not, unlike the vast majority of other US trading partners, enjoy non-discriminatory treatment in comparison to other trading partners. This is because Russia is still subject to restrictions under the Jackson-Vanik amendment included in the Trade Act of 1974.¹¹ While Russia has been granted temporary (rather than permanent) NTR status since 1992, it has not, unlike other former Soviet Republics, fully</p>

⁶ See Russia Business Week (2008, p.1).

⁷ The Gore-Chernomyrdin Commission was created in 1993 and ceased to exist in 1999. See also Charap and Kuchins (2009, p. 13) and Carey (2009, p.3).

⁸ See Aslund & Kuchins (2009, p. 10).

⁹ For details, see <http://premier.gov.ru/eng/anticrisis/>.

¹⁰ See e.g. Aslund & Kuchins (2009), Charap & Kuchins (2009), Carey (2009), Cohen (2006).

¹¹ See CRS Reports (2008, 2005). The Jackson-Vanik amendment stipulates that countries are not eligible for permanent NTR status with the US as long as they deny their citizens the right of freedom of emigration. While there were impediments to emigration during Soviet times, Russia started to grant freedom of emigration already in the early 1990s.

graduated from Jackson-Vanik coverage. Against this background, Russia has been calling for the US to remove the Jackson-Vanik restrictions and to grant Russia permanent rather than temporary NRT status. The US Congress has, however, not passed the necessary legislation. It is very difficult to assess or even quantify the related impact on US-Russia economic relations. In fact there have not been any restrictions due to Jackson-Vanik in place for almost two decades as the US president has waived these restrictions every year. However, the fact that Jackson-Vanik has been kept may have weighed negatively on US companies' sentiment towards Russia. At the same time, Jackson-Vanik may have deterred and irritated Russian politicians and the Russian business community, undermining a more active economic exchange.

Russia is not a member of WTO and OECD

Second, Russia is neither a member of the WTO nor of the OECD. This implies, other things being equal, that there is more institutional and legal uncertainty in Russia than in countries, which are members. Estimating the impact of WTO and OECD membership is challenging. There is some empirical evidence available for the impact of WTO membership on trade flows.¹² From the Russian perspective, non-WTO membership appears for instance to have biased trade towards non-WTO members, i.e. also away from the US. If Russia joined the WTO, exports to current WTO members could increase in the longer run by as much as 50%. At the same time, there might also be trade diversion away from current non-WTO members, i.e. the net effect remains somewhat uncertain.

Russia has not ratified the 1992 bilateral investment treaty with the US

Third, Russia has not ratified the bilateral investment treaty (BIT) concluded with the US in 1992. The BIT would grant investments made by a US investor in Russia or vice versa a number of guarantees including fair and equitable treatment, protection from expropriation, free transfer of means, and full protection and security.¹³ Lack of a BIT is thought to have caused US companies to invest in Russia via other countries, e.g. a European subsidiary, in order to enjoy better legal protection.¹⁴ This would imply that actual direct investment by US companies is understated in the official statistics. Experts from the US Commerce department estimate that total direct investments by US companies in Russia are about 30% higher than official statistics show.

¹² See Lissovolik and Lissovolik (2006). Note that WTO membership talks started already in 1993.

¹³ For the bilateral investment treaty see: http://www.unctad.org/sections/dite/ia/docs/bits/usa_russia.pdf.

¹⁴ See Aslund & Kuchins (2009, p. 10).

Summary and conclusion

The level of bilateral economic exchange between Russia and the US is low. Each only accounts for minor fractions of the other's trade with the rest of the world. Trade is dominated by inter-industry trade, with the US mainly exporting skill-intensive products to Russia while importing commodities. This is not surprising given the countries' different economic structures and factor endowments.

There are a number of reasons explaining why a priori not to expect particularly flourishing economic relations between Russia and the US. Nevertheless, there are concrete ways to foster bilateral economic relations.

While US-Russia economic relations are low, there is no general trend distinguishing US-Russian trade and investment from US relations with other large emerging market countries such as Brazil, India and Turkey. There is, however, evidence of a special trade relationship between the US and China.

While this note has not least been motivated by the implicit causality linking political stability to economic interdependence, there is of course also a crucial link from political to economic relations. To put it in a nutshell: starting a virtuous circle of economic and political relations between Russia and the US requires a strong initial push by their respective administrations.

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