IBUS 598: Doing Business in Emerging markets

Group research paper:
Russia’s path from communism to capitalism

Johannes Goetz
Sofie Gotting
Sansiri Suangchomphan
Introduction

Since the dissolution of the Soviet Union, Russia has been perceived as a potential superpower suffering from a painful transition from socialism to capitalism showing excesses of capitalism such as corruption, criminality and unbridled enrichment of post-communist elites. However, we should not wrong the Russian people and underestimate their capacity to strive for a new frontier. What the world experiences presently is just the beginning of a struggle that will eventually change the Russian people’s lives substantially. In this paper we seek to depict decisive political and socioeconomic stages since the 1920’s and give an outlook on post-Soviet capitalism that, based on its natural resources, might become the envy of the world.

Communism in the former Soviet Union

“It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest”

In the mid 1800’s, capitalism became a dominant force in Europe and America marked by deprivation and enrichment. The owners of economic property (commodities or means of production) yielded profits at the expense of workers who worked under inhuman conditions for little wages that could hardly sustain their lives. Karl Marx (1818-1883) a German philosopher and economist developed a theory of history - the so-called historical materialism- based on his economic analysis of capitalism. In 1847 an international group of workers, the Communist League, commissioned Marx to write The Communist Manifesto, the history of all hitherto existing society which he envisaged as a ‘history of class struggle between the proletarians, that “class in society which lives entirely from the sale of its labor” and the capitalists, who buy the labor power and who own the land and technology to produce. Marx was an atheist who believed that religion was “the opiate of the people” corrupted by capitalists to prevent the masses from thinking of their present misery but of future happiness in heaven. Marx founded his ideology on his strong belief

2 A brief history of communism in Russia. www.worldof teaching.com/...history/A%20brief%20history%20of%20communism%20in%20Russia, slide5; seen October 16, 2010
10 K. Holland, Capitalism vs. Communism, slide 25
that class conflict between the proletariat and the capitalists could only be resolved by violent revolution.\textsuperscript{11} He envisioned a dictatorship of the working class as a temporary necessity before communism is possible. After a workers’ revolt followed by the destruction of capitalism paradise would appear on earth\textsuperscript{12} where each person would work according to his or her ability and receive according to his or her need.\textsuperscript{13} Marx based his ideology on the Theory of Alienation. In a nutshell his theory presupposes that under capitalism workers will be estranged from themselves and their work thus ceasing to be autonomous beings.\textsuperscript{14} Real liberty can only unfold when workers gain control over their workplace and work which can only be accomplished collectively.\textsuperscript{15} Hence Marx predicted the collapse of industrial capitalism and its replacement by communism which marked for him an inevitable historical process.\textsuperscript{16} Marx considered a peaceful solution unlikely as the ruling class would never give up their power. Violence was therefore acceptable on the basis that the end justified the means.\textsuperscript{17}

Marx’s ideology largely influenced the Russian Bolsheviks who, led by Lenin, overthrew the government in Russia in the 1917 October Revolution. Russia at that time was ruled by a Czarist government under Czar Nicholas II. Most of the Russian people were still underpaid workers on land owned by a small number of wealthy landlords. Besides Lenin there were two other men who were leaders in the Bolshevik party: Leon Trotsky and Joseph Stalin.\textsuperscript{18} Under Lenin’s control, The Soviet Union underwent radical changes resulting in a New Economic Policy (NEP) as Lenin considered it unwise to prohibit entirely each form of private capitalism as long as the majority of production remained under the government’s control. The first steps taken by the new regime aimed at increasing the productivity of peasant farming to improve conditions of workers and support the alliance between workers and peasants.\textsuperscript{19} Throughout Lenin’s government there were a number of achievements. After Lenin’s death, Stalin became head of the Soviet Union Party and ruled as a dictator. He launched command economy which replaced the New Economic Policy marking a period of rapid industrialization and economic collectivization. Upheaval in the agricultural sector led to massive declines in the food production which caused widespread famine.\textsuperscript{20} During the Great Purge Stalin deported to Siberia all those who did not agree with him. His secret police used arrests, torture and mass executions to maintain Stalin’s dictatorship\textsuperscript{21}. During this period World War I broke out but after the war, national unity was improved and the Soviet Union again became a super power of the world. The Cold War began as the Second World War ended. It was the geopolitical, ideological, and economic struggle between the Soviet Union and its satellite states and the powers of the western world, in particular the United States, after World War II.\textsuperscript{22} After Stalin’s death in 1953 Nikita Khrushchev became the Party’s First Secretary. Khrushchev strongly believed in the superiority of Communism and was confident that it

\begin{footnotes}
\item[11] K. Holland, Capitalism vs. Communism, slide 21
\item[12] A brief history of communism in Russia, slide 8
\item[13] \url{http://plato.stanford.edu/entries/marx/}
\item[14] Marx:Capitalism and Alienation. \url{http://faculty.frostburg.edu/phil/forum/Marx.htm}
\item[15] Marx: Capitalism and Alienation
\item[16] k. Holland, Capitalism vs. Communism, slide 28
\item[17] Karl Marx (1818-1883) Marxism’s Final Utter Failure. \url{http://www.ukapologetics.net/Marx.html} seen October 18, 2010
\item[19] Lenin’s N.E.P. \url{http://web.jjay.cuny.edu/~jobrien/reference/ob40.html} seen October 17, 2010
\item[21] Joseph Stalin. \url{http://en.wikipedia.org/wiki/Joseph_Stalin}
\item[22] K. Holland, Capitalism vs. Communism, slide 2
\end{footnotes}
would ultimately bring about the destruction of Capitalism.\textsuperscript{23} One of his major achievements was liberalization in several fields of Soviet life, especially censorship and his criticism of Stalin’s tyrannical rule. Khrushchev launched a new policy of economy known as \textit{New Course}\textsuperscript{24} that was to balance agriculture and increase food production to diminish food shortages.

Although Nikita Khrushchev started a process of reform he was dismissed due to massive shortage of dairy products. Moreover, he failed to meet any of his objectives and was replaced by Leonid Brezhnev in 1964. Under his control central power was restored. However, his attempt to rule without major economic reforms resulted in a dramatic economic decline. His rule known as Brezhnev stagnation saw a significant increase in military expenditures as well as elderly and ineffective leadership. Brezhnev’s refusal to investigate into government corruption nourished the people’s disappointment of the Communist Party.\textsuperscript{25} March 1985 again marked a turning point in the Communist Rule of Russia. Michael Gorbachev was elevated to the position of General Secretary. The dramatic events following the change of leadership led to the dissolution of the Soviet Union at the end of December 1991.

The general level of education had risen significantly and there was greater though restricted knowledge of the outside world. Besides the pull of social change there was the push of policy failure. The rate of economic growth in the Soviet Union had declined gradually from the 1950s to the 1980s. There was lower life expectancy and higher infant mortality rates. On the eve of Gorbachev’s perestroika the country faced serious political and economic problems.\textsuperscript{26} The Soviet Union was not only falling behind the Western countries but behind the newly industrialized Asian countries. Its foreign policy was marked by incapacity to win new friends. However, it must be stressed that the final collapse did not come as the result of an economic or political crisis but rather in the wake of liberalization and democratization. On the whole, the last years of the communist system were influenced by five transformations. On the path to democratization, the decisive turning point was Gorbachev’s consent contested elections for a new legislature to be called the Congress of People’s Deputies. The elections took place in the spring of 1989 and resulted in defeats for numerous party officials and victories of critics of the Communist party, such as Boris Yeltsin, who, though still a member of the Central Committee of the Communist Party, opposed its hierarchy and who by the competitive elections could start his political comeback. By 1989 glasnost (openness and transparency) had resulted in freedom of speech and publication. The new political system lead to the breakdown of the “command economy”. The Soviet economic system had been highly centralized based on five-year plans, Gorbachev, however, favored marketization, though he was reluctant to free prices as he was aware that the public would have to face substantial rises in price. That step was ultimately taken by Boris Yeltsin in 1992. During the last two years of the Soviet Union’s existence its economy faced a transformation from a command economy towards a market system. Significant reforms permitting private enterprise had destroyed old structures and lead to unbridled development.\textsuperscript{27}

These economic changes were closely connected with changes in foreign and domestic policies on the basis of the “new political thinking” which entailed the belief that “universal

\textsuperscript{23} Nikita Khrushchev \url{http://www.pbs.org/redfiles/bios/all_bio_nikita_khrushchev.htm} seen October 16, 2010
\textsuperscript{24} Russian Life: Nikita S. Khrushchev \url{http://www.russianlife.com/article.cfm?Number=174} seen October 16, 2010
\textsuperscript{25} Leonid Breshnev. \url{http://en.wikipedia.org/wiki/Leonid_Breshnev} seen October 16, 2010
\textsuperscript{26} Prof. Archie Brown, Reform, Coup and Collapse. The end of the oviet state. \url{http://www.bbc.co.uk/history/worldwars/coldwar/soviet_end}, p. 1 seen October 16, 2010
\textsuperscript{27} Brown, Reform, Coup and Collapse, p. 2
interests and values should prevail over class interests and the old East-West-divide.\textsuperscript{28} This also included the right of each country to decide for itself the nature of its political and economic system.

When more and more countries of East-Central Europe moved out of the Soviet camp Gorbachev refused to use force to prevent the empire from disintegrating.

The breakup of the Soviet Union came when Boris Yeltsin demanded Russian Sovereignty from the Union in 1990. Conservative communists within the party apparatus, the military and the KGB counteracted with a coup in August 1991. At its outset they put Gorbachev under house arrest. However, when faced with the defiance from Yeltsin and his supporters, the putschists lacked resolution. As a result the coup failed. The putschists were arrested. Gorbachev, however, was weakened by the revolt against him. Yeltsin took advantage of his newly gained position of strength and proceeded to dissolve the USSR. On 25 December 1991 fifteen new states replaced the former superpower.\textsuperscript{29}

\textbf{Why did communism fail?}

There have always been attempts to develop concepts of a utopian classless society which would offer mankind better living conditions. However, all such social utopias failed to consider basic human traits properly. The most decisive incentive and human motive for action and change is self-interest. The utmost social economists and moral philosophers can do is to address other than purely selfish instincts so that society as a whole benefits from the individual’s endeavor.

Communism was doomed from the start due to the moral weakness of human mankind and the corruption of its leaders. The totalitarian states they erected made millions of people suffer. In this context it is Gorbachev’s historic achievement to have accepted the peoples’ strive for freedom.

Ironically, those countries that crusaded against capitalism in the past, nowadays show signs of chaotic capitalism. This to some extent is true for Russia as well. In order to judge the political situation in this country with an open mind, let us turn to the term and its implications. What is the true nature of capitalism?

In terms of Marxist ideology the “bourgeois” or capitalist class as the dominant economic class merely aimed at serving its own class interest.\textsuperscript{30} The term “capitalism” was popularized in this restricted sense by Marxist writers to underline class antagonisms whereas in the 1860’s the term capitalist had simply been used to refer to the owner of capital.

\textbf{Capitalism}

In common usage capitalism is an economic system “in which all or most of the means of production are privately owned and operated, and where investment and the production, distribution and prices of commodities (goods and services) are determined privately in a free market, rather than by the state.”\textsuperscript{31} In the ensuing analysis we want to assess the nature and tendencies of Russian capitalism.

\textsuperscript{28} Brown, Reform, Coup and Collapse, p.3.
\textsuperscript{29} A. Brown, Reform, Coup and Collapse, p.4.
\textsuperscript{31} Capitalism \url{http://www.spiritus-temporis.com/capitalism/etymology.html}
In this context it is helpful to distinguish between ‘varieties of capitalism’. There are more or less three different models of capitalism which differ from each other concerning the coordination between economy and its sub-systems, such as corporate finance, industrial relations and technological development to mention a few. Generally speaking, there are the neoliberal model as in the UK and the US which is “governed by markets through competition”, the coordinated model which is applied in Germany and Sweden where the economies are “underpinned by private non-market institutions that facilitate cooperation” and the public model which “is directed by public institutions exercising political control” like in France.

On a descriptive level, some major landmarks in the history of present Russian capitalism might help to judge how and on which basis Russia and its people have adjusted to present conditions.

**Transition from communism to capitalism in Russia**

There are many reasons that led to the fall of communism in Russia. People always prefer to have freedom in their hands instead of giving it to the government, especially when the government does not deliver on its promises. By the time Mikhail Gorbachev was positioned as General Secretary of the U.S.S.R. in March of 1985, the Russian socioeconomic situation was in collapse and ruin. Criminals ran freely, corruption, alcoholism and drug addictions were the mainstream of an oppressed people. This is what the leaders in the U.S.S.R. faced that culminated into them voting their communist government out of existence in 1991. Boris Yeltsin was elected as the President of Russia and by 1992 he brought the change to Russia to move toward a market-oriented economy. Yeltsin's deputy prime minister Yegor Gaidar, a 35-year-old liberal economist, designed the programs of liberalization and stabilization known as “shock therapy”. With this program, Russia started to open up foreign trade, prices and currency, reduced its trade barriers and cut subsidies to state farms and industries while allowing foreign companies into the market in order to break the power of state-owned local monopolies. One of the major obstacles of the transition is the legacy of the Soviet Union’s commitment to the Cold War. During the war at least half of Russian work forces worked in defense plants. When the war ended, budget cuts hit the industry severely and it was almost impossible for them to quickly change the markets, retrain workers and create new equipments. The enormous size of the country was another major obstacle. Russia has vast land across the Asian continent to Eastern Europe. With geographical diversity, transportation and communication between each region are very difficult. Local governments relied on only a few large enterprises. The production of the whole country dropped by more than fifty percent resulting in high unemployment rates. The lack of governmental control of social security and welfare proved to be a further obstacle. The responsibility went to the companies to maintain social welfare function such as managing workforces’ education, health and similar facilities and also maintaining their housing. The employers had to depend on their firms. If the latter could not afford to fulfill these commitments they were forced to close down their factories.

33 Andre Nilsen, Russian Capitalism, p. 4.
34 Nilsen, p.4.
35 Nilsen, p.4.
36 Nilsen, p.4.
**Capitalism in Russia**

“Capitalism takes into account the true nature of our species and will always survive through self-adjustment.”

The first decade of post-Soviet capitalism was painful for the Russian people. Russia suffered from a deep economic depression in the 1990s. At its lowest in 1996-1998, the economy dropped more than 40%.

With old prices low and the economy in a deep recession, the government was not able to collect taxes to cover expenditures. Like in other new capitalist countries, abuse and corruption were high. The majority of the owners of new profitable businesses were not “self-made men”, i.e. belonged either to the old elites or had simply gained control of state-owned resources such as oil, gas, automobile, banking and other enterprises as in the case of Mikhail Khodorovskiy, 33-year-old former head of the Communist Youth League and founder of the Menatep Bank. The Yeltsin government transferred 80 percent ownership shares of Russia’s second largest oil company to him in return of over $168 million back to the Yeltsin administration. Due to corruption and inefficient government, there were many conflicts between the government and a number of other state and non-state actors, including Yeltsin’s opponents in the federal legislation; directly-elected regional governors; a new oligarchy that controlled large parts of the bureaucracy, courts and legislature through corruption; managers of state-owned firms who burned them into personal fiefdoms (?); and media chiefs who at times used the threat of negative coverage to put pressure on or even extort money from the state.

By early 1998, more than half of the industrial transactions were carried out in barter. The government and many companies had accumulated debts to their employees exceeding the amount of 10 months wages. The government changed from monetary financing of its deficit to issuance of short-term debt but when the oil price dropped to $10/bbl, the ruble depreciated by 75%.

In term of foreign investment, the Russian government tried to introduce a Civil Code based on that of The Netherlands, while American advisors have written statutes to govern operations of joint stock companies. But as Russia’s experience with capitalism differed from the Dutch and American, the cooperation between Russia and the two countries proved to be rather inefficient.

The economy went down and GDP dropped until 1999-2000 when President Vladimir Putin took power. He immediately began to reverse the political pluralism which had contributed to the breakdown of central state authority. Putin also eroded the power of regional governors. Finally he reasserted government control over state-owned companies by replacing the management with close allies and appointing senior administration officials to their boards. The most difficult challenge for Putin was to rebuild the government’s relationship with the business oligarchs. The 1990s privatization process was extremely unpopular. Until 2007, only 40% of respondents in opinion polls said that the state should take back everything that it had privatized during 1990s. The same percentage of those polls thought that property should be returned to the state in cases where the privatization had undoubtedly been carried out in violation of the law. But Putin refused to embark on renationalization of LSEs because it would cause economic crisis and conflict. On the other hand, he proposed that under the condition that leading oligarchs stopped the attempt to influence politics they could keep the property they had earned during the 1990s. The country’s macroeconomic indicators have rebounded very fast since 2000. The weak Ruble restored the competitiveness of many trade

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38 For further information concerning natural resources and their role for the Russian industry see notes at the end of this paper.
goods. As oil prices rose, oil production began to recover. Many reforms during President Putin created a major improvement in Russia. Government had more budgets to develop infrastructure to the east and the north of the country. At present, Russia is considered to be one of four countries known as “BRICs” that have potential to be the largest economy in the world. Among the BRICs, Russia has a real chance of catching up with living standards of the current G7.

**Conclusion**

Despite the vast amount of natural resources Russia possesses within its boundaries offering the potential to make the country one of the world’s leading market economies, it suffered seriously from a sharp recession in 2008/2009, the worst for the BRIC and G20 economies. As a matter of fact, Russia has not fully recovered, yet.

If there is one message that can be learned from these recent developments it is that Russia’s long term economic outlook depends heavily on the price of oil and gas.

In the past decade Russia could take advantage of high oil prices and relatively low capital costs to borrow from abroad. However, external debt piled up, demanding for high export revenue to restore economic credibility.

Another key point is that Russia’s economic development is heavily dependent on how the global economy is doing. To be more precise, especially western European countries determine Russia’s economic future. Roughly 65% of export revenues comes from oil and gas and the main export markets are Germany, the Netherlands, Turkey and Italy. The degree to which these countries are recovering will have a major impact on Russia’s recovery.

Another factor that determines Russia’s economic future outlook is the ability to serve debts. Again, Russia is dependent on the state of global finance. The recent credit market situation makes banks prone of holding excess revenue, slowing down Russia’s recovery.

Another factor that should not be neglected concerns government policy. Clearly, government flexibility has a major implication on the recovery process.

Another burden is the double digit inflation rate. If prices of oil recovered again, the subsequent capital inflows would cause even higher rates of inflation.

To put it in a nutshell: Russia has provided opportunities for investment in recent years. However, there is a whole bunch of problems which make it a risky investment environment nevertheless capitalism in Russia is real and getting robust.

Over the last decades the Russian economy has been shaped by opposing forces from a non-capitalist command economy under communism to a “full-fledged public capitalist society.” However, the conditions under which Russian capitalism emerged in 1992 were diametrically opposed to those known in the western countries. The legacy of Soviet state socialism, command economy, corruption, waste and militarization as well as earlier forms of patrimonialism (the political authority’s control of the nation’s economy as well as of the individual property) had prevented the development of networks “in which the habits of self-governance, personal responsibility and peaceful reconciliation of interests” might have developed.

Another fundamental characteristic of Russian capitalism is the way democracy emerged. In contrast to the old capitalist democracies, where “the authority of law and the security of property were found to be compatible with a liberty of discussion and individual action.”

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39 Nilsen, p.4.
40 Leon Aron, The strange case of Russian capitalism, p.1
41 Aron, p.2.
This had an impact in the following phases of privatization which were aiming at taming inflation and reducing budget gaps. In many cases domestic buyers of profitable enterprises proved to be connected to organized crime. This made the economic system largely dependent on “corporate families” or “financial-industrial groups” (FIGs). In many cases domestic buyers of profitable enterprises proved to be connected to organized crime. This made the economic system largely dependent on “corporate families” or “financial-industrial groups” (FIGs). In many cases domestic buyers of profitable enterprises proved to be connected to organized crime. This made the economic system largely dependent on “corporate families” or “financial-industrial groups” (FIGs).

In spite of such flaws there have been some achievements. Lately, the Russian economy was further opened to foreign investment and partners were permitted to cooperate in the exploitation of natural resources.

So where does Russian capitalism stand today? – It is hard to say as the process is incomplete. Given the circumstances in which Russian capitalism came into existence and the heavy burden of its historic antecedents, it would be too optimistic to predict a swift shift towards liberal and democratic forces. The process is bound to be difficult yet not unlikely. To put it in the words of Leon Aron: “In the longer run, Russian development will depend on the outcome of the clash between two fundamental and competing tendencies, both very much in evidence today: statist, oligarchic, authoritarian, closed, and Left-populist, on the one hand, and liberal (in the European sense of the term), democratic, open, and centrist, on the other. A great deal will also depend on the caliber of Russian political leadership, continuing democratic institutionalization, and the state of the world economy. The battle for the soul of Russian capitalism is likely to be tough and long. Its outcome is uncertain. Yet, given the adversity in which the market revolution began and what has been accomplished since January 2, 1992, the chances for success are real and formidable.”

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42 Aron, p.5f.
43 Aron, p.6.
44 Aron, p.6.
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Notes:
Russia’s Natural Resources

Oil and Natural gas
Russia is one of the world’s largest producers of oil. Currently they stand for about one fifth of the yearly oil production. They are also big producers of natural gas; almost one fourth of the world’s yearly production of natural gas comes from within Russia. Most of the oil and natural gas reserves in Russia are found in the region of west Siberia. There is also smaller but still substantial findings in the region around Volga and the Ural mountains. Most of the produced output is being transported by a widespread net of pipelines that extends both within the country but also to other former Soviet Union countries as well as other eastern European countries.¹

Minerals and Metals
Russia has big reserves of coal which is still a big source of energy in many countries. The coal production is spread of several regions within the country; among these are East Siberia and areas along the Trans-Siberian railroad. The coal mines began to be privatized in the 1990s which forced many of the smaller, non profitable mines to close down. Russia is also a large producer of steel and other metals. They stand for one sixth of the worlds iron production but also a large share of the production of nonferrous, rare, and precious metals.¹

Forest
Russia has the world’s largest forest reserve. This makes the paper and lumbering industries important. Even though the forest reserve is big it’s takes a long time to reproduce due to the harsh weather conditions.¹

Agriculture
Even though a lot of the land in Russia is not suitable for agriculture they still have production of grains, sugar beets, beef and milk. Only about on sixth of the land is suitable for agricultural use and out of this about three fifths is used to grow crops. The major product within the crops is grain that stand for almost half of the crops being farmed. Most of the farms are still being run as collective farms, which are a set up that was left over from the Soviet era.¹

Fishing
Russia has fishing industry both, in the Atlantic and Pacific oceans, as well as the black and Caspian Sea. The fishing industry is a great sort of export income and larger than the one from the grain exports.¹

Other
Except for the traditional resources Russia also has large supplies of fresh water. This is something that is not very valued in today’s society but might be of greater economical value in the future.

¹ http://www.britannica.com/EBchecked/topic/513251/Russia/38605/Resources-and-power, 2010-10-13
¹ http://www.britannica.com/EBchecked/topic/513251/Russia/38605/Resources-and-power, 2010-10-13
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