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Assistant Secretary for Import Administration
Attn: Import Administration
Central Records Unit, Room 1870
U.S. Department of Commerce
Pennsylvania Avenue and 14th Street, N.W.
Washington, D.C. 20230

Attn: Albert Hsu, Room 3716

Re: Inquiry Into the Status of the Russian Federation as a Non-Market Economy Under the Antidumping and Countervailing Duty Laws

Dear Assistant Secretary Shirzad:

At the public hearing in the above-referenced matter on March 27, 2002, the U.S. Department of Commerce (the "Department") provided interested parties an additional opportunity to submit comments on the status of the Russian Federation as a non-market economy under the antidumping and countervailing duty law. Pursuant to the Department's invitation, we submit the attached comments on behalf of Bethlehem Steel Corporation; National Steel Corporation; and United States Steel Corporation.

Respectfully submitted,

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Enclosure

BEFORE THE
OFFICE OF IMPORT ADMINISTRATION
INTERNATIONAL TRADE ADMINISTRATION
DEPARTMENT OF COMMERCE
WASHINGTON, D.C.

Case No. A-821-816
Inquiry Into the Status of the Russian Federation as a Non-Market Economy Country Under the Antidumping and Countervailing Duty Laws

INQUIRY INTO THE STATUS OF THE RUSSIAN FEDERATION AS A NON-MARKET ECONOMY UNDER THE ANTIDUMPING AND COUNTERVAILING DUTY LAWS

POST-HEARING COMMENTS OF BETHLEHEM STEEL CORPORATION; NATIONAL STEEL CORPORATION; AND UNITED STATES STEEL CORPORATION

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EXECUTIVE SUMMARY

The Department's analysis in the instant inquiry involves a complex review of market inputs, actual market mechanisms and the current state of the Russian economy in the light of the statutory criteria. These statutory criteria must be the basis upon which this analysis is made, regardless of political motivations, or a temptation to reward Russia. This determination of market economy status for antidumping purposes has broad-reaching ramifications which will not only set precedent for the reviews of other former Soviet countries, but will also determine the nature of the antidumping and countervailing duty cases which can be brought against Russia in the near future.

Review of the statutory criteria further evidences the complete failure of the Russian Federation, or other proponents of NME status revocation, to demonstrate Russia's transition to a market economy:

(i) While the Russian ruble is technically convertible to the currencies of other countries, persistent concerns about currency fluctuations and the use of barter in all levels of the economy demonstrate that Russian currency does not support a finding of a market economy.

(ii) Low wage rates and poor workers' rights in Russia continue to evidence a lack of free bargaining between labor and management, and instead evidence government control, restricted labor mobility (*propiska*), and the pervasive nonpayment of wages. The actual situation of workers relations in Russia has yet to evidence any positive changes due to the three-month old, new Labor Code.

(iii) As evidenced by the testimony of former investors and the abysmally low foreign direct investment of less than US $15 per capita, joint ventures and foreign direct investment are neither afforded adequate protection nor the same treatment as national investment, despite legislative guarantees. Investors drawn to Russia's virtually limitless natural resources and huge population face a 90 percent chance that their investment will be lost, according to the World Bank.

(iv) Many sources, including the Russian government itself, agree that the extent of government ownership and control of the means of production in Russia is widespread and, in fact, increasing; this ownership is not attributable to natural monopolies or areas of state interest, but instead represent deeply imbedded remnants of the Soviet-era centrally planned economy.

(v) The government-entwined structure of the largest companies in Russia, most notably Gazprom and UES, results in price distortions and government control over the allocation of resources and the determination of prices.

(vi) The Department has considered membership in international organizations like the WTO as reflective of positive evidence of movement toward a

> market economy. The fact that Russia currently lacks, and is far from securing, WTO membership; that fundamental, widespread market distorting activities, such as institutional corruption, are rampant; and that Russia lacks an independent judiciary and respect for the rule of law, all evidence the undeniable failure of Russia to meet the minimum standards of a market economy.

Although Russia's progress is admirable, progress toward market principles is not contemplated in these criteria; accordingly, a *de facto* analysis of the current state of Russia's economy is required in this inquiry. The overwhelming weight of the evidence submitted indicates that Russia "does not operate on market principles of cost or pricing structures, so that sales in the country do not reflect the fair values of the goods" and, therefore must retain the designation of nonmarket economy.

I. INTRODUCTION

The statutory criteria upon which the U.S. Department of Commerce ("the Department") bases a decision to graduate a non-market economy ("NME") to market economy status for antidumping purposes address the most fundamental characteristics of a market economy. These factors are intertwined and inseparable from one another--when one or more factors are not operating on market economy principles, the distortion spreads to and is multiplied by the other factors. As this submission shows, distortions and subsidies at federal and subnational levels have infected the entire Russian economy so greatly that prices and costs are not set by the market and do not reflect market value.

As discussed in the previous submissions by the Domestic Steel Producers, continuing government ownership or control of key sectors of the economy, including its largest and most important enterprises, an unhealthy investment climate, and rampant corruption at the highest political and economic levels demonstrate that Russia fails to satisfy the Department's criteria for revocation of its NME status. Aspirations, good intentions, and incremental progress toward a market-based system are not sufficient for the Department to revoke Russia's NME status. Given the fact that much of the crucial data offered to support the revocation is contradictory, unreliable, and in some instances simply incorrect, the Department does not have sufficient positive evidence on which to make such an important decision. Finally, the recent determination to grant Kazakhstan market economy status does not compel a like determination for Russia because there are significant differences between the two economies, with Russia being significantly less market oriented.

Congress recognized that the Department's antidumping analysis would be skewed and inaccurate if the Department were to rely on prices and costs in an economy that was not a market. Accordingly, it provided for a separate NME antidumping analysis and later enacted specific criteria for determining the existence of a non-market economy.[1]

As the earlier submissions by Domestic Steel Producers thoroughly examined these statutory criteria, these comments do not reiterate that analysis. Rather, the following discussion demonstrates that although Russia has made some progress toward becoming a market economy, pervasive distortions in the cost and pricing structures of the Russian economy still prevent sales from reflecting the fair market value of goods. Accordingly, by law, the economy of the Russian Federation must continue to be deemed an NME for purposes of the antidumping law.

1 19 U.S.C. §1677(18)(B).

II. PROPER ANALYSIS OF THE STATUTORY CRITERIA

During the March 27th hearing, participants were asked to give their views on how the six statutory criteria should be weighed and applied in the specific case of the Russian Federation.[2] In considering this question, the Department must keep in mind two concepts. First, the ultimate question that the statutory criteria are intended to assess is whether the prices and costs to be used in the antidumping calculations are reliable reflections of market-determined, supply-and-demand forces.[3] Second, the statute itself does not mandate a particular weighing of these criteria and, therefore, the Department "must weigh the degree to which economic reforms have been implemented based on the unique facts in each case."[4] These two concepts were encapsulated by Assistant Secretary Shirzad:

> *The ultimate challenge that we have as a Department is to take the various factors that are there for us to look at, as well as whatever other factors we deem appropriate to consider, and see how the mix of those factors in a particular environment contribute or don't contribute to assuring that price signals and costing -- the cost structure is such that it's sufficiently market oriented that it allows us to do our anti-dumping analysis using the actual prices in the market.*[5]

Accordingly, proper analysis of the statutory criteria necessarily must take account of the fact that the criteria are interdependent.

As shown by an examination of the statutory criteria, each of the values of prices and costs considered in an antidumping (or countervailing duty) investigation involving Russian exports is not determined by market-oriented supply and demand forces. Figure 1 illustrates the fundamental economic factors that determine a respondent's cost and price structure, as examined in an antidumping case. Simply put, management brings together the labor, capital, and materials (raw or intermediate) to create an output product, and management decides how much to produce and what price to ask. The perceived value of each of those inputs, however, is distorted in the Russian Federation, as is the allocation of outputs due to extensive government control and ownership. In addition, each of the statutory criteria are inter-related. In particular, the crucial component of capital directly affects material inputs as well as labor.

Capital. The allocation of capital is perhaps the most significantly distorted factor of production in the Russian Federation today. Banking is largely government controlled, with politically based capital allocation and interest rates, and equity markets and foreign direct investment are insufficiently developed to provide a market-oriented alternative. The

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2 In particular, Assistant Secretary Shirzad asked, "Is there a common view on the part of the opponents that there are certain factors we need to give greater weight to that trump the others?" Hearing Transcript, A-821-816, at 148 (Mar. 27, 2002) ("Transcript").

3 19 U.S.C. §1677(18)(A).

4 U.S. Department of Commerce Internal Memorandum from G. Smolik to F. Shirzad, Case No. A-834-807 at 16 (Mar. 25, 2002) ("Kazakhstan Determination").

5 Transcript at 147-148 (emphasis added).

Department has recognized that statutory criteria 3, 4, and 5 -- foreign direct investment, government ownership and control of enterprises, and control of prices and output, respectively-- all are affected by the degree to which the market does or does not allocate capital inputs in the economy.[6]

As a preliminary matter, the *existing* physical capital base -- machinery, for example -- was largely created at the direction of state planners without regard to market considerations. Although the statutory criteria do not contemplate taking such vast distortions in installed capacity into account, the existence of this huge state-planned physical capital base puts an enormous premium on current capital markets to provide new capital on a market basis, which they do not.

By far the dominant source of new capital in Russia is the domestic banking system. As demonstrated in Section III below, the assets and deposits in Russia's banking system are predominately controlled by Russian federal, regional, and local governments and organs of these governments.[7] In fact, Russia's banking sector

> *lags that of other transition economies . . . in several key areas. Firstly, in contrast to the situation in these countries, the large state-owned banks in Russia have not been privatized...truly independent private-sector banks, with diversified shareholders and diversified customer bases, do not exist in Russia.*[8]

The federal government owns Russia's two largest banks, the largest of which (Sberbank) alone accounts for 25 percent of total banking sector assets, owns around half of all bank branches in the country, and holds over 75 percent of household deposits.[9] The government uses this control to allocate capital at interest rates not set by market forces:

> *those banks still in the state orbit end up having to serve their owners' interests to the full. Usually this means they have to lend to state organizations no matter how slim the chances are of ever seeing the money returned.*[10]

This problem is discussed more fully in Section III.

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6 Indeed, the Kazakhstan Determination gave particular emphasis to the banking sector and its effect on the "pricing" criterion - "resource allocation, specifically, the status of commercial banking reform." Kazakhstan Determination at 12.

7 *2001 Transition Report Update*, European Bank for Reconstruction and Development (Apr. 2001) at 84 ("*2001 Transition Report Update*"), *appended to* Letter from Dewey Ballantine LLP to the U.S. Department of Commerce, Case No. A-821-816 at Exh. 13 (Dec. 10, 2001) ("Domestic Steel Producers' Dec. 10 Brief").

8 "Special Report: Banks Rebound, But Reform Slow in Coming," *The Russia Journal* (Apr. 13-19, 2001). Exh. 1.

9 *The Investment Environment in the Russian Federation,* Organization for Economic Cooperation and Development (2001) at 161 ("*Investment Environment in the Russian Federation*"), *appended to* Domestic Steel Producers' Dec. 10 Brief at Exh. 5.

10 "Who Owns Russia: Russia's Banking Sector. The Situation Today." *The Russia Journal* (Jan. 25-31, 2002). Exh. 2.

The government's allocation of banking capital and interest rates would be of less concern if enterprises had reasonable access to either of the two other fundamental channels for market-driven capital: domestic equity markets or foreign direct investment (FDI). Yet neither of these two are available in sufficient quantity to provide an alternative to state-controlled banking capital. Equity markets are severely underdeveloped and FDI cannot play this role because its levels in Russia continue to be very low due to an inadequate and, in fact, hostile investment climate.

Therefore, Russian government control of domestic banking continues to distort capital allocation for the entire Russian economy. With regard to this capital control, "{g}ranting of various preferences and subsidies is for the most part not formalized, and governors make full use of this in order to keep enterprises close to them afloat . . . {t}his undermines the competitiveness of companies which do not have access to the administrative resource."[11] As a result, large state-controlled enterprises -- particularly in the energy sector -- get the lion's share of capital, starving the rest of the economy. Even the federal government's efforts to counterbalance these problems with special programs constitutes another layer of non-market capital allocation. According to the Organization for Economic Cooperation and Development (OECD), government policies to support small businesses financially through credit guarantees distort the market further:

> *Given the inherently high degree of subjectivity in the allocation of these funds, there is a great risk...they could be used at the regional or local level for corrupt purposes or the political favoritism of certain firms at the expense of fair competition.*[12]

It is critical to recognize that the problem in Russia is not simply that of underdeveloped capital markets. For purposes of the Department's analysis, the crucial fact is that the capital that is available to Russian enterprises is largely controlled, allocated, and priced by the state. The underdevelopment of alternative capital sources merely exacerbates this fatal problem.

In summary, the Russian Federation cannot meet criteria 4 or 5 of the statutory test because of Russian governments' ownership and control over the main financial institutions, the capital they provide, and the prices (interest rates) they set. Russia also performs poorly with respect to criterion 3, which considers the role of foreign direct investment in ameliorating non-market forces governing domestic capital. The fundamental input of capital, therefore, is not market-based in Russia.

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11 "World Bank Loan to Russia To Aid in Reform of Regional Finance, Promote Small Business," *Vedomosti* (Mar. 31, 2002). Exh. 3.

12 *OECD Economic Surveys: Russian Federation,* Organization for Economic Cooperation and Development (Feb. 2002) at 96 ("*OECD Economic Surveys: Russian Federation*"). Exh. 4.

The distortions of capital markets in Russia forecast even greater problems for antidumping investigations if Russia is prematurely graduated to a market economy as the criteria that speak to capital inputs are important in antidumping investigations in two aspects. First, *capital costs* (specifically, interest charges) are a specific line-item that the Department examines when considering the costs of production. Second, *depreciation costs* are also a line-item in the cost of production, and distortions in the allocation of *new* capital in the Russian economy result in Russia's capital base remaining a reflection of capital-allocation decisions made by central planners. In other words, the depreciation being examined is the depreciation charge on assets installed and "priced" (or never priced) under central planning.

Material inputs. Criterion 5 addresses whether material inputs are allocated on a market basis. Criterion 4, regarding government ownership and control of enterprises, also addresses the problem of non-market forces determining the value of the material inputs. There are two separate but related economic issues here: (1) whether materials are being priced on a market basis and (2) whether the allocation of these inputs is being determined on a market basis. When considering these two factors, it becomes clear that the answer to both questions is largely "no," especially for major Russian export-oriented industries, which are of particular concern from the standpoint of U.S. anti-dumping and countervailing duty laws. In particular, Russian exports are likely to be energy-intensive because -- even as Russian interests themselves claim -- Russia is an energy-rich country and has a comparative advantage with respect to energy.

Russian federal, regional, and local governments control prices through direct price regulation, predominantly in the energy, transportation, and communication sectors. In addition to predominant government ownership in these sectors, the federal government has identified hundreds of specific enterprises for which the government has direct authority to set prices because the enterprise is considered to be a "natural monopoly."[13]

While the Russian government argues that most of its interference in pricing is simply designed to regulate "monopoly pricing," the scope and scale of such 'natural' monopolies in Russia is staggering. The Department must not allow itself to be misled regarding the extent of Russia's use of "competition policy" to regulate prices and we urge the Department to consult with the Antitrust Division of the U.S. Department of Justice, which has several officials familiar with this extensive problem.

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13 The term "natural monopoly" as used in the Russian context is somewhat different than the definition as conventionally employed in the West. Whereas a "natural monopoly" in the West describes a enterprise in a sector for which the technology (or production function) inherent in the production of the good favors a single supplier as the low-cost solution (usually due to a declining, rather than increasing, cost curve), in the Russian context the term "natural monopoly" is used far more broadly for any enterprise, almost always a former Soviet enterprise, that dominates a sector or geographic region (or both) to such a degree that its commercial and political power can prevent potential competitors from entering the sector or region. In other words, in the Russian context the term "natural monopoly" often applies to sectors, such as the automobile industry, wherein a Western economist would be unlikely to use the term because of the lack of an inherent, technological ("natural") barrier to entry for competitors.

It is important to emphasize that the supply and demand for key material inputs are not simply "distorted" in the Russian economy, but the information and mechanisms that provide the pricing signals are frequently absent. In other words, the problem in Russian materials sectors is not simply that the supply (or demand) curve is "shifted" in one direction or the other by, say, government subsidies *overlaid* on a market of buyers and sellers. The fundamental problem is that government interference -- often outright control -- is so pervasive that "supply and demand curves" cannot be found. For example, when a regional government mandates that electricity continue to be provided to a bankrupt steelmaker despite the latter's inability to pay for the input, and the electricity utility is facing such government interference with many of its large customers, the market is not determining supply and demand. In an antidumping analysis, it will not be possible to determine the true cost of this input, absent resort to a surrogate country value.

Labor. The allocation of labor and the price of labor (criterion 2) are severely distorted in the Russian economy by a wide variety of problems.

Russian workers are often "paid" in barter, are commonly subject to arbitrary reprisals by their employers if they seek to improve compensation or working conditions, and in several regions, most importantly in the Moscow oblast, they are still restricted in their mobility by a Soviet-era residence registration system (*propiska*). Trade unions that purport to represent workers to counterbalance these forces are weak or corrupt, strikes are widely considered illegal and are often suppressed when they do occur, and the government rarely enforces laws which purport to guarantee labor rights. Such conditions in the underlying labor market cannot give rise to an allocation of labor or labor wages that represent market outcomes. As noted by the Department in the Kazakhstan Determination, "wages...are an important component of producers costs and prices."[14] Russia clearly fails on this criterion.

Thus, in the Russian economy capital, materials (raw or intermediate), and labor are not brought together on a market basis. Instead, powerful distortions exist in all three categories, mainly due to government interference and involvement, that prevents market-based valuation. The resulting prices of material inputs, allocation of capital, and labor costs do not represent fair market value, making accurate antidumping analysis by the Department impossible.

Data Reliability

Because the statute directs the Department's analysis to the *de facto*, rather than the *de jure*, state of affairs in Russia, accurate data are all the more important. Unfortunately, the data, when available, conflict wildly-- except to show that Russia has not made sufficient progress to have transitioned to a market economy.[15] Notably, such a lack of reliable data, in itself, is considered by the World Bank to indicate that market forces are not at work.[16] Although a lack of reliable data alone does not require a determination that Russia is an NME, the Department cannot ignore the fact that the submissions of the Russian steel producers are lacking in

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14 Kazakhstan Determination at 7

15 *See* Domestic Steel Producers' Dec. 10 Brief at 8.

16 *Id.* at 25, n.110.

evidentiary support. The problematic data regarding the actual state of affairs in Russia has been discussed extensively.[17] As highlighted at the hearing, "{t}he data cited in support of graduation of market status is flawed and unreliable {and} the proponents of graduation are asking the Department to take a leap of faith and base a very, very momentous decision on weak and inconsistent data."[18] Given that respected and reliable sources of data, such as the World Bank, the OECD, and the European Bank for Reconstruction and Development (EBRD), are unable to obtain concrete figures regarding the state of affairs in Russia, it is difficult to see how any Department determination finding the Russian economy to be operating on market principles could be seen to be based on anything more than speculation and wishful thinking.

III. PERVASIVE DISTORTIONS IN RUSSIAN COSTS AND PRICES PREVENT SALES FROM REFLECTING THE FAIR VALUE OF GOODS

Capital allocation is badly distorted in the Russian economy, with the government controlling the only major banks in the economy, allocation and interest rates being set by political considerations rather than market-based ones, and equity markets and FDI insufficiently developed to provide a viable alternative. The resulting shortage of capital acts as a severe restraint on business and enterpreneurship. Another major factor underlying Russia's poor economic performance has been the distortion of prices and output throughout the Russian economy by federal, regional, and local governments.

A World Bank research paper recently concluded that "Russia's economic problems have resulted from distorted {price} incentives in addition to weak institutions."[19] These distortions involve elements central to the six statutory criteria, such as labor, pricing, government ownership and control, and foreign direct investment, especially as related to capital allocation. Therefore, although not a separate statutory criteria, the distortions in capital allocation and pricing directly affect all the statutory criteria to varying degrees and are indicative of the lack of decisive progress toward a market economy.

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17 Letter from Dewey Ballantine LLP to the U.S. Department of Commerce, Case No. A-821-816 at 2 (Feb. 28, 2002) ("Domestic Steel Producers' Feb. 28 Brief").

18 Transcript at 94-95 (statement of Mr. Ward).

19 *Dismantling Russia's Nonpayments System: Creating Conditions for Growth*, World Bank Technical Paper No. 471 (June 2000) at x ("*Dismantling Russia's Nonpayments System*"), *appended to* Domestic Steel Producers' Dec. 10 Brief at Exh. 17.

A. Russia's banking system is largely government controlled, and government controlled banks allocate capital and set interest rates on a non-market basis.

According to the EBRD, restructuring of the Russian banking sector "remains one of the weakest elements in the overall reform process."[20] In fact, Russia's banking sector

> *lags that of other transition economies- for example, Bulgaria, Hungary, Kazakhtan, Poland, and the Baltic countries- in several key areas. Firstly, in contrast to the situation in these countries, the large state-owned banks in Russia have not been privatized.*[21]

In addition, "truly independent private-sector banks, with diversified shareholders and diversified customer bases, do not exist in Russia."[22] Second, in contrast to its neighbors, "the benefits of foreign direct investment -- notably, increased capital and management know-how -- have not flowed through the Russian banking system . . . . "[23] According to the U.S. Foreign and Commercial Service, Russia's "banking system largely fails to perform the basic role of financial intermediator, taking deposits and lending to businesses and individuals."[24] Equally troubling, the "GOR {Government of Russia} remains deeply divided over the basic question of whether Russia's banking sector should develop toward a model centered on state banks or one centered on private commercial banks."[25] As a result of these problems, the Russian banking system remains largely unreformed and controlled by the state. Of the more than 1,300 lending institutions in Russia, it is reported that the state holds shares in 679.[26]

Despite the well-publicized reforms launched in 2001, a "huge problem is that the reforms leave untouched the biggest distorting influence in the whole system: the central bank."[27] Russia's Central Bank (CBR) "wields considerable power both as a regulator and a participant in the financial sector, while answering to no one. This creates conflicts of interest and lays the foundation for rampant corruption . . . . "[28]

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20 *2001 Transition Report Update* at 84. *See also* "Special Report: Banks Rebound, But Reform Slow in Coming," *The Russia Journal* (Apr. 13-19, 2001).

21 "Special Report: Banks Rebound, But Reform Slow in Coming," *The Russia Journal* (Apr. 13-19, 2001). Exh. 1.

22 *Id.* Exh. 1.

23 *Id.* Exh. 1.

24 *Russia Country Commercial Guide FY2002,* U.S. Commercial Service, U.S. Department of Commerce, Chapter 7 ("Investment Climate Statement") at 14 ("*Russia Country Commercial Guide FY2002*"). Exh. 5.

25 *Id.* at 15. Exh. 5.

26 "Who Owns Russia: Russia's Banking Sector. The Situation Today," *The Russia Journal* (Jan. 25-31, 2002). Exh. 2.

27 "Don't Bank on It," *Economist* (Oct. 18, 2001). Exh. 6.

28 "The Building Blocks of Bank Sector Reform," *The Moscow Times* (Jan. 30, 2002). Exh. 7.

The CBR owns Russia's two largest banks -- Sberbank and Vneshtorgbank -- taking a 61 percent stake in the former.[29] Sberbank, which accounts for 25 percent of total banking sector assets, owns around half of all bank branches in the country and holds over 75 percent of household deposits.[30] Given its relationship with the CBR, Russian savers view Sberbank as having a "de facto deposit guarantee {which} makes it the obvious choice" for deposits.[31] In addition, the CBR reportedly uses its regulatory authority to unfair advantage. "Banks with good political connections obtain lucrative favors and exemptions," while "{o}utsiders risk penalties for missing a comma."[32] Despite criticism from international financial organizations and calls for privatization, the CBR has been reluctant to divest its ownership of these banks. It has set 2003 as a deadline for withdrawal from Vneshtorgbank "{b}ut this process could end up taking years," and no deadline has even been set for withdrawal from Sberbank.[33] The CBR's "lack of forceful action" in spearheading much-needed reform of the banking sector, "has resulted in a system that is clogged with undercapitalized, shadowy institutions . . . and skewed by the actions of state-owned banks with noncompetitive advantages."[34]

One of the most serious consequences of Russia's unreformed, state-controlled banking system, is that capital allocation is not determined by the market. On the contrary:

> *those banks still in the state orbit end up having to serve their owners' interests to the full. Usually this means they have to lend to state organizations no matter how slim the chances are of ever seeing the money returned.*[35]

In Russia's regions, "{g}ranting of various preferences and subsidies is for the most part not formalized, and governors make full use of this in order to keep enterprises close to them afloat...{which} undermines the competitiveness of companies which do not have access to the administrative resource."[36] Among Russia's top 20 banks, the Bank of Moscow and Bashkreditbank are owned by regional authorities. They "serve the needs of the Moscow and Bashkortostan authorities, respectively. For the Bank of Moscow, its situation depends on the personal relations between its head Andrei Borodin and Moscow Mayor Yury Luzhkov," and the same applies to Bashkreditbank.[37] Other banks have been set up to serve the interests of a

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29 "Don't Bank On It," *Economist* (Oct. 18, 2001). Exh. 6.

30 *Investment Environment in the Russian Federation* at 161.

31 "Don't Bank On It," *Economist* (Oct. 18, 2001). Exh. 6.

32 *Id.* Exh. 6.

33 "Who Owns Russia: Russia's Banking Sector. The Situation Today," *The Russia Journal* (Jan. 25-31, 2002). Exh. 2.

34 "The Building Blocks of Bank Sector Reform," *The Moscow Times* (Jan. 30, 2002). Exh. 7.

35 "Who Owns Russia: Russia's Banking Sector. The Situation Today." *The Russia Journal* (Jan. 25-31, 2002). Exh. 2.

36 "World Bank Loan to Russia To Aid in Reform of Regional Finance, Promote Small Business," *Vedomosti* (Jan. 31, 2002). Exh. 3.

37 "Who Owns Russia: Russia's Banking Sector. The Situation Today." *The Russia Journal* (Jan. 25-31, 2002). Exh. 2.

particular industrial sector, and private-sector banks "remain wedded to the financial-industrial group (FIG) model."[38] Recently, the Anti-Monopoly Ministry "spearheaded its attack against banks, saying 80 percent of them were 'pocket' banks serving only their own stockholders."[39]

As a result, "investments are concentrated mostly in the monopolized sectors, primarily in the oil and gas industry. The fuel and energy sector accounts for 53.3 percent of total investment in Russian industries, including 34.8 percent in oil production."[40] While these sectors have easy access to capital, the "processing industry, on the other hand, is experiencing an acute shortage of resources."[41] In the telecom sector, "the situation remains critical and the shortage of capital is aggravating."[42] According to reports, "Russia's IT sector is also suffering from a lack of venture capital, with just over $100 million invested in the industry so far, compared with about $300 million in India last year alone."[43]

The OECD also cites the lack of capital investment as one of the reasons why Russia places "well behind most Eastern European transition countries according to basic measures of the climate for business and entrepreneurship."[44] While policies to support small businesses financially through credit guarantees might be effective, according to the OECD, they are difficult to implement in a country like Russia:

> *Given the inherently high degree of subjectivity in the allocation of these funds, there is a great risk...they could be used at the regional or local level for corrupt purposes or the political favoritism of certain firms at the expense of fair competition.*[45]

This problem would be alleviated if enterprises had access to another source of capital, such as equity markets or foreign investment. Unfortunately, neither is the case in Russia.

Russian equity markets are characterized by low trading volumes and a lack of liquidity for all but the few largest and most stable stocks.[46] Trading volumes remain low on Moscow-based exchanges and are almost non-existent outside of the capital.[47] This situation prevents

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38 "Special Report: Banks Rebound, But Reform Slow in Coming," *The Russia Journal* (Apr. 13-19, 2001). Exh. 1.

39 Natalia Kulakova, "Don't Give Money to the Banks!" *Kommersant* (Mar. 27, 2002). Exh. 8.

40 "Investments in Russia: Russia's Investment Climate: Problems and Prospects," *The Russia Journal* (Feb. 8-14, 2002). Exh. 9.

41 "Russian Economist Denies Reports of Financial Crisis," *Vedomosti* (Mar. 20, 2002). Exh. 10.

42 "Telecoms Russia: Telecoms Cry for Investments," *The Russia Journal* (Jan. 25-31, 2002). Exh. 11.

43 "Report Wary of Future of Russia's IT Sector," *The Russia Journal* (Nov. 23-29, 2001). Exh. 12.

44 *OECD Economic Surveys: Russian Federation* at 73. Exh. 4.

45 Id., at 96. Exh. 4.

46 *Russia Country Commercial Guide FY2002,* Ch.7 ("Investment Climate Statement") at 14. Exh. 5.

47 *Id.* Exh. 5.

Russia's equity markets from offering a viable alternative for enterprises to find badly needed capital.

Foreign Direct Investment (FDI) continues to be a very small portion of Russia's capital expenditures and, in any case, often does not constitute truly free-market resources being committed on the open market. Additionally, very little of the capital that enters Russia carries with it the managerial control necessary to stimulate Russian enterprises to operate on a market basis. For example, it is indisputable that foreign purchases of Gazprom shares have not translated into Gazprom being run on a market basis.

FDI inflow into Russia is inhibited by inconsistent regulation, political and economic uncertainties, corruption, and the government's consistent failure to enforce existing laws to protect investors' rights. Reflecting these problems, Russia received less than $14 per capita in FDI, compared with $436 per capita for the Czech Republic, $277 per capita for Slovakia, and $77 for Kazakhstan.[48] In addition, the quality of that FDI adds to the problem of the insufficient quantity in that most of it comes in the form of either minority shares or majority shares without effective control over the joint venture or investment and quickly leaves the economy again.

Although foreign investors are protected by law, such protections have not been effectively implemented.[49] The failure to enforce supposed protections is the rule rather than the exception. To the extent that protection of foreign investors has become embodied in Russian law, the failure to enforce laws generally has created an environment in which the rights of minority shareholders and the most basic of corporate governance norms are disregarded.[50] The U.S. Embassy is currently tracking a series of cases brought by foreign investors to recover property and investments expropriated by regional governments in the Federation – an exercise which has thus far proven fruitless.[51]

The most recent case has been that of Sawyer Research Associates, a member of the U.S.-Russia Business Council. Sawyer became a major shareholder in Gus-Khrustalny Quartz Glass Plant and, following the plant's bankruptcy, Sawyer invested over $8 million in the plant, including paying off $1.5 million of its debts. Sawyer also secured a 25-year lease on one of its workshops, spending millions of dollars on modern equipment. Soon after the American company paid off the plant's debts, a state prosecutor filed a suit to have Sawyer evicted from the plant because it was "a strategically important asset."[52] Several Russian courts have ruled

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48 *2001 Transition Report Update* at 59, 71, 85, 87. Latvia, recently graduated, received $166.25 per capita in FDI in 2000. *Id.* at 75.

49 *FY 2001 Country Commercial Guide: Russia*, U.S. Department of State at 44 ("*FY 2001 Country Commercial Guide: Russia*") (discussing both the 1991 Investment Code and the 1999 Law on Foreign Investment), *appended to* Domestic Steel Producers' Dec. 10 Brief at Exh. 10.

50 *Id.* at 45.

51 *Id.* at 47 (noting that, to date, no award payment had been made).

52 Guy Chazan, "U.S. Company Loses Control Of Quartz Glass Plant in Russia," *The Wall Street Journal* (Aug. 3, 2001). Exh. 13.

against the U.S. company, which is threatened with losing its entire investment and inventory.[53] Films by Jove, which has voiced its opposition to the revocation at the hearing, is another member of the U.S.-Russian Business Council that is suffering from the lack of adequate protection of ownership rights in Russia.[54] Both companies would likely take issue with the statement of the U.S.-Russia Business Council representative at the Department's hearing who could not "think of a single one of our member companies that would oppose revocation," even though one of those companies appeared across the table from him and vocally opposed the revocation.[55]

A recent World Bank report found that there is a startling 90 percent probability of losing foreign direct investment in Russia within five years, as compared with a 25 percent in Hungary.[56] According to the American Chamber of Commerce in Russia, an ardent revocation supporter,

> *it is clear that the judicial system is in the throes of a deep and profound crisis. Its lack of independence from the executive branch is clear to and recognized by all, a fact which is having the worst possible impact on how Russia's investment climate is perceived.*[57]

Therefore, the tremendous capital shortage in Russia that results from the distortion of the sector by government ownership and control cannot be filled by FDI.

Another consequence of Russia's state-controlled banking system is that interest rates on loans are not determined by the market. Private-sector banks have complained that Sberbank "lends at negative interest rates."[58] Indeed,

> *State-owned banks have less incentive to act as profit-oriented commercial enterprises than to lend to state-owned or affiliated companies at lower rates than private banks can afford. The country's two largest banks, Sberbank and Vneshtorgbank, belong to the Central Bank, which may allow them access to cheaper money than other banks. They can lend at lower rates, which skews the sector.*[59]

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53 *Id.* Exh. 13.

54 Transcript at 121-127 (statement of Ms. Borsten).

55 Transcript at 49 (statement of Mr. Marshall).

56 *Seize the State, Seize the Day: State Capture, Corruption and Influence in Transition*, World Bank (2000). "*[I]n Russia where adequate law does not secure valued resources the risks of economic activity become prohibitive in many instances, and the economy has stagnated or declined.*" O. Lee Reed, *Law, the Rule of Law, and Property: A Foundation for the Private Market and Business Study*, 38 AM BUSS. L.J. 441, 458 (2001).

57 *The Economic Situation and Investment Climate in Russia: Analysis of 2001 Changes and Long-Term Prospects for the Russian Economy*, American Chamber of Commerce in Russia and the Expert Institute (Mar. 2, 2002) at 6 ("*The Economic Situation and Investment Climate in Russia*"). Exh. 14.

58 "Don't Bank on It," *Economist* (Oct. 18, 2001). Exh. 6.

59 "The Building Blocks of Bank Sector Reform," *The Moscow Times* (Jan. 30, 2002). Exh. 7.

According to head of the Duma's Budget Committee, Alexander Shokin, "banks with state participation {have} had a stifling effect on competition in the sector."[60] The OECD warned that without structural reform, private banks would "have little prospect of long-term survival" and would be crowded out by state-owned banks.[61] Yet, by mid-2001, the EBRD observed, "the dominant role of state banks has further increased."[62] A Russian government commission set up to investigate state assets in the banking sector, recently advised the government to sell some of its holdings, "but analysts say that so far, the government looks to have avoided spending time and effort breaking down the resistance of bureaucrats determined to hold on to their 'pocket banks.'"[63]

The intermediary function exercised by banks in a market economy, consisting of capital mobilization and resource allocation based on expected returns, is clearly absent in the Russian economy. Most of the banks "are not yet operating as bona fide financial intermediaries between savers and investors," consequently, the level of intermediation of the local banking system as measured by loans as a percentage of GDP at 12 percent "pales in comparison with that of other emerging countries, which is two to five times higher."[64] As one observer put it:

> *The lack of financial intermediation is probably Russia's single biggest economic weakness. Russian banks tend to be small, badly run, and do little deposit-taking and lending. Many are no more than treasury departments for large companies, for channeling money offshore. Some are heavily involved in organized crime. Most Russians keep their savings in hard cash.*[65]

According to Russian government estimates, the country needs at least US$100 billion a year simply to replace worn-out and obsolete equipment, while it only gets US$55 billion. An official from the Ministry for Economic Development and Trade "insists that twice the present rate of investment is required just to maintain production at its present level. . . . "[66] Total registered capital at the start of 2001 amounted to a mere 3.7 percent of year 2000 GDP, or under US$8 billion. Of total fixed capital formation in the economy, the banking sector financed just 4 percent in 1999. Indeed, the state (budgetary) sector share of fixed capital formation financing was over four times as high as the banking sector share, while internal resources of enterprises

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60 "Bankers Note Successes, Call for More Work," *The Russia Journal* (Dec. 7-13, 2001). Exh. 15.

61 *Investment Environment in the Russian Federation* at 36.

62 *2001 Transition Report Update* at 84.

63 "State Not Ready To Pull Out of Pocket Banks," *The Russia Journal* (Jan. 25-31, 2002). Exh. 16.

64 "Banking in Russia: Nascent Local Capital Market Hamstrung by Negative Economic, Legislative Factors," *The Russia Journal* (Nov. 30-Dec. 6, 2001). Exh. 17.

65 "Mr. Rouble Quits," *Economist* (Mar. 21, 2002). Exh. 18. The share of household deposits in GDP is just 5.5 percent. *See* "China and Russia Pick up the Baton from the West," *Lombard Street Research Monthly Economic Review,* Quest Economics Database (Feb. 5, 2002) at 9 ("China and Russia Pick up the Baton from the West"). Exh. 19.

66 "Investments in Russia: Russia's Investment Climate: Problems and Prospects," *The Russia Journal* (Feb. 8-14, 2002). Exh. 9.

accounted for 53 percent of financing. This situation is even more pronounced in the financing of working capital, where the banking sector's role is insignificant.[67] In the words of one analyst:

> *the resources of the domestic banking sector are not enough to finance the needed high investment growth. Unlike China, Russia has not been able to attract much foreign direct investment. Both countries have a dysfunctional financial intermediation system which has prevented them from transferring savings into productive investment. But in the case of Russia there were no huge FDI inflows to fill the gap.*[68]

Russia's "{i}nadequate legislation, numerous restrictive measures, an archaic banking system in need of urgent reform and several other negative factors have all combined to make the local financial market unattractive to most strategic investors."[69]

Another factor that limits the development of the local capital market is that most of the financial instruments used internationally to raise funds "are either non-existent or are only in the nascent stage, with the legacy of speculation-driven activities still prevalent on the local market." Consequently, "more than 80 percent of local companies are experiencing extreme difficulties in raising or accumulating operating capital on the financial market."[70] In addition, traditional sources of capital for major investment projects such as pension funds, insurance company reserves, long-term saving funds from banks and investment funds "have not been sufficiently developed in Russia, either because the capital situation in the country has been so constrained with huge government borrowing, unstable currency or because of restrictive legislation in the past decade."[71]

As there has been no fundamental reform of the Russian banking system to date:

> *The retail giant Sberbank continues under state control, private-sector banks remain beholden to the interests of their industrial shareholders, the legal and regulatory environment is still weak and arbitrary, financial disclosure limited, and little foreign direct investment (with corollary inflow of technology and know-how) has come to Russian banks. Russian credit culture remains stunted. A consequence of these factors is that banking intermediation, essential for the efficient accumulation and reinvestment of capital, is woefully undeveloped in*

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67 *Investment Environment in the Russian Federation* at 160.

68 "China and Russia Pick up the Baton from the West" at 9. Exh. 19. Compared with countries like the Czech Republic and Slovakia, whose 2000 FDI levels per capita are $437 and $278 respectively, Russia receives only $14 per capita in FDI. *See 2001 Transition Update* at 59, 85, 87.

69 "Banking in Russia: Nascent Local Capital Market Hamstrung by Negative Economic, Legislative Factors," *The Russia Journal* (Nov. 30-Dec. 6, 2001). Exh. 17.

70 *Id.* Exh. 17.

71 *Id.* Exh. 17.

Russia, and banks continue to carry a higher degree of credit risk than in almost any other country in the world.[72]

B. Continuing government control of production and pricing distorts prices and allocation of material inputs in many sectors, including transportation, communications, and energy.

The Russian government continues to exercise a large degree of control over prices of material inputs and their allocation. In fact, the government continues to own and control a considerably larger percentage of the economy than the supporters of revocation have claimed. In addition, federal, regional, and local governments set prices for a huge number of purported "natural monopolies" in the economy. Massive subsidies funneled through government-owned or controlled enterprises further magnify these distorting effects.

The Russian government's control over prices and allocation of inputs is made easier by the fact the government still directly owns or controls large, important sectors of the economy. The recent claim at the hearing that 86 percent of Russia's economy has been privatized does not comport with reality.[73] The Russian government does not provide specific data to support this claim, but it is evident from independent data that this figure is inflated substantially by several factors: (1) the Russian Federation's definition of "private enterprises" apparently includes enterprises that are partially private but partially government owned and controlled; (2) companies "privatized" by the federal government but purchased by other governmental entities may be considered to be in "private" hands; (3) in many significant cases, after a privatization has been ostensibly completed, regional and local governments have stepped forward to acquire ownership and/or control of a nominally "private" enterprise.[74]

Many former state-owned factories that were privatized by the federal government have become, in fact, companies under the control of regional and local governments.[75] Such "de-

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72 "Special Report: Banks Rebound, But Reform Slow in Coming," *The Russia Journal* (Apr. 13-19, 2001). Exh. 1.

73 Transcript at 11 (statement of Mr. Sharonov).

74 *See* Domestic Steel Producers' Dec.10 Brief at 24-30.

75 As summarized by one study: "Regional and municipal governments have also re-asserted property rights claims in the wake of the August crisis. Since mid 1998, de facto renationalizations of previously privatized property have taken place among several well-known corporations. The Belgorod iron-ore combine, Alkar Aluminum in Sverdlovsk, Kransnoyarsky Metalurgichesky Zavod, Mikhailovsky Iron Works, Tatneft, Kamaz, Avtovaz, Zil, and Moskvitch all underwent partial renationalization by the end of 1998. In 1999, further takeovers have occurred in Sverdlovsk, Ulyanovsk, Krasnoyarsk, Voronezh, Primorye, Chelyabinsk, and Moscow. In oil producing regions, shares of several oil companies found their way into regional governments or regional government-owned companies - including Komineft (Yamalo-Nenetsky), and ANKH (Irkutsk)." Raj M. Deai and Itzhak Goldberg, *The Vicious Circles of Control: Regional Governments and Insiders in Privatized Russian Enterprises* at 10.

privatizations" are quite common, but can be identified only through examining specific companies and industries at the local levels. Among Russia's six "privatized" second-tier regional steel companies, for example, three have again found themselves back largely under government control: Kuznetsk, Zapsib, Nizhny Tagil.[76]

The most transparent means by which the Russian governments at the federal, regional, and local levels control prices is through direct price regulation. The prices of nearly all goods and services in the energy, transportation, and communication fields are set by the government. In addition to predominant government ownership in these sectors, the federal government has identified hundreds of specific enterprises for which it has direct authority to set prices because the enterprise is considered to be a "natural monopoly."[77] In 1999, there were 215 such entities in the transportation sector – including companies such as those that provide airport services – and 200 in the communications field, including TV advertising. Such enterprises must have at least one government official on the governing board, and for each enterprise the "principal competence of the Board is to determine the prices (tariffs)" charged.[78]

The government's role in the pricing decisions for these hundreds of core Russian companies goes well beyond ensuring that they do not charge monopoly prices. Indeed, the stated goal of price-setting in these "natural monopolies" often relates to ensuring the sector remains subsidized and competitive with foreign enterprises, or that such macroeconomic goals -- such as low inflation[79] -- are achieved. As one 1999 government document acknowledged:

> *In course of accomplishment of the state tariff {price} policy in the field of railway transportation, the increase in efficiency of the Russian transport system functioning, <u>aiming at securing competitiveness of Russian producers</u> and supporting the strategic goods carriers, the governmental commission was created on improving the state tariff policy on federal railway transportation and transportation policy.*[80]

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76 *See* Domestic Steel Producers' Dec. 10 Brief at 28-29 (specifically discussing these de-privatizations).

77 The term "natural monopoly" as used in the Russian context is somewhat different than the definition as conventionally employed in the West. Whereas a "natural monopoly" in the West describes a enterprise in a sector for which the technology (or production function) inherent in the production of the good favors a single supplier as the low-cost solution (usually due to a declining, rather than increasing, cost curve), in the Russian context the term "natural monopoly" is used far more broadly for any enterprise, almost always a former Soviet enterprise, that dominates a sector or geographic region (or both) to such a degree that its commercial and political power can prevent potential competitors from entering the sector or region. In other words, in the Russian context the term "natural monopoly" often applies to sectors, such as the automobile industry, wherein a Western economist would be unlikely to use the term because of the lack of an inherent, technological ("natural") barrier to entry for competitors.

78 Ministry Of The Russian Federation For Antimonopoly Policy And Support To Entrepreneurship, *Annual Report On Competition Policy Developments In The Russian Federation In 1999.* ("*MAP Annual Report 1999*"), *appended to* Domestic Steel Producers' Dec. 10 Brief at Exh. 18. Unlike the United States, regional and local authorities have no separate *de jure* competition-policy authority.

79 *MAP Annual Report 1999,* ¶ 38.

80 *Id.*, ¶ 39 (emphasis added).

The problem of government interference in nominally private pricing decisions is even more widespread at the regional and local levels. The World Bank recently concluded that "{r}egional governments, through their interaction with large regional enterprises and regulatory interference, play a role in hampering competition as well."[81] In its annual Deregulation Report, the Asia-Pacific Economic Cooperation (APEC) organization noted that Russian government price regulation is a significant problem.

> *It's clear that economic activity of Russian enterprises is not transparent and the state regulation of business activity is not in sufficient order. At the same time, forms and methods of their regulation are often in contradiction with the antimonopoly legislation. The activity of licensing, certifying, supervising and controlling bodies should be put in order. Numerous abuses and requisitions by these organizations in some cases hinder the development of business and investment. One of the way to improve market relations consists in creating the framework for developing the competitive market and preventing these bodies from {participating in} the process.*[82]

Typically, price regulation overlaps with the other two channels for government price and output control: the *anti-monopoly* regime and the use of government enterprises to affect price and output levels.

In the early years of the Russian Federation, the federal government established an anti-monopoly regime to enforce competition policy in an economic environment in which the large Soviet-era enterprises would dominate the Russian economy as private or quasi-private enterprises. Russian officials and experts typically refer to these large enterprises as "monopolies" or even "natural monopolies."

The Department must see through this rhetorical device and ignore the inaccurate contention that the government's interference in pricing is simply to regulate "monopoly pricing" by "natural monopolies." We urge the Department to review the data on how many industries and enterprises are currently granted "natural monopoly" status by the Russian government. As cited in Domestic Steel Producers' December 10th submission, thousands of such enterprises are added to the list each year and the total accumulated volume must represent a sizable portion of the entire economy.[83] Accordingly, government bureaucrats are setting prices throughout the Russian economy under the guise of regulation of anticompetitive practices.

The Russian government controls the price of most energy inputs into the Russian manufacturing and service sectors through its ownership and control of the major energy

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81 World Bank Country Assistance Strategy: Russian Federation (Jan. 11, 2001) ¶ 34-35, available at <http://wwwwds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2001/02/02/000094946_010125053 12027/Rendered/INDEX/multi_page.txt>. ("*World Bank Country Assistance Strategy*").

82 APEC *Deregulation Report 2000*, available at <www.apecsec.org.sg/deregulation/dereg2000.html> (emphasis added).

83 *See* Domestic Steel Producers' Dec. 10 Brief at 33.

suppliers, particularly RAO UES (mainly electricity) and Gazprom (natural gas). Given the fact that most Russian exports are energy-intensive due to Russia's comparative advantage as a huge energy producer, these energy subsidies are of particular concern from the standpoint of U.S. antidumping and countervailing duty law.

In addition to setting listed prices on a discriminatory basis, these government entities often provide enormous subsidies to energy users by simply not collecting payments on the energy provided. In January 2001, the World Bank concluded that:

> *Although there has been a significant turn-around in the economy, there have been few underlying changes in the overall environment for private sector development.... Unfortunately, the bankruptcy legal regime needs further reform, <u>and the continued implicit subsidization, through low energy prices and non- payments, of unrestructured large firms makes the playing field uneven.</u>*[84]

The consequences for the overall Russian economy of such subsidization is vast. In a June 2000 Technical Paper, World Bank officials identified implicit subsidies arising from selected companies' non-payment for government-controlled energy as a major factor behind Russia's financial crisis as well as its continuing economic problems.[85]

C. Allocation and Price of Labor in Russia Are Severely Distorted

The inability of Russian workers to effectively negotiate their wages in accordance with market principles coupled with obstructions to labor mobility distort allocation and wages of labor in Russia such that they do not represent a market-based outcome. In Russia, trade unions that purport to represent workers are weak or corrupt, strikes are widely considered illegal and are often suppressed when they do occur, and the government rarely enforces laws which purport to guarantee labor rights. In addition, Russian workers are severely restricted in their mobility by a Soviet-era registration system (*propiska*), are often "paid" in barter, and are commonly subject to arbitrary reprisals by their employers if they seek to improve compensation or working conditions.

According to Andrei Ryabov of the Carnegie Endowment in Moscow, "Russia has yet to develop trade unions that represent workers as their main task, and don't fear confrontation with authority."[86]

> *On paper, there is plenty of protection, for working conditions and trade-union rights in general. In reality, the unions' leaders are tame; the media give little coverage to labour issues; employers can do pretty much what they want; and anyone who steps out of line risks the sack, or worse.*[87]

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84 *World Bank Country Assistance Strategy*, ¶ 34-35 (emphasis added).

85 *Dismantling Russia's Nonpayments System* at x.

86 Fred Weir, "Russia's bold new proletariat," *Christian Science Monitor* (Sept. 6, 2001), *appended to* Domestic Steel Producers' Dec. 10 Brief at Exh. 9.

87 "And what about the workers?" *Economist* (Dec. 9, 2000) at 58.

Workers' freedom of movement is still restricted in Russia because the Soviet era system of registry and residency permits, or *propiska*, has survived in several regions, effectively preventing workers from freely moving throughout the country.[88] Under this system – notwithstanding federal legislation designed to abolish it and three Russian Constitutional Court orders – some regional governments, most importantly Moscow's, require workers to be registered in the locality of their residence in order to be eligible for such necessities as health care, pensions, and childcare. Changing residences -- as might be necessary to pursue work opportunities in a different location -- requires either the purchase of an apartment or registration by a new landlord, both of which are usually impossible.[89]

As a result of the *de facto* lack of effective opportunity to negotiate collectively and the continuing restrictions on freedom of movement, the bargaining power of Russian labor is significantly reduced. In the context of an antidumping investigation, Russia clearly fails on this key economic factor, and any consideration of total labor costs (the number of workers in the enterprise times the average wage rate) in an antidumping investigation will be severely distorted by both the non-market allocation of labor (number of workers) and the non-market wage rate.

IV. PROPONENTS' CLAIMS OF MARKET ECONOMY STATUS DO NOT REFLECT ANALYSIS OF THE STATUTORY FACTORS

It is important for the Department to recognize that general claims that Russia has become a market economy, like those made by the American Chamber of Commerce in Russia, do not address the statutory criteria. Even the claims made by the Russian government and steel producers ignore the statutory mandate that the Department examine the actual market conditions. These parties have instead focused on the *de jure* status of these factors in Russia's economy. The overwhelming evidence on the record, however, demonstrates that the *de jure* departs significantly from the *de facto* in Russia's economy.

The Russian government's perpetual aspirations regarding privatization and creation of a market economy are far removed from the current *de facto* economic conditions in Russia. In this inquiry, as discussed at the hearing, the Russian government would like the Department to

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88 *2000 Country Reports on Economic Policy and Trade Practices: Russia*, U.S. State Department Bureau of Economic and Business Affairs (Mar. 2001) at 11, *appended to* Domestic Steel Producers' Dec. 10 Brief at Exh. 7; "Russia Survey: A reconditioned model," *Economist* (July 21, 2001) at 7; Global IDP Project, available under "Protection Concerns" at <http://www.db.idpproject.org/ Sites/ IdpProjectDb/ idpSurvey.nsf/wCountries/Russian+Federation>.

89 Human Rights Watch, "The Residence Permit System (*Propiska*)," available at <http://www.hrw.org/ reports98/ russia/srusstest-04.htm>; *Unlocking Economic Growth in Russia*, McKinsey Global Institute (Oct. 1999). Guido Friebel and Sergei Guriev, "Should I Stay or Can I Go? Worker Attachment in Russia" (Nov. 2000) at 2, 27, available at <http://www.gdnet.org/awards-shrtlist.htm>; *Russian Federation: Selected Issues*, International Monetary Fund (Washington, DC: IMF Publications Service, Nov. 2000) at 27, *appended to* Domestic Steel Producers' Dec. 10 Brief at Exh. 11; *FY 2001 Country Commercial Guide* at 53.

interpret these aspirations as actual achievements. In fact, the Department is being asked to elevate aspirations and good intentions as well as expectations and incremental movement toward a market economy over the fact that the economy does not, as a whole, operate on market principles. The primary thrust of the arguments favoring Russia's graduation to a market economy is that Russia has made great progress in becoming more like a market economy. However, no part of the six-factor test, as stated in 19 U.S.C. § 1677 (18)(B), directs the Department to look at the progress of the country under consideration. Instead the statute calls for a strict economic analysis of the current state of the economy, in light of the statutory criteria. The Department itself has recognized that the statutory issue when examining an NME is whether functioning markets are in place, not whether substantial reform has occurred.[90] Especially given Russia's mixed history of implementation, [91] the actual state of affairs in Russia cannot be de-emphasized in favor of purported legislative progress.

The Russian Federation's current request for market economy status relies heavily on the existence of various provisions and guarantees in the *text* of the Russian constitution and in national laws and regulations. While *de jure* considerations are one element of an NME determination, the *de facto* existence of the basic elements of a functioning market economy is the ultimate test of whether a change in status is warranted. The distinction between *de jure* and *de facto* circumstances is particularly important in a situation in which, as here, the subject country is characterized by a wholesale disregard for constitutional and legislative guarantees and the rule of law.[92] *De facto* circumstances were the Department's primary reasons for denying a change in Russia's status in 1995:

> *Many of the state controls have been abandoned, but that does not mean that functioning markets have replaced controls. Because the evidence does not demonstrate that prices and costs in Russia adequately reflect market considerations, we cannot at this time alter Russia's designation as a nonmarket economy.*[93]

The Department is instructed by the statute to place emphasis on the *de facto* state of affairs rather than *de jure* aspirations, and to view the state of the economy of the country as a whole. While Russia is commonly described as a country "in transition" from a nonmarket to a

90 In determining that the Ukraine was not yet a market economy, the Department stated, "While many of the state controls have been abandoned, functioning markets have not completely replaced government controls." *Certain Cut-to-Length Carbon Steel Plate from Ukraine*, 62 Fed. Reg. 61,754, 61,756 (Nov. 19, 1997) (Final Determination of Sales at Less Than Fair Value).

91 "Scratch and sniff: Russia's economic recovery is more fragile than it seems," *Economist* (Feb. 14, 2002), appended to Domestic Steel Producers' Feb. 28 Brief at Exh. 6.

92 *See*, in particular, Sections V and VIII A and F of Domestic Steel Producers' Dec. 10 Brief.

93 *Pure Magnesium and Alloy Magnesium from the Russian Federation*, 60 Fed. Reg. 16,440, 16,443 (Mar. 30, 1995) (Final Determinations of Sales at Less Than Fair Value). The fact that an NME analysis must focus on the actual state of the economy rather than mere progress toward a free market was even recognized as appropriate by the Russians. The Department summarized the Russian views as follows: "{C}onsideration of whether to revoke Russia's NME status should hinge upon whether there are concrete indicators of market-driven activity rather than on the degree to which the market has moved 'toward an orderly Western-style brand of capitalism.'" *Id.* at 16,447.

market economy, this "transitional" status provides no basis for a finding that it has become a market economy. In fact, the statute was drafted to permit a change in the NME status *only* of countries that had fully transitioned into working market economies -- not countries "in transition," e.g., which had implemented an array of partially-effective and/or incomplete reforms.[94] Until prices and costs adequately reflect market considerations free of government control, and the other statutory factors demonstrate the existence of a free market, Russia must retain its NME status for antidumping purposes.

Proponents as well as opponents of revocation of Russia's NME status have recognized the problems that demonstrate that the Russian economy is not a market economy. A recent study, dated only three weeks before the Department's hearing was issued by one of the main proponents of revocation, the American Chamber of Commerce in Russia.[95] The study contends that Russia has achieved "a basic market environment"[96] and discusses some Russian reforms of recent years. Yet it is clear from a number of the study's findings that that there is simply no rational basis to conclude that Russia is a market economy, if analyzed in the light of the statutory criteria.

It is illuminating to highlight some of the findings of this study:

- *A distorted relevant price structure is one of the most important problems afflicting the Russian economy. The historic structural proportions and pricing principles that formed within the context of the planned economy (as a result of which the Russian economy inherited excessively low energy and transportation tariffs and a generally low-yield and uncompetitive secondary industry) and were transplanted to a market environment, have distorted the entire system of economic signals (prices, tariffs, interest rates, ruble exchange rate) so that the energy sector now subsidizes the entire economy. This transplantation of aspects of one economic system into another has also led to other overt and covert forms of subsidization, and has removed the incentive to save energy, modernize plants and equipment, and enhance efficiency, with the result that some businesses generate negative added value. Another subsidy is to be found in the artificially low charges for housing and utilities, electricity, and rail transport, which are keeping wages at an artificially low level within the economy as a whole, and in particular in the public sector and non export-oriented industries.* (pp. 15-16)
- *Productivity remains extremely low at Russian enterprises-- several times lower than at American enterprises. ...These tendencies show that the Russian economy is still in transition and point to instability of growth....* (p. 15)

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94 *See* Domestic Steel Producers' Dec. 10 Brief at 8.

95 *See The Economic Situation and Investment Climate in Russia.* Exh. 14.

96 *Id.* at 2. Exh. 14.

- *...inadequate nature of the financial system, the high degree of mistrust among businesses, and inadequate protection of ownership rights,* {are} *all typical features of the current Russian economy.* (p. 4)
- *Corporate governance and the protection of ownership rights have been the Achilles' heel of the Russian investment climate for ten years now. Bad corporate governance and the poor level of ownership rights' protection have prevented an inflow of investment into the economy, held back the development of business, and prevented the economy as a whole from becoming more competitive.* (p. 32)
- *Only a few Russian commercial banks conform to the generally accepted international concept of what a commercial bank should be. Moreover, Sberbank is the only Russian bank that can be considered a major bank.* (p. 27)
- *...under the provisions set forth in the law, more than 80% of Russia's enterprises effectively qualify as bankrupt.* (p. 34)
- *...it is clear that the judicial system is in the throes of a deep and profound crisis. Its lack of independence from the executive branch is clear to and recognized by all, a fact which is having the worst possible impact on how Russia's investment climate is perceived.* (p. 6)[97]
- *The current administrative apparatus is unable to cope with its functions. It is incompatible with the needs of a democratic society and open market economy.... For one thing, it is incapable of abiding by the rules, which is vital for democratic and market institutions.* (p. 8)
- *Among the factors preventing a qualitative improvement in corporate management is the presence of state structures among company shareholders. Such structures (shareholders) often have ineffective control over their shareholdings and make poor investment decisions. They also lack a balanced management policy. For example, the State is currently entangled in a conflict of interests with regard to RAO UES of Russia, since the State is simultaneously the regulator, primary customer and principle shareholder of this company. State structures owe huge amounts of money to energy companies in many regions. Thus, the principle shareholder of RAO UES of Russia impairs the environment in which the energy operator might otherwise develop and evolve, and harms the investment appeal of the energy sector as a whole.* (p. 34)
- *The Government's achievements regarding the reform of the natural monopolies, meanwhile, have been modest... Almost nothing has been done with regard to the reform of Gazprom. However, the reform of these three monopolies* {Gazprom, UES, and the railways} *is of crucial importance to business in Russia, as trends in energy, gas and transportation tariffs have a major impact on the costs and risks incurred by manufacturers.* (pp. 4-5)

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97 Compare this with the praise that the representative of the American Chamber of Commerce in Russia lavished on Russian judicial reform during the Department's hearing on March 27, 2002. *See* Transcript at 46-47 (statement of Mr. Somers).

➢ *It is no exaggeration to say that RAO UES of Russia, Gazprom, and the Railways Ministry are the three mainstays of the entire Russian economy. These three giants have a tangible influence on how the country's domestic and foreign policies are formed.* (p. 36)[98]

At the hearing, the representative of the American Chamber of Commerce in Russia purported to present "the views of 650 American companies who are operating in the Russian marketplace."[99] We ask the Department to carefully consider the facts and conclusions in the Chamber's own research study that contradict the statements made on its behalf at the hearing.

V. THE RECENT DETERMINATION THAT KAZAKHSTAN IS A MARKET ECONOMY DOES NOT COMPEL THE SAME RESULT FOR RUSSIA BECAUSE THERE ARE IMPORTANT DIFFERENCES BETWEEN THE TWO COUNTRIES

The Department has recently granted the Republic of Kazakhstan market economy status over the objections by many U.S. companies. The superficial comparisons that might be drawn between the economies of Russia and Kazakhstan do not compel a finding of market economy status for Russia. There are many key differences between the two countries' economies that show that Kazakhstan's graduation (although premature, in our view) was more justified than a similar decision would be in Russia's case.

One important difference is the comparative investment climate. According to the U.S Foreign and Commercial Service, Kazakhstan has created a "liberal investment regime" where "no sectors of the economy are closed to investors," and has "wholly privatized many large-scale companies and sold majority shares in other companies to foreign investors."[100] On the other hand, the U.S. Foreign and Commercial Service notes that in Russia although

> *large investors continue to receive incentives...these incentives are usually outbalanced by chronic severe shortcomings in the investment climate. High tax levels and extremely high costs in complying with Russian tax authorities, inconsistent government regulation, the inability of some investors to obtain redress through the legal system, and crime and corruption all dissuade investors.*[101]

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98 *The Economic Situation and Investment Climate in Russia.* Exh. 14.

99 Transcript at 40 (statement of Mr. Somers).

100 *Kazakhstan Country Commercial Guide FY2002,* U.S. Commercial Service, U.S. Department of Commerce, Chapter 7 ("Investment Climate Statement") at 2-3. Exh. 20.

101 *Russia Country Commercial Guide FY2002,* Chapter 7 ("Investment Climate Statement") at 1 (emphasis added). Exh. 5.

In addition, "Russian privatization sales often are confined to limited positions and face problems with minority shareholder rights and corporate governance,"[102] a point discussed in this and previous submissions by the Domestic Steel Producers. Unlike Kazakhstan, Russia has failed to effectively privatize its largest companies, selling their shares in small blocks and not relinquishing control to foreign investors in cases where the latter succeeded in buying a majority of the shares. In addition, unlike Russia, Kazakhstan has not engaged in de-privatizations, in part because of its weak subnational actors that, unlike autonomous republics and oblasts in Russia, do not act independently of the policies of the national government.

With a population of 17 million, Kazakhstan has succeeded in achieving a total FDI figure roughly equal to that of the Russian Federation with about 150 million people. Annual FDI as a percentage of GDP constituted 15 percent in 2000[103] compared to Russia's 1.7 percent.[104] There is also a functioning U.S.-Kazakhstan Bilateral Investment Treaty designed to provide a more secure investment climate,[105] whereas Russia has yet to ratify its Bilateral Investment Treaty with the United States, although approved by the U.S. Senate in 1992.[106]

Crucial distinctions exist in the financial sector as well. The U.S. Foreign and Commercial Service's assessment is that "Kazakhstan has successfully reformed its financial sector," and the "National Bank has overseen a successful reform of the financial sector, which is beginning to serve as mediator between savers and investors."[107] It also noted that the "official policy is clearly supportive of credit allocation on market terms...."[108] This praise presents a stark contrast to that same agency's finding that Russia's "banking system largely fails to perform the basic role of financial intermediator, taking deposits and lending to businesses and individuals."[109] Equally troubling, the "GOR remains deeply divided over the basic question of whether Russia's banking sector should develop toward a model centered on state banks or one centered on private commercial banks."[110]

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102 *Id.* at 3. Exh. 5.

103 *Kazakhstan Country Commercial Guide FY2002,* Chapter 7 ("Investment Climate Statement") at 21. Exh. 20.

104 *The Economic Situation and Investment Climate in Russia* at 16. Exh. 14.

105 *Kazakhstan Country Commercial Guide FY2002,* Chapter 7 ("Investment Climate Statement") at 1. Exh. 20.

106 *2000 National Trade Estimate Report on Foreign Trade Barriers*, U.S. Trade Representative (2000) at 357. Exh. 21.

107 *Kazakhstan Country Commercial Guide FY2002,* Chapter 1 ("Executive Summary") at 1. Exh. 20. It should be noted that although it has gone further than Russia in its reforms, the fact that the financial sector is only beginning to act as such a mediator is one of the reasons why the Department's determination that Kazakhstan is a market economy was premature.

108 *Id.*, Chapter 7 ("Investment Climate Statement") at 15. Exh. 20.

109 *Russia Country Commercial Guide FY2002,* Chapter 7 ("Investment Climate Statement") at 14. Exh. 5.

110 *Id.* at 15. Exh. 5.

Although like Russia, Kazakhstan has some problems with undercapitalization of its banks, the presence of a large amount of foreign direct investment provides an alternative source of badly needed capital. That option is absent in Russia due to the very low FDI levels.

These are just a few selected points on which Kazakhstan has performed considerably better than the Russian Federation in meeting the test of the Department's criteria.

VI. CONCLUSION

The Department's analysis in the instant inquiry involves a complex review of market inputs, actual market mechanisms and the current state of the Russian economy in the light of the statutory criteria. These statutory criteria must be the basis upon which this analysis is made, regardless of political motivations, or a temptation to reward Russia. This determination of market economy status for antidumping purposes has broad-reaching ramifications which will not only set precedent for the reviews of other former Soviet countries, but will also determine the nature of the antidumping and countervailing duty cases which can be brought against Russia in the near future.

Although Russia's progress is admirable, progress toward market principles is not contemplated in these criteria; accordingly, a *de facto* analysis of the current state of Russia's economy is required in this inquiry. The overwhelming weight of the evidence submitted indicates that Russia "does not operate on market principles of cost or pricing structures, so that sales in the country do not reflect the fair values of the goods" and, therefore must retain the designation of nonmarket economy.

Fundamental Costs and Prices in Antidumping Cases

Figure 1