

RUSSIA AND THE WTO

Katinka Barysch, Robert Cottrell, Franco Frattini,
Paul Hare, Pascal Lamy, Maxim Medvedkov and
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THE CER'S RUSSIA PROGRAMME

The CER has established a research programme on Russia and the European Union. This looks at the growing political and economic ties between the EU and Russia. It examines the economic reform process within Russia. The programme also looks at Russia's place in Europe's emerging security structures, including its partnership with NATO.

The programme is managed by Katinka Barysch and its chairman is Sir Rodric Braithwaite. The CER is grateful to BAT and BP for supporting the work of its Russia programme. The programme collaborates with many partners in Russia, including the Moscow School of Political Studies, directed by Lena Nemirovskaya; and the Committee for Russia in a United Europe, chaired by Duma member Vladimir Ryzhkov. These institutions have translated many CER publications into Russian.

For this pamphlet on Russia and the WTO, the CER has been delighted to co-operate with the Aspen Institute, Italy.

Earlier publications of the CER's Russia programme include:

Russia in Europe by Sir Rodric Braithwaite, 1999

How the EU can help Russia by David Gowan, 2000

Unwritten rules: how Russia really works by Alena Ledeneva, 2001

The twain shall meet: the prospects for Russia-West relations, 2002 (the report of a joint working group of the CER, the Atlantic Council of the US and the Institute for US and Canadian Studies at the Russian Academy of Sciences)

Details of these and other publications can be found on www.cer.org.uk



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Preface

Franco Frattini

All major economic powers, including China, have already signed the agreements of the World Trade Organisation (WTO). But Russia, while a member of the G8, is not yet part of the world's key trading regime. This pamphlet, published jointly by the Centre for European Reform and Aspen Institute Italia, explains the reasons for this delay and offers possible ways to overcome it. Although the contributors disagree on some individual issues, their conclusions add up to a powerful and overwhelming case for Russia's entry into the WTO.

Prospects for Russia's membership now look better than at any point since accession negotiations began almost a decade ago. Moscow's co-operative stance in the aftermath of September 11th has helped to improve Russia's relations with the West, as shown by the NATO-Russia summit in Italy in May 2002. It has also served to generate international political support for its WTO application. The decision by the US and the EU in 2002 to recognise Russia as a market economy has delivered a further boost to the accession process. Good progress with economic and legal reforms within Russia has left the country's economy better prepared for membership.

Nevertheless, the Russian economy still suffers from various weaknesses, including pervasive subsidies for energy, transport and credit, as well as persistent

bureaucratic interference. For Russia and the WTO members, some tough negotiations still lie ahead. They have yet to tackle many contentious and technically complex issues, for example Russia's inefficient customs administration, inadequate food standards and patchy protection of intellectual property rights.

Two – partially conflicting – trends will determine the terms and the speed of Russia's WTO accession. On the one hand, the negotiating partners – Russia, the US, the EU and others – agree that Russia's full integration into the international trading system would be beneficial for all. In particular, Italy has always supported the notion that the creation of a European Economic Space with Russia would be a useful contribution to the accession process, and would provide a solid foundation for the new EU-Russia partnership. On the other hand, each country or trading bloc has clearly defined economic interests that are not always easy to reconcile. The dilemma boils down to the question of whether these potential conflicts can be more easily solved within the WTO framework.

The authors of this pamphlet answer – with very solid and persuasive arguments – in the affirmative. Their contributions shed light on the complex issues on Russia's trade policy agenda; they discuss the most controversial parts of the negotiations; they weigh the economic costs and benefits of Russia's WTO entry; they explore the political economy of accession; and they present recommendations on how both Russia and the EU should manage not only the WTO accession process, but also their mutual relations. With this, they offer an important set of guidelines for countries, such as Great Britain and Italy, which have been consistently advocating a closer relationship between the EU and Russia.

1 Introduction

Katinka Barysch

Russia's accession to the World Trade Organisation (WTO) matters. It matters for the WTO, since Russia is the last big country still outside the club. It matters for the EU, which uses the WTO negotiations to provide vision and structure to its commercial ties with Russia. It matters for the US, which can reward Russia for its post-September 11th support by backing Russia's WTO application. Most of all, it matters for Russia itself. President Vladimir Putin sees WTO membership as an integral part of his pro-western foreign policy. Any suspension of Russia's accession may force him to re-think other aspects of that policy. WTO membership could also be crucial for Russia's long-term economic development. To catch up with the West, Russia needs two things first and foremost: more investment and less dependency on raw material exports. WTO membership could make a real difference in both areas. And yet, most Russian businessmen and bankers remain sceptical. Their lobbying power is stronger than that of the millions of workers and consumers who stand to gain from WTO entry. Accession talks stalled more than once in the course of 2002, and the Russian government has abandoned its objective of joining the WTO as early as 2003. Nevertheless, Russia will and should become a member of the WTO.

This is the unanimous conclusion of all contributors to this pamphlet. Behind this broad consensus, however, lies a fascinating discussion about issues as diverse as energy prices and banking reforms. Since some of the authors are intimately involved in Russia's WTO negotiations, it is not surprising that their views reflect the heated debates that are now taking place, not only in the WTO's Geneva

headquarters, but also within Russia's government, in its business community, on the streets of Moscow and in the regions.

Yevgeny Yasin sets the stage by making a strong case for free trade. He explains how the restrictions of Soviet foreign trade policy contributed to Russia's current economic woes. Russia now has two options. It can continue protecting its smokestack industries in the hope that state support will somehow make them more competitive. Or it can press ahead with its WTO application, and let market forces do the job of weeding out uncompetitive enterprises. Russia may have to endure some economic pain after WTO accession, but it would gain better access to western markets and attract more foreign investment. Yasin's conclusion is that Russia should join the WTO as soon as possible.

Pascal Lamy very much agrees, and promises that the EU – Russia's largest trading partner – will do all it can to support Russia's membership. The EU has already upgraded Russia to 'market economy' status, which should make life easier for Russian exporters and speed up accession. Nevertheless, there are unresolved disputes, for example about Russia's very low energy prices, which the EU regards as an illegal industrial subsidy. The speed of Russia's accession, concludes Lamy, depends mainly on Russia's own reform efforts.

Maxim Medvedkov looks at the same issues from a Russian perspective. Although he has no doubts about the Putin administration's political commitment to WTO accession, he insists that Russia's scope for concessions is limited by the country's economic and political realities. A rapid liberalisation of energy prices, for example, could devastate the industrial sector in ways that would far outweigh any gains from WTO membership. The EU, says Medvedkov, should re-think some of its demands. After all, it is EU businesses which stand to gain most from Russia opening its market for imports and investment.

Given these persistent differences, a big political push may be required to move the negotiations forward. However, as **Robert Cottrell** explains, it is by no means clear that Putin wants to see Russia in the WTO as soon as possible. Russia's membership in the trade club – and western support for it – would fit neatly into Putin's pragmatic approach to foreign policy, and his sharp westward turn after September 2001 in particular. However, with parliamentary and presidential elections coming up, Putin also has to consider the domestic political context. He may not be willing to pay the political price for the reforms that rapid WTO entry would require.

Paul Hare considers the economic pros and cons of WTO membership. After ten years of economic transition, Russia has already been through the worst. Any further disruption from WTO accession is likely to be small in comparison. The potential benefits of membership include market access for Russian manufacturers, a more secure investment climate, less power for domestic lobbyists, and new sources of financing once the banking sector is opened fully to foreign institutions. Since the balance of profit and loss will depend on Russia's accession terms, Hare provides a list of policy recommendations for the Russian government to shape its negotiating stance.

2 Russia and the WTO: what is the alternative

Yevgeny Yasin

Since 2000 the issue of Russia's WTO membership has gradually moved from the world of trade specialists to one of the hottest topics in Russia, debated by industrialists, businessmen, the media and the general public. Negotiations on Russia's accession began as long ago as 1992. With prospects of actual entry so distant, the issue appeared rather theoretical, although there was a measure of political support from the then US President Bill Clinton and other western leaders. But it was only when Vladimir Putin took over the Russian presidency at the start of 2000 that the question of WTO accession became an immediate and practical one. Businessmen started to speculate about the potential costs and benefits. Sectoral lobbies prepared their positions. The Russian people sought to understand how accession would affect the family budget. This essay will argue the economic case for Russia's WTO membership and address some of the practical issues now discussed in Russia.

The case for international trade and the WTO

In principle, international trade – the exchange of goods and services across borders – benefits all countries that take part in it. Exports can stimulate growth and create jobs. Imports increase the range of products in the domestic market and push down local prices, which benefits consumers. On the other hand, the competitive pressure exerted by imports can put domestic producers out of business, especially if they are poorly prepared, and their output cannot compete in terms of quality and price.

Jobs disappear and domestic output falls. In an extreme case, the stability of the domestic economy can be threatened.

Market conditions, however, are not set in stone. Any expansion in international trade benefits some countries more than others, but who wins and who loses changes over time. So do attitudes towards free trade. The US, for example, has traditionally supported free trade – which is only natural for a highly developed economy capable of competing across the board. At the same time, it is not immune to protectionist tendencies. When Japanese cars started flooding the US market, taking advantage of traditional US openness, local producers complained to the federal administration and Congress. The US quickly turned into an advocate of protectionism in the automotive sector. Developing countries tend to favour protectionism because their economies are weaker. Some, however, break out of the vicious circle of coddling uncompetitive industries behind high tariff walls. The ‘Asian tigers’ and China, for example, enjoyed phenomenal growth rates mainly on the back of rapidly rising exports to the US and Europe.

There is long-standing evidence that – despite conflicting interests, shifting economic conditions and an uneven distribution of gains and losses – international trade is beneficial to all. Over the last 30 years, trade barriers have gradually decreased while the volume of cross-border commerce and investment has expanded steadily. As a result, production and living standards have risen both in developed and in developing countries.

David Ricardo, one of the founders of economic theory, provided an early explanation of the benefits of free trade. In a nutshell, his theory of ‘comparative advantage’ states that countries should concentrate on producing the goods which they are best equipped to produce, and import goods for which their national conditions make them less suited. As a result, the costs of production fall across the board, the volume and quality of output improves, and

each country ends up with higher growth and a better standard of living than if it had tried to produce all goods on its own territory. Although this theory has been validated by economists and borne out in practice, it is frequently criticised, above all by developing countries. For them, the advantages of free trade are not immediately obvious, especially when their narrow export specialisation in raw materials leaves them heavily dependent on shaky world markets and the trade policies of the developed countries. However, although a country’s comparative advantage may be weakly developed or distorted, it is clear that closing the economy will only exacerbate these distortions and push the country further backwards.

In the long term, Ricardo’s theory is still valid, even for trade relations between the developed and the developing world. In the short term, however, individual countries and sectors do suffer losses from foreign competition, which often sends local producers scrambling for protection. Governments often heed their appeals and close off domestic markets through protectionist barriers. This then prompts other countries to retaliate, although not necessarily in the same market. One nation increases tariffs on steel imports to prop up its own steel producers; another bans chicken imports, citing public health grounds. This can quickly escalate into a tit-for-tat trade war in which ultimately everyone loses. Between the two world wars protectionism spread rapidly, with devastating consequences: collapsing international trade exacerbated the economic crisis of 1929-1933 and, ultimately, fuelled political hostility between nations.

The large trading nations learnt a lesson from this. In 1948 they drew up the General Agreement on Tariffs and Trade (GATT), a permanent international framework to promote free trade, reduce protectionism and forestall future trade wars. In 1995, the GATT was turned into a permanent international organisation, the WTO. Its coverage expanded from trade in goods to trade in services (through the General Agreement on Trade in Services, GATS),

trade-related investment measures (TRIMs) and trade-related aspects of intellectual property rights (TRIPs).

Today, the WTO has 144 members, and thirty more countries, including Russia, are waiting to enter. The WTO is a club of nations that have undertaken to observe certain rules in their mutual trade and business relations, in the belief that this will ultimately benefit all of them. By joining the WTO, Russia would show its willingness to adopt these rules and abide by them. At the same time, the other WTO members would recognise that Russia is capable of observing the rules, that it is prepared to make concessions where necessary, and that Russia's membership is in the interest of all.

The WTO's basic rules are the following:

- ★ Protection only through tariffs. The WTO does not rule out trade protection altogether. But it stipulates that if a country deems it necessary to shield its domestic producers from international competition, it should do so through import tariffs only. So-called quantitative restrictions, for example quotas for import volumes of certain goods, are forbidden, with some rare exceptions.
- ★ Obligation not to raise tariffs. WTO members promise not to raise customs tariffs above the level agreed upon at the time of their accession (this is referred to as tariff binding). They also commit to lowering them through the WTO's multilateral negotiations. Exceptions exist for the least developed countries.
- ★ The most favoured nation (MFN) principle. WTO members have to apply the same regulations, including tariffs, to all other member countries.
- ★ National treatment. WTO members are not allowed to treat imported goods and services differently from domestically produced ones. This also applies to taxation.

- ★ Regulation of subsidies. The use of subsidies is prohibited or restricted if they disrupt trade flows by creating artificial advantages for domestic goods. Using a traffic light analogy, the WTO relies on a three-tier classification of subsidies: 'Red' ones, such as direct subsidies or tax rebates on exported goods, are ruled out altogether. 'Amber' subsidies are not per se illegal but can lead to penalties if they cause 'serious' damage to the interests of other countries. 'Green' subsidies are generally accepted and include support for small and medium-sized enterprises, or research and development.

If member-states cannot agree on the rules or their implementation, the WTO offers a dispute settlement mechanism, which is similar to an arbitration tribunal. Specially-appointed panels assess whether the losses resulting from the breach of trade rules are 'serious' enough to warrant the imposition of sanctions.

The WTO rules will determine the costs and benefits that each individual country can expect from joining the club. New members can ask for transition periods, giving them more time after accession to implement certain WTO rules. Mostly, applicants ask for these to delay opening certain sectors to international competition. But they can be more far-reaching than that. China negotiated a general transition period to implement the measures needed for its upgrade to 'market-economy' status.

Russia's trade policies

Until 1992 Russia belonged to a world that was utterly different from that regulated through the GATT. In the Soviet bloc, state planning and interference was pervasive, and free trade was not seen as beneficial. Like all production and distribution, foreign trade was a state monopoly. The central plan determined the volumes of exports and imports. Producers transferred their output to state-owned foreign trade organisations at set internal wholesale prices. They generally had no contact with foreign companies and

had no idea what their output might be worth on international markets. The government determined the external rouble exchange rate, just like all other prices. The central plan also determined the amount and allocation of imports at prices that bore no relation to the goods' international value. By conducting international trade, the government was not seeking a profit. It mainly tried to fill gaps in the central plan. If Russia lacked grain, for instance, the government gave an order to buy it abroad. If there was a surplus of oil, the government decreed to sell it. Since the market mechanism of competitive advantage was not allowed to operate, foreign trade made no contribution to enhancing economic efficiency.

The Soviet Union's sphere of military and political influence in Eastern Europe and elsewhere provided it with a guaranteed market for its producers. By the same token, the Soviet Union offered its allies a secure market for their output. While the West had the GATT, the Soviet Union and its partners conducted trade within the Council for Mutual Economic Assistance (COMECON). Countries specialised not on the basis of their comparative advantage but through the co-ordination of national central plans. Czechoslovakia supplied all COMECON countries with passenger cars and trolley buses, electric locomotives and Tatra lorries; the German Democratic Republic provided optical instruments and railway carriages; Poland coal and cosmetics; Bulgaria tomatoes and industrial trucks. The Soviet Union supplied all 'Socialist' countries with oil, gas, iron ore, machinery, and aircraft. Arms were also shipped to countries that showed political sympathy towards the Soviet Union – Kalashnikov rifles, T-52 tanks, and MIG fighters are still found in all corners of the world. This artificial system is the reason why the Soviet Union's export structure appeared more diversified than Russia's does today (see table).

Exports of the USSR and Russia, per cent of total exports

	USSR (1990)	RUSSIA (2000)
Machinery and equipment	18.3	9.0
Fuels and electric power	40.5	55.8
Ores and ore concentrates, metals, metal articles	11.3	21.6
Chemicals	4.6	7.2
Timber, cellulose, paper	3.7	4.3
Textiles and semi-finished textile products	1.2	n/a
Foods and agricultural produce	2.0	1.6
Durable consumer goods	3.6	n/a
Miscellaneous	n/a	1.4

Sources: USSR Economy in 1990; Russian Statistical Annual report, 2001.

The share of machinery in total exports has halved in ten years while that of raw materials, in particular oil and fuel, as well as intermediate products has increased. Manufacturing products account for only 25 per cent of Russian exports, compared with typically 80 per cent or more in developed countries. The current sorry state of Russian manufacturing exports is almost entirely the consequence of the Soviet heritage.

The collapse of Soviet military and political influence was in many ways inevitable. The Soviet economy was undermined by imperial ambition and the inefficiencies of central planning. At a time when

the Soviet economy was already severely weakened, the secure export markets of the eastern European satellite states disappeared, and the Soviet Union fell apart. The national economy quickly moved to the brink of collapse, marginalised as it was and cut off from the invigorating stimulus of market competition in the rest of the world. It was the onset of liberal market reforms that prevented a total collapse. The opening up of the national economy was one of the most important steps in this context. The government abolished the foreign trade monopoly and introduced a market exchange rate for the rouble. Queues and shortages – those integral features of Soviet economic life – disappeared almost overnight. Private businesses sprang up to exploit the opportunities that economic liberalisation created.

At the same time, however, market-oriented reforms dealt a heavy blow to the deeply distorted structure of the economy. Many enterprises failed to adapt from the cosy world of the central plan to the imperatives of the market. Many could not cope with the sudden competition from cheaper and/or higher-quality imported goods. Domestic production slumped, capital ran out, bills to suppliers and wages remained unpaid, living standards plummeted and open unemployment erupted. Faced with this situation, the government quickly moved from a very liberal trade regime in 1992 – no import tariffs and a rouble exchange rate determined by the market – to a more restrictive one in 1993, with import tariffs, quotas and licensing requirements. Tariff protection continued to grow rapidly, and by 1995 the average tariff had reached 15 per cent of the value of imported goods. As tariff protection rose, so did smuggling and other attempts to evade trade restrictions. This meant that the effective level of import protection was considerably lower than by official tariffs, indicated probably closer to 9 or 10 per cent.

Investors started complaining that competition from smuggled goods made it unprofitable to develop production in Russia. Other forces pushed for a change in the trading regime as well, including

the IMF, which at that time extended major loans to the Russian government. However, the privileges bestowed by the inefficient trade regime quickly became entrenched. Numerous lobbies secured special rights from the government, such as the license to import alcoholic beverages and tobacco without paying custom duties and value-added tax (well-known examples include the National Sports Foundation and the Afghan War Veterans Committee). The government found it ever harder to revoke these privileges. They became subject to fierce local competition and even feuds between organised crime groups. Thus Russia learned the rules of international trade through bitter experience.

In 1993, at a time when trade policies were still in a state of flux, Russia started accession negotiations with the WTO. In 1995, a special WTO session, in which I took part as a member of the Russian delegation, for the first time discussed the issue of Russian membership. During this first phase of the accession process, we provided information about the country and its reform progress. The WTO countries put forward more than 2,000 questions. Our answers demonstrated that Russia met most of the WTO requirements, or could rapidly prepare to meet them.

However, the 1998 rouble crisis put a temporary hold on Russia's accession process and taught Russia another bitter lesson, this time about the relationship between the exchange rate, foreign trade, and domestic production. In 1995, Russia pegged the rouble to the US dollar through a 'foreign exchange corridor'. The combination of nominal exchange rate stability and relatively high inflation pushed up the real exchange rate of the rouble. This, in turn, undermined the competitiveness of Russia manufacturing. Imports grew rapidly while exports and domestic production contracted. Yet the Russian government clung to the pegged exchange. By 1998, the peg could no longer be saved, and in August that year the government devalued the currency and defaulted on its domestic debt. The rouble's value against the dollar collapsed, which made most imports prohibitively expensive in the Russian market.

Exporters, meanwhile, received a much-needed competitive boost. Before long, output was growing again, investment revived and the state budget recovered. Russia realised that a low exchange rate can be much more effective than any tariff protection – especially if the tariff regime is riddled by exceptions and undermined by smuggling and corruption.

Soon after it took office the Putin administration revived the dormant WTO accession process. It provided political impetus and, by launching a comprehensive economic reform programme, improved the economic conditions for actual membership. The negotiations moved into the more complicated multilateral stage, where all participants pursue their own commercial interests. This second stage continues to the present day, and the demands that our trading partners have made have created much political controversy in Russia.

Why Russia should join the WTO

Although the Russian economy is now growing again, it is far from flourishing. Russia has travelled only the first half of the journey towards a well-functioning market economy. It has reformed the state apparatus, privatised most enterprises and established the basic institutions of a market economy. It has liberalised trade and most prices. As a result, industry and agriculture have been through years of contraction and crisis. In my judgement, Russia has already absorbed most of the losses from opening the economy. Whatever costs WTO accession entails will appear mild in comparison. The Russian economy is now in the process of recovery, mainly using old production capacities that are capable of churning out reasonably competitive products.

The second part of the journey still lies ahead. Russia must establish and consolidate the full range of market institutions. It must modernise and upgrade its production facilities so that it can manufacture and market new, competitive products. It must re-

organise enterprises to vastly increase their productivity. And it must train and re-train the work force. In short, Russia is presently lagging behind its potential competitors in all respects. In these circumstances does it make sense to enter the WTO? Perhaps it would be wiser to modernise first, and to accept the rules of a new game only when the economy is sufficiently strong?

The Russian economy is already very open, with exports and imports taken together accounting for about 60 per cent GDP at the market exchange rate. Nevertheless, its integration into the world economy continues. At present, Russia has a competitive advantage in oil, gas, metals, artificial fertilisers, and timber – in short, raw materials and low-value added products. The other sectors of the Russian economy – manufacturing, services, agriculture – struggle to compete internationally. But Russia's economy is still in the process of transition, and two alternative scenarios for further development appear plausible:

- ★ Russia continues on its current reform path and, as the next natural step, joins the WTO.
- ★ Russia erects new trade barriers on the pretext that its manufacturing sector is not yet competitive and would be seriously harmed, if not destroyed, by further market opening. This would delay, possibly indefinitely, Russia's entry into the WTO.

In the second case, the outcome is easy to predict. In the absence of foreign competition, Russia's obsolete economic structures would be preserved since there would be no incentives to invest, restructure and enhance efficiency. The country would fall further and further behind its competitors.

WTO membership, on the other hand, presents Russia with a great opportunity. It is for Russians to decide how we make use of it. It is true that WTO membership will require Russia to open its

economy to further international competition, not only in the markets for goods, but also services. WTO rules do permit protectionist measures under certain circumstances, but the basic proposition is that after a certain period (which may vary depending on the product) tariffs should come down to 3-4 per cent and that quantitative restrictions, such as quotas, will have to be abolished. The inflow of foreign goods will increase, at least in the initial period, and local enterprises will face much tougher competition. Profits will fall, and many companies will lose market shares. Some will go bankrupt. Others will try to enhance their competitiveness by cutting costs and attracting new investment. Jobs may disappear, and there may be a decline in domestic demand.

In the worst-case scenario, the economy would be pushed back into recession. But this would put downward pressure on the rouble. A weaker rouble, in turn, would reduce production costs and help to restore international competitiveness. Russian enterprises would regain their strength in their own market and domestic demand would recover. Foreign investment may help in this adjustment process, especially since WTO accession will require the Russian authorities to remove the privileges that local firms enjoy over foreign ones, referred to as 'national treatment' in trade policy.

WTO membership would also create new export opportunities for Russian companies since all WTO members would have to treat Russian exports exactly like exports from any other member country. At present, Russian manufacturing exports are minuscule, and finding new markets for them appears next to impossible. To sustain growth in the medium to longer term, Russia will need to move into the production of higher-value added goods, first for the home market, but eventually also for export. At present, however, many Russian exports face trade barriers. US steel tariffs are only the latest examples in a long series of protectionist measures that have affected exports ranging from fertilisers to textiles and

uranium. If Russia is to diversify its exports, it has to get rid of the trade barriers to the greatest possible extent.

The decision of the US and the EU in 2002 to grant Russia 'market-economy' status is an important first step to protect Russian producers against 'unfair' anti-dumping action. However, it is only within the WTO, when Russia has access to the organisation's dispute settlement system, that its producers will be able to fight back. Anti-dumping action would still be possible against individual Russian firms, but it would have to be preceded by a clear and transparent investigation. Defensive measures against Russian products would only be allowed if the importing country could prove that these cause 'serious injury' to its industries. Moreover, as a WTO member, Russia too would have the possibility of taking protective measures, including a temporary rise in import tariffs to allow suffering sectors to recover.

Import protection and the rouble

For WTO entry, Russia will have to agree maximum rates for all tariffs – or 'bind' them, in WTO jargon – and then bring them down gradually as agreed in multilateral trade agreements. As remarked above, tariffs will eventually come down to 3-4 per cent, and non-tariff barriers will be effectively prohibited. Most enterprises should find this gradual fall in tariff protection bearable. Russia should be able to get an agreement that binds its average tariffs at around 12 per cent, which is still above the current effective level of 9-10 per cent, once illegal exemptions and smuggling are taken into account.

Higher nominal tariffs would probably lead to an increase in smuggling. And smuggling poses a greater problem for domestic producers than growing import competition as a result of lower tariffs, simply because there are no effective countermeasures. What is more, the resulting atmosphere of distrust and corruption poisons the business environment.

As pointed out above, the exchange rate can act as a tool of trade protection. An undervalued exchange rate can do more to shield domestic producers from foreign competition than high customs tariffs. When the rouble collapsed against the dollar in 1998, many foreign goods were simply priced out of the Russian market. Since then, the rouble has recovered gradually against the dollar in real

¹ *This means that 100 roubles translated into dollars should buy the same basket of goods in Russia and the US. If the exchange rate is below this level, Russian producers have a competitive advantage over their US counterparts.*

(inflation adjusted) terms. Nevertheless, in late 2002, the real rouble-dollar rate was still some 25 per cent below its 1997 level. In terms of purchasing power parity,¹ the rouble still looks grossly undervalued, and that is the way it should be for a transition economy like Russia.

However, if oil prices remain as high as they have been since 2000, the Russian economy could be heading for trouble. Russia earns billions of dollars in foreign exchange from exporting oil and oil-

related products at current high prices. But these foreign exchange inflows push up the exchange. Or if the nominal exchange rate is kept stable, create inflationary pressure within Russia. The result under either scenario is a real appreciation that makes Russian industrial producers uncompetitive. Oil companies would then flourish at the expense of the rest of industry.

At the moment, the rouble exchange still looks rather competitive. It is all the more worrying that Russian companies are already reacting to any increase in competitive pressure by asking the state for help, rather than cutting their costs and boosting their productivity. Few make any real attempts to attract investment. Competitive forces are still underdeveloped in Russia. Unless the stimulus of the market is allowed to act, neither a competitive exchange rate nor high tariffs will be enough to propel the economy forward.

The use of subsidies

The WTO prohibits its members from extending certain subsidies to local industries. Will WTO membership therefore prevent the Russian government from supporting local companies and help them to establish a foothold in international markets? First, it should be emphasised that Russia has already phased out most direct subsidies in the course of its economic transition. By now, the federal (central) government gives practically no subsidies that would be 'forbidden' under WTO rules. Regional governments, however, do provide such subsidies. In many cases, these are intended to offset economic distortions caused by price controls.

Most subsidies in Russia are so-called transfer or cross subsidies. They are not granted through direct payments from the state budget, but through regulating utility prices. For instance, low energy prices help to keep down household bills for heat and electricity. Low energy bills are in line with paltry wages and pensions. But they do not always cover the costs of producing the energy provided, which distorts incentives and harms energy producers. The Russian government will eventually have to resolve this problem by introducing real market prices for power supplies and other services. This is part and parcel of Russia's economic transition process and would have to be done irrespective of the WTO accession process. Nevertheless, Russia's low energy prices have caused controversy in the WTO negotiations. Some of Russia's trading partners argue that they represent an implicit subsidy not only for households – which is of little relevance for the WTO – but also for industrial producers, which can then export more cheaply to world markets.

However, what is under discussion here is not a state policy, but Russia's competitive advantage as a naturally resource-rich country. Gas, of which Russia has plenty, is the main input into electricity generation in Russia. Local power stations, in turn, can supply cheap energy to manufacturing enterprises. Similarly, Siberian hydro-electric power stations produce very cheap power that

benefits Russia's aluminium producers. Russian producers are simply reaping the rents from the country's natural riches.

The WTO does by no means rule out all subsidies. Export credits and guarantees, for instance, are allowed, unless they are provided at rates below the government borrowing rate. At present Russian exporters cannot offer their customers the credit terms that are widely available in international trade, which is one of the reasons why they fail to win tenders. If they could raise credit at normal market rates with a government guarantee, they would have a much better chance to expand their presence in world markets, especially in the engineering sector. Importantly, the WTO also permits subsidies for the kind of research and development that is required to develop new high-technology products and help to modernise the Russian economy. It also allows support for innovative small and medium-sized businesses.

The WTO's rules on the protection of intellectual property rights will, of course, prevent Russia from continuing to exploit valuable information without paying for it. But at the same time it will protect the rights of Russia's own inventors and creative artists, and will encourage increased investment into science and applied technology. For a nation that regards its intellectual potential as a development resource, this is a strong argument. Russia may have to shoulder some losses at first. But these should be regarded as investment in creating the conditions for gaining a prominent position in the global knowledge economy.

Financial services

WTO accession will also require Russia to open up its market for services, including financial services. This market opening may entail risks, unless it is managed carefully. Foreign companies could fully operate in the Russian markets for banking, insurance and investment services. They would not only be allowed to invest, but also to withdraw their capital at any time, including

the money raised in Russia. A large and sudden outflow of foreign capital could lead to an exchange rate crisis. At present, this risk is not very high, not least because there is as yet very little foreign money in the financial sector. But it cannot be disregarded altogether.

On the other hand, financial services in Russia are currently extremely underdeveloped. Indeed, they are almost non-existent. At present, there is no functioning mechanism for transforming household savings into productive investments (economists call this financial intermediation) and thus provide the capital which the economy needs for sustained growth. It will take the banking sector eight to ten years to raise its capitalisation to a level that would allow it to fulfil this basic function. Russia therefore needs the participation of foreign capital, but also the experience and up-to-date technology that comes with foreign investment. Russia's real problem is not any far-fetched risk of financial crises, but the reluctance of foreign companies and banks to invest in Russia because of the prevalence of informal relationships and the insecurity of property rights. In the financial sector the advantages of joining the WTO therefore outweigh the disadvantages. Should genuine threats to financial stability emerge, the WTO rules provide ample room for managing and controlling them, for example by suspending the opening of a specific services market.

Overall profit-and-loss balance

I have identified two possible strategies for Russia: to join the WTO as it stands, and to accept the inevitable problems and losses in the hope that they will be outweighed by future benefits; or to give up the idea of entering the WTO, at least for now, in the hope that our competitiveness will improve with time, presumably as a result of state support for industry that would not be permitted under the WTO rules. A third alternative, or rather a variant of the first, is also conceivable: Russia could join

the WTO after tough negotiations for the best possible entry conditions, without making major concessions simply to secure entry by a particular date. This seems to be the policy of the Russian government at present.

The government together with representatives of the business community (in the form of the Mordashov commission set up by the Russian Union of Industrialists and Entrepreneurs) has investigated the attitudes of Russian business. It transpired that only a few sectors – the automobile and textile industries, and some others – wanted high protective tariffs. The demands of the others industries were rather moderate, which has helped to define Russia's negotiating position. By April 2002, Russia had agreed tariff bindings for more than 75 per cent of all tariff items. In other areas, progress has been slower, but agreement should be possible, since Russia's opening position – for example on agriculture – contains room for concessions. So do the positions of a number of WTO members, who are still trying hard to obtain concessions from Russia without offering much in return. For example, the conditions on civil aviation, which have been tacked onto the accession agreement, are not a standard requirement for entry into the WTO.

One important obstacle to Russia's WTO accession was resolved in the summer of 2002, when both the US and the EU decided to grant Russia 'market economy' status. This is crucial not only for on-going and future anti-dumping investigations, but also for determining Russia's entry conditions into the WTO. Without market economy status, Russia, like China, would have failed to reap the full benefits of WTO entry during a transition period. However, many of the demands, particularly from the EU, that were originally linked to Russia's upgrade to a market economy are still on the table and may yet turn into obstacles to a final agreement on entry.

The EU had put forward a number criteria for recognising Russia as a market economy, including price liberalisation in the energy sector;

improved transparency and financial discipline in the corporate sector; better protection of property rights; and a freely convertible national currency. Although the EU has since granted market economy status, it still requests progress in some of these areas before Russia can join the WTO. In particular, the EU wants to see a firm commitment on energy price liberalisation. The argument that low prices bestow an unfair advantage on Russia producers may yet obliterate the practical gains from Russia's upgrade to market economy status. EU producers could use this argument to demand protection from Russian competition, especially in energy-intensive manufacturing. However, as explained above, low energy prices in Russia are a competitive advantage that stems from rich natural resources – just as Europe gains a competitive advantage from its capital and knowledge-intensive manufacturers. Since we are not talking about a subsidy in the traditional sense of the term, the issue of energy prices should not be allowed to hold up Russia's WTO accession. Nor should EU demand for improved corporate governance and the protection of property rights. Russia's market economy is inefficient, and its institutions are immature and imperfect. But reforms are making good progress. For example, Russia is planning the introduction of international accounting standards in 2004. And a new bankruptcy law, passed in 2002, is designed to impose financial discipline on companies and prevent abuses. It is not reasonable for the EU to expect Russia to reach perfection before it joins the WTO. Nobody makes such demands of India, Columbia, or Namibia. Yet they are all members of the WTO.

To put it bluntly, these arguments, reflect at least partly, attempts by existing WTO member-states to preserve protectionist barriers or extract additional advantages from Russian membership. This is entirely normal. Since Russia can only effectively deal with such protectionist tendencies inside the WTO, this is just another argument in favour of Russian's accession.

There are also good reasons for Russia to join as early as possible. First, as explained above, the weak rouble currently provides

reliable protection for Russian producers. But the real exchange rate will continue to rise as the economy continues to recover. The later we join, the weaker the protection from the exchange rate will be. Second, the WTO has launched a new round of multilateral trade negotiations in Doha in 2001, which covers important areas such as a liberalisation of agricultural markets, trade in services (including energy and maritime and air transport), market access for non-agricultural commodities; trade aspects of intellectual property rights; trade and investments; and a modification of WTO rules, in particular on subsidies and compensatory measures, as well as on regional trade agreements whose creation may harm third countries (for instance, relations between the EU and Russia). It is very important for Russia to participate in the negotiations on these and other issues, not as an observer (as at present), but as a WTO member with full voting rights, especially as WTO decisions are taken by consensus.

Conclusion

WTO rules do not accord privileges to any particular country or sector. They are a legal framework for an existing body of international practice. They do not entirely rule out protective measures against foreign competition, or aid for the development of the national economy. Restrictions are imposed only on actions that might damage others. This is the old Biblical principle: Do unto others as you would have others do unto you.

Russia should join the WTO as quickly as possible to reap the full advantages of international integration and free trade, to draw benefits from globalisation rather than to suffer from it. It will be a complex and painful process. But ultimately the advantages outweigh the disadvantages. The disadvantages are mostly tactical, short-term and immediate. The advantages are strategic. Perhaps the potential benefits will never be realised. But it will be within Russia's power to reduce this risk once it is inside the WTO. We cannot win if we are not playing the game.

3 The EU supports Russia's WTO bid

Pascal Lamy

The Russian president, Vladimir Putin, and his government have put Russia's early entry into the WTO at the top of their external economic policy agenda. The EU very much welcomes this commitment to early accession, and we shall do all we can to make it happen. We have pushed for speedy progress in the WTO working party, which co-ordinates the multilateral accession negotiations with Russia. And we have upgraded Russia to 'market economy status', since Russia saw its non-market economy status as a major obstacle for accession.

After a period in early in 2002 when Russia's drive towards WTO accession seemed to have stalled, I was glad to see – on my most recent visit to Moscow in October 2002 – that negotiations are back on track. They are now entering a critical stage. This is reflected in the fact that a lively and, I think, healthy debate has begun in Russia on the pluses and minuses of WTO membership. Accession is not to be undertaken lightly, or without a clear understanding of what membership implies.

As Russia's biggest trading partner, the EU has a strong interest in its accession. The EU now accounts for more than one-third of all Russian exports and imports, and this share will rise to more than half after the EU's eastward enlargement. Our trade relations clearly benefit both sides. Russia enjoys a substantial trade surplus with the EU, which helps it to earn much-needed foreign currency. And the EU relies on Russia for a significant, and increasing, share of its energy supplies.

Russia's WTO membership will not only liberalise trade with the EU and other highly developed market economies. It will also make Russia a safer place to invest in, for domestic and foreign companies alike. Domestic investment spending has yet to recover from its precipitous collapse in the 1990s. An estimated \$20 billion, the equivalent of 8 per cent of Russia's GDP, still leaks out of Russia every year in the form of capital flight. Foreign direct investment (FDI), meanwhile, remains minuscule, at less than \$3 billion a year. At roughly \$40 per capita, this is much less than in any other country in Central and Eastern Europe. The Czech Republic has attracted more FDI since 1990 than Russia, whose population is almost 15 times larger. China receives more FDI in a month than Russia does in a year.

Russia badly needs more investment to move away from its traditional dependence on exports of energy and raw materials; to develop a well-functioning services sector; to promote new technologies and skills; and to ultimately boost growth and create jobs for its people. By joining the WTO, Russia would reassure potential investors, at home and abroad, that it is determined to integrate into the global economy on the basis of a stable, predictable framework.

Russia's progress in the accession talks

Joining the WTO is easier said than done. The accession process involves lengthy negotiations within a multilateral working party, in addition to bilateral negotiations with as many existing WTO members as wish to be involved. This is much more challenging than accession to other international organisations, such as the United Nations or the IMF, which do not have such onerous entry conditions. The difference in accession procedures reflects the contractual nature of the WTO. Any new WTO member enjoys the legal rights and has to take on the obligations that have previously been negotiated by the existing members. This usually requires the acceding country to carry out extensive legal and structural reforms,

which turns WTO accession into a difficult and sometimes politically-charged process.

Russia has already made good progress in its accession process. Like any other government applying for membership, the Russian authorities started their accession process by submitting information about its trade and economic policies with a bearing on the WTO agreements. This was followed by more detailed descriptions of specific aspects of trade policy, such as current tariffs, the trade regimes for services or agriculture, product standards, and the protection of intellectual property rights. The WTO working party for Russia, which first met in 1995, has been continuously scrutinising this information and pointing out rules and policies in breach of WTO requirements.

It is the ability of the applicant country to remove these inconsistencies, or at least promise to do so within clearly defined transition periods after accession, that largely determines the pace of accession. Here, I pay tribute to the efforts of the Russian government over the last year or so. It has adjusted many local laws to WTO requirements and pushed through some structural reforms which will help Russia to withstand competitive pressure. I hope that the autumn session of the Duma, Russia's lower house of parliament, will move this process forward with continued vigour.

Once the WTO working party thinks that the Russian government has made sufficient progress, it draws up draft reports on the basis of which the final accession package will then be negotiated. The working party for Russia started this process in early 2002, and will submit a second, revised version of its draft report before the end of the year.

With more than 60 members, the working party examining Russia's request for accession is the largest of the 28 WTO working parties in existence. This reflects WTO members' recognition of Russia's importance as a trading partner, its

potential for future growth, as well as the significance of the country's accession to the organisation as a whole. At the same time, Russia is conducting more than 50 separate bilateral negotiations with WTO members. While the working party examines general principles and policies, bilateral talks concentrate on national commercial interests, which differ from country to country. Major exporters like the EU, US, China or Japan typically have a wide range of trade interests across many goods and services sectors. They want to see those interests reflected in the market access and other legal commitments made by the acceding country. Other countries may focus their talks more narrowly on agriculture or specific industrial sectors.

Once these negotiations are finished, the results are pulled together and applied on a multilateral, non-discriminatory basis. Assume, hypothetically, that the EU accepted a commitment from Russia to apply a tariff on imported watches no higher than 10 per cent, but that another watch-exporting country, Switzerland say, successfully insisted that the tariff should be no higher than 5 per cent. Then 5 per cent would apply to watches sold by all WTO members irrespective of their bilateral agreements.

So what remains to be done in Russia's accession process? Once the negotiations – both multilateral and bilateral – are sufficiently far advanced, the working party will finalise its draft report and other legal texts into a package of the terms of accession. This is the main substantive part of the multilateral accession process and often the most difficult one. Negotiations within the working party determine the terms and conditions of entry. These include the new member's commitments to observe WTO rules, as well as any transitional periods required to make legislative or structural changes to implement these commitments.

The process is further complicated by the fact that the results of bilateral negotiations may have to be included in the working party report, as is often the case for commitments concerning non-tariff

barriers or regulatory changes. This means that, normally, a working party will only complete the report once all bilateral talks have been wrapped up. The fundamental principle is that “nothing is agreed until everything is agreed”.

Finally, the accession package – consisting of the working party report, a protocol of accession and the lists of the new member's commitments with regard to trade in goods (including agriculture) and services – is presented to the WTO member-states. They have to approve the package by consensus, since each member has to be satisfied with the outcome of the negotiations. On the other hand, if the acceding country feels it has been asked to make unreasonable commitments, it can choose not to sign the final deal. The WTO cannot impose accession terms on would-be members. Usually, of course, the trade negotiators seek to resolve all contentious points before this stage. Once all sides have approved the deal, the new member can sign its protocol of accession, which often has to be ratified by the domestic parliament.

The speed of the accession process

How long does all this take? Just as there are no fixed terms and conditions for entry, there is no hard and fast answer to this. Since 1995, the year when the General Agreement on Tariffs and Trade (GATT) was transformed into the WTO, 16 countries have joined the organisation. All but three of them had already submitted their application before 1995. The other three, Georgia, the Kyrgyz Republic and Oman, applied during the course of 1996 and became WTO members in 1998 (Kyrgyz Republic) and 2000 (Georgia and Oman). But the accession process can take much longer than that. Counting from the initial application date to formal accession, it lasted 10 years for Bulgaria (September 1986 to December 1996) and Chinese Taipei (January 1992 to January 2002) and as long as 15 years for China (July 1986 to December 2001). Russia first applied to the GATT in 1993. However, in the nine years since then there have been periods, for example, after the 1998 financial crisis,

when the Russian authorities put the WTO accession process on the back burner.

A number of factors determine the speed of the accession process. There are often major competing demands on the WTO, and on WTO members' individual and collective negotiating capacity, for example a new round of global trade talks. Developments in the applicant country, such as a change of government, economic difficulties or changes in domestic political priorities, can also cause delays. Given that WTO accession usually requires the country in question to liberalise and open up its own market to additional trade and investment flows, powerful domestic lobbies often work hard to preserve the status quo and limit foreign competition.

It is basically for the government of the acceding country to resolve these internal issues. In some cases, transition periods – the right to comply with WTO requirements within a specified period after accession – can help to resolve political differences. However, WTO members are generally very reluctant to accept transition periods, especially if they allow the new member-state to delay applying fundamental WTO rules. The acceding country should start to reform its trade regime as soon as it applies and not just at the date of accession.

Standard terms of accession?

In its attempt to reach agreement on the details of accession, Russia has insisted that it would not join on anything other than 'standard terms'. However, the WTO does not have 'standard terms of accession'. The WTO agreement simply states that accession should take place "on terms to be agreed between [the new member] and the WTO". Accession commitments have to be tailored to match the particular circumstances of the country concerned. What is appropriate for a large competitive exporter that already plays a major role in world trade may not be right for a smaller developing country.

The accessions of countries undergoing transition from a centrally planned to a market economy pose their own specific problems. Many such economies have joined the WTO since 1995, including Albania, Bulgaria, Croatia, the three Baltic republics, Georgia, the Kyrgyz Republic and Moldova. Their WTO accession term frequently included provisions to deal with the specific features of a transition economy, such as extensive government pricing controls and the operation of state-trading companies.

The underlying principle behind the specific package that the WTO negotiates with any new member is that the obligations accepted by the acceding country establish a fair balance with the rights it acquires. I am aware that day-to-day negotiations can appear at odds with this principle. Applicant countries sometimes feel that they have to keep making offers, while the existing members respond with more and more requests without, seemingly, giving anything in return. The accession talks may then look like a one-way street with no end in sight.

However, such impressions fail to take full account of the benefits that come with WTO accession. New members not only enjoy the legal protection that the WTO's comprehensive set of trade rules. But they also gain the rights of market access that the existing members have agreed upon during years of multilateral trade negotiations. Last but not least, the WTO offers new members access to a binding system of dispute settlement to ensure that their new rights are respected. If Russia stayed outside the WTO, it would enjoy none of these rights and benefits.

Russia's national interest

As the accession negotiations have progressed, individual sectors and lobbies in Russia have started pushing for their interests. Some sectors oppose WTO accession while others are uncertain about the benefits it may bring. Some argue that joining the WTO, or joining it quickly, is not in Russia's national interest.

However, I have a strong sense that, on the whole, Russia has concluded that it has much to gain from opening its economy. At present, low confidence in the local banking sector means that domestic savings are not transformed into productive investments to a sufficient degree. This particularly affects small and medium-sized enterprises, which remain underdeveloped. Energy companies and natural resource-intensive sectors continue to dominate the industrial sector. It is clear that Russia should not shield this inefficient economic structure. Instead it should push for greater integration into the global economy, pursue structural reform and industrial diversification, and strive to attract more foreign investment and expertise.

This is, in fact, the route towards Russia's economic modernisation that President Putin and his government have sketched out in their economic reform programme. The current Russian administration has done well in confronting the task ahead. But the hard part is to keep up the momentum of reforms and to use WTO accession – both the negotiating process and the eventual package of legal obligations – to lock in the results.

There is another reason why rapid WTO accession would be beneficial for Russia. The WTO is presently at a key stage in its own development. Its members are now fully engaged in the new round of multilateral trade negotiations, the Doha Development Agenda. The sooner Russia joins the WTO, the sooner it too will have a voice in these negotiations and be able to influence the outcomes. This is important because – alongside questions of market access for goods (including farm goods) and services that are the bread and butter of any trade round – the Doha agenda includes a very significant regulatory and rule-making element. It seeks to draw up new WTO rules in areas such as competition and investment, as well as clarifying the relationship between international trade and environmental protection or social protection, and the role of 'non-trade concerns' such as food safety in agriculture. If Russia's WTO accession were to be delayed

beyond the conclusion of the Doha round – scheduled for the end of 2004 – the country would face a whole new host of WTO obligations in addition to those on the basis of which it is now negotiating. Russia would then have to meet requirements in areas that are entirely new for the WTO, such as competition. It may also find that the benchmark for market access has moved. It could then be forced to re-think its proposals for future obligations in respect of tariffs, services and agriculture.

Outstanding issues in EU-Russian talks

Of course, there is still a lot of work ahead to bring the positions of Russia and the EU closer together in a number of areas. The EU is concerned that Russia seeks to maintain protective barriers – for a number of sectors in both goods and services and in some cases even increase them. These include motor vehicles, pharmaceuticals, aluminium and aircraft; and in services such as banking, insurance and telecoms. The EU – the home of many internationally competitive companies in these sectors – wants to ensure better access to the Russian market and, more broadly, that trade takes place on a stable basis in conformity with WTO rules.

Energy prices are another key issue that we have raised with the Russian government, and one that has proved very controversial with Russia's negotiators. It is undeniable that the cost of energy in Russia is artificially low. Natural gas costs as little as one-sixth of the world market price. Low energy prices and other indirect forms of support, such as barter trade, translate into an annual subsidy to Russian industry of around \$5 billion (2.5 per cent of GDP). Since Russian producers' energy bills are kept down in this way, they can export goods at prices that are unfairly low. The EU has therefore asked Russia to commit itself to eliminating this distortion. We are not singling out Russia in making this request: in the WTO accession negotiations with Saudi Arabia we have asked the government to address a similar problem of dual pricing that benefits its national industry.

The EU's request fits in with the government's own plans for energy sector reforms, which include opening the market and removing price controls. We recognise that domestic energy prices cannot be raised to world market levels overnight, and we are ready to consider transitional arrangements. We also accept that Russia should be able to continue subsidising energy for households, schools or hospitals and, if it wishes to, levy much lower taxes on energy production and use than we do in the EU. Our concern is with the unfair advantage given to Russian industry. Russia's abundant supplies of oil and gas are, arguably, part of the country's comparative advantage. But it is essential to make Russian manufacturers pay market-determined prices for energy, to ensure sustainable management of these natural resources and to create a liberal trading environment for the export of Russia's manufactured goods.

The home straight

Given the remaining difficulties, when will the accession process realistically come to an end? Soon, I hope. Russia has set itself the ambitious target of completing WTO accession negotiations before the end of 2003. In December 2001, the EU presented Russia with its final list of specific requests on WTO accession, which we crafted in a deliberately modest manner. Indeed we chose not to push a number of the demands made by European industry. And we accepted that Russia should be able to levy duties on industrial products at an average rate roughly double that currently applied in the EU or in other OECD economies.

We have, naturally, asked for better access to some sectors of particular interest to us, such as financial services and telecoms. We also made clear what we believe Russia should do to meet its goal of bringing its trade regime into line with WTO requirements by the time of accession. And we have suggested how it can use WTO accession to improve the general investment climate. As in any other WTO accession, the actions and negotiating positions of the

acceding country effectively determine the pace of negotiations. The ball is in Russia's court.

Accession would constitute a major political achievement for Russia. It would be a clear signal that old-style state micro-management of the economy has gone for good. It would cement Russia's growing profile in the international economy. I am convinced that WTO accession will be to the mutual benefit of Russia, the European Union and the multilateral, rules-based trading system. On behalf of the EU, I want to ensure that we do all we can to help Russia to achieve its objective of WTO membership as rapidly as possible.

4 Russia's accession to the WTO: the view from Russia

Maxim Medvedkov

The government's point of view

Accession to the WTO is the logical continuation of Russia's advance towards a market economy. Even during the era of central planning, in 1978, the government of the USSR sought to cooperate with the GATT, although it was neither able nor willing to comply with GATT rules at the time. Since the GATT (and now the WTO) has always been about more than cross-border trade, membership would have threatened to curtail Soviet control over the domestic economy. Now, however, Russia is willing and able to enjoy the same rights, and offer the same standards for international business, as all other members of the multilateral trade system. We seek to reap the benefits that WTO membership offers by further integrating Russia into the international economy.

Russia's motivation for joining the WTO is thus well thought-out and based on both pragmatic economic and long-term strategic considerations. It is inconceivable that we should change course on this issue – unless we were asked to pay too high a price for membership. The Russian government would like to see the negotiations progress as fast as possible – as fast as prevailing differences on both sides permit. We are keen on early membership, but we are by no means ready to accept each and every request from the WTO's current members. We hope that we will be able to overcome the main hurdles before the WTO members' attention becomes focused on the new round of multilateral trade talks launched in Doha in 2001.

As mentioned above, Russia's accession bid is based on the pragmatic view that WTO membership is in the country's economic interest. On the most basic level, we expect WTO membership to ensure:

- ★ non-discriminatory treatment of Russian exporters in the markets of the other WTO members;
- ★ equal status with other WTO members in anti-dumping procedures and an end to all existing discriminatory measures against Russian exporters;
- ★ participation in the development of new multilateral trade rules and disciplines; and
- ★ a positive impact on foreign investment inflows and economic growth.

The moderate increase in competitive pressures that we expect from WTO accession should be beneficial for our domestic economy. However, we also need to strike the right balance between allowing competitive forces to bring about benefits for Russian consumers and protecting the interests of Russian producers. We simply cannot agree to accession terms that would result in significant and lasting damage to Russian industries.

We also expect WTO accession to lead to general improvements in the business environment, and to lighten the burden of regulation, which is largely a legacy of the past. In fact, preparations for accession have already brought about such improvements. WTO accession requires more transparent regulations, for example for customs, and an improved protection of property rights through courts and arbitration. We expect these indirect, or 'systemic', benefits of WTO accession to be at least as valuable as the direct economic ones.

Benefits for European businesses

It appears to us that joining the WTO tends to be more beneficial for the trading partners of the acceding country than for its domestic businesses, at least initially. Foreign exporters can take immediate advantage of the concessions that the new member makes as part of its accession bid. In Russia's case, it will be the EU, our most important trading partner, that will reap most of the benefits, not only from lower Russian tariffs, but also from liberalisation of services, and 'systemic' changes that will improve the business environment. These gains have already started to materialise, as Russia is amending its economic rulebook in preparation for WTO accession. For example, foreign companies will enjoy speedier and more transparent customs procedures; increased certainty of trade policies, including for services; better protection against 'hidden' trade barriers in the form of product standards or licensing rules; and better protection for their brand names and trade marks (see box for details).

If we add other recent improvements in the Russian business environment, it becomes clear that the conditions for European businesses in the Russian market have improved significantly in the course of Russia's WTO accession process. These other improvements include the new bankruptcy law (passed in a first reading in June 2002), a significant reduction in the tax burden (personal income tax is now levied at a flat rate of 13 per cent and corporate profit tax at a maximum of 24 per cent), as well as a special tax regime for small businesses.

KEY LEGISLATION IN PREPARATION UNDER RUSSIA'S WTO ACCESSION BID

- ★ A new version of the *Customs Code* will greatly simplify customs procedures. It will reduce the maximum time for customs clearance from ten to three days, and allow for clearance to take place at the point of destination rather than at the border or even before the goods arrive in customs. It also establishes a WTO-compliant procedure for setting customs fees. Most importantly, the new code is a unified document that will replace the plethora of rules and regulations issued by the State Customs Committee. Customs procedures will thus become much more transparent and foreign exporters will enjoy a higher degree of protection against arbitrary decisions.
- ★ A new law *On Special Safeguard, Anti-dumping and Countervailing measures* will introduce clear and transparent procedures for anti-dumping procedures and provide increased certainty for our foreign trading partners.
- ★ Amendments to the law *On State Regulation of Foreign Trade Activities* will define the exact scope of state competences in the area of foreign trade. This will rule out arbitrary actions in breach of WTO provisions, including with regard to export and import licensing and trade in services. This law is the foundation for making all Russian foreign trade rules WTO compatible.
- ★ The law *On the Basics of Technical Regulation* will bring Russian practices for certification procedures, standards, conformity and risk assessment into compliance with the WTO rules. Most product standards and certification requirements will become voluntary, with only a limited number of mostly safety-related standards enshrined in federal law. This will make it much more difficult to use regulations and certification procedures as 'hidden barriers to trade'.
- ★ A new chapter of the tax code (part II) *On Customs Duties and Fees* will bring these rules fully in line with WTO requirements on customs valuation.

- ★ The Duma is in the process of passing a raft of legislation on the protection of *intellectual property rights*. These relate to patents, copyright, trademarks, geographical indications and computer software.
- ★ Of particular importance for foreign businesses working with and in Russia is the adoption of the new *Procedural Code on Arbitration*. One of the novelties is that the results of court trials between businesses and state bodies will now have to be made public.
- ★ Among the other legal changes pushed through in 2002 are: a clarification and easing of foreign exchange controls and the abolition of the 1 per cent tax on purchases of foreign currency; more liberal rules for trade in precious metals and stones and in alcohol and alcoholic beverages; a new law on special economic zones; and a reduction in the number of state inspections of business, in particular start-ups.

Divisive issues

The WTO accession talks are multi-layered and technically complex. They deal simultaneously with: industrial and agricultural tariffs; foreign access to the Russian services market; agricultural subsidies; and systemic issues. Progress has varied in the different areas, but generally the talks are more advanced with regard to tariffs than with regard to services and systemic issues. Agriculture is clearly lagging behind the other areas.

In each area we have identified, together with our negotiation partners, the main stumbling blocs to a final agreement, which often go to the heart of national economic interests on both sides. This is a significant improvement on a year or two ago, when Russia was still faced with a large number of requests that were of a general nature and had little practical significance.

As far as tariffs are concerned, the most difficult topics are aircraft, automobiles, iron and steel, aluminium and agricultural products. In these areas the current WTO members have requested a degree of liberalisation that goes beyond what Russian industries can reasonably be asked to accept. In services, we have yet to reach agreement on foreign access to the Russian banking and insurance sectors. Problems also remain with regard to securities, telecommunications and some aspects of international transport services. Furthermore, we reject demands that are based on the content of the Doha round of multilateral trade negotiations. These relate to areas such as energy-related services, maritime transport, or the movement of physical persons, which are not (yet) part of the WTO rulebook and should therefore not hold up Russia's accession.

The difficulties in the WTO accession process are basically the same for all acceding countries, although their severity depends on the degree of economic development and industrial diversification of the country in question. Our problems are exacerbated by the fact that we have a well-diversified economy, which means that a great number of different industries stand to gain or lose from WTO accession. We have already made considerable concessions, which is illustrated by the fact that we are now negotiating on the basis of the fourth version of the tariff offer and the third version of the services offer. However, our negotiating capacity is not unlimited.

The negotiations on systemic issues essentially deal with the legislative changes required to bring Russian rules in line with WTO agreements. The problem is not one of accepting, or not accepting, WTO norms, but rather Russia's progress with preparing and adopting the necessary legal amendments – which, of course, should concern only changes required by existing WTO agreements. The main drafts and amendments are already before the Duma while others are under preparation (see box). Practically all of them should be either drawn up or even passed into law by the end of 2002. Both the government and parliament have given priority to this legislation.

However, there are a number of systemic demands that in our view exceed WTO requirements as agreed in the Uruguay round of multilateral trade negotiations. The most widely discussed is the issue of energy prices. Some of our trading partners claim that the gap between domestic Russian energy prices and world market prices bestows an 'unfair' advantage on Russian producers. We disagree. There is no evidence that our energy pricing structure causes real and serious damage to firms in the EU or other WTO member-states, which would be a precondition for it being defined as subsidies prohibited by the WTO. If Russia were to push up energy prices to world market levels too quickly, the result would be economic devastation on a scale that would easily outweigh the economic benefits of WTO accession. If we accepted the energy issue as part of the negotiation process, we would set an unfortunate precedent for assuming commitments in an area in which the WTO itself has not set any clear rules.

The attitudes of Russian business

Business attitudes to WTO accession have changed dramatically over the last two years. Initially, attitudes were characterised by ignorance in most cases and staunch resistance in a few others. This has given way to a better understanding of what WTO accession entails. Although there is growing support from the business community, individual sectors have expressed concern about the consequences of membership and are calling for transition periods for the implementation of WTO rules. Despite the government's concerted efforts to increase public awareness of the issues involved – an information campaign was launched in 2001 – the level of knowledge remains low. We firmly believe that more and better information is the key to turning public opinion and business attitudes in favour of WTO accession.

There is not a single sector in Russia now that is against WTO accession in principle. Businesses' main concerns are when and on what terms. Strong concerns persist, however, in sectors such as

automobiles, aluminium and ferrous metals. Attitudes of large businesses headquartered in Moscow differ from those of companies located in the regions. A general lack of information in the regions has led to a more reserved approach to WTO membership. Regional businesses are most concerned with the implications of WTO accession on industry (in particular light industry, metals, energy and fuel) and agriculture, but less so on services (banking and insurance), which tops the list of concerns of Moscow-based businesses.

Russia's WTO accession and co-operation with the EU

The EU is Russia's single most important trading partner, while Russia ranks sixth on the EU's list of top trading partners. The EU covers about 15 per cent of its energy demand through imports from Russia. Russia, on the other hand, relies on the EU for 20 per cent of its imports of machinery and equipment, 13 per cent of its imported food products and 10 per cent in the case of electric and telecommunications equipment. Bilateral trade continues to grow rapidly. Although 2001 was a poor year for EU growth, trade between Russia and EU grew by 26 per cent, with EU imports into Russia jumping by one-third, to almost €28 billion.

The EU is a key player in Russia's WTO accession talks. EU businesses will be the largest beneficiaries from Russia's accession. Both sides have a strong interest in opening up their economies and lowering barriers to bilateral flows of goods and services. Both sides can only gain from Russia's WTO membership. This is why we think we can count on EU support for our WTO accession.

Russia's WTO accession will provide new momentum to our economic ties, and it is an indispensable ingredient of our relations as strategic partners. WTO accession will influence almost all areas of mutual co-operation and it may well serve as a platform to foster co-operation in various new fields.

We are pleased to see that the WTO accession process has already helped to solve one long-standing problem in bilateral economic relations, that of Russia's status as a 'non-market economy' for EU trade policy purposes. This allowed the EU to base anti-dumping investigations on prices in 'comparable third countries', rather than on conditions within Russia. At the EU-Russia summit in November 2002, the EU granted Russia market-economy status, following an official announcement to this effect in May. By no means do we expect this step to end all anti-dumping measures currently in place against Russian producers or even forestall new investigations. But we are glad to see that in principle Russia will now enjoy the same treatment in anti-dumping investigations as other WTO members. However, we are attentively watching the legal changes that the EU is making in connection with this decision, hoping that they will not impair the general principle of equal treatment.

The negotiations have progressed to a stage where we are discussing issues of prime economic importance for both sides. The Russian government has signalled its commitment to continued intensive and fruitful negotiations. We are stepping up our work on legislative change. More efforts are being devoted to pushing agricultural talks forward. The more results we show, the easier it should become to find solutions across the full spectrum of issues under negotiations. However, it would be unrealistic to expect that agreement can be reached on the basis of unilateral concessions on our part. We advocate a reinforced quest for balanced solutions. To this end, I would like to suggest a joint EU-Russia action plan, which defines the main problems and draws up possible solutions. European businesses should initiate a dialogue with their Russian counterparts and express their support for Russia's WTO accession vis-à-vis their respective governments. I stand ready to provide contacts and contribute to the development of this dialogue.

5 The political context of Russia's WTO accession

Robert Cottrell

For Putin, to make a consensus is not a very difficult thing. He simply has to say: "this is the consensus". Grigory Yavlinsky, presentation at the Carnegie Endowment in Washington, 2002.

Grigory Yavlinsky's joke was all the better for its accuracy. Such is President Vladimir Putin's power and personality that few if any high-ranking politicians want to contradict him publicly, especially on an issue that Putin deems vital. And from the moment he took power, he declared the early entry of Russia into the WTO to be one of his economic priorities. As a result, there is little if any high-level political debate within Russia about the principle of joining the WTO. "The matter has been decided – the question is not posed in this way", replied Yevgeny Primakov, a former prime minister, when asked in March 2002 whether Russia should join the WTO.

But Primakov is usually grouped among those with strong reservations about Putin's urgency. They argue that Russia should bide its time, devise an industrial policy and build a more competitive economy before pushing its way into the WTO. For these sceptics, who include many – probably even a majority – of business leaders, the job is to persuade Putin that his tactics need revising, even if his strategy of joining the WTO cannot be questioned. "The country should be patiently modernised bit by bit until it is genuinely ready to join organisations like the WTO", in the words of Mikhail Delyagin, a Russian economist. It would be a

“huge mistake” for Russia to insist on joining as early as 2003, the date once favoured by the government. Delyagin has withheld further comments on the issue since he became economic advisor to the Russian prime minister, Mikhail Kasyanov, in March 2002.

Delyagin suspects that Putin’s reasons for wanting Russia in the WTO are not purely economic, but ideological: integration into the world market and a return to the civilised world. On this point, Putin may partially agree. In June he said joining the WTO would “extend to Russia the whole range of legal relationships in the civilized world. It will influence fundamentally the economic, the social, and the political spheres in the country”.

It is easy enough to imagine how Putin’s lofty political vision of the WTO as a force transforming Russian society can collide with the short-term worries of Russian businessmen, who have been managing very nicely in their protected markets and who see only disaster from opening up those markets to more foreign competition. It is less easy to predict which will prevail – the ‘join-now’ camp championed by Putin, or the delayers. Putin has the power, but his opponents have more appealing arguments. They may prevail precisely because they are not so rash as to challenge the president directly and to claim WTO entry will be very bad for Russia. They argue only that the government has yet to make a sound economic argument in favour of WTO membership, supported by concrete forecasts. In this they are right.

Old and new foreign policy

Putin ascended to power, first as prime minister in 1999 and then as president in 2000, with a pragmatic view on foreign policy. The goal of WTO membership formed an important element of this view. It became even more central when his foreign policy took a westward turn after September 11th 2001. Putin’s early foreign policy was largely inherited from Primakov, who served as foreign minister from 1996-98 and as prime minister in 1998-99. Putin

may have been forming ideas of his own, but he certainly followed in Primakov’s footsteps – showing coolness towards the United States, warmth to China, and busying himself building and restoring ties with states such as Iraq and Iran, which the US views as ‘rogue states’.

But Putin was a younger man than Primakov, more energetic, and very probably more open-minded as a result of taking power without having had time to accumulate his own baggage of public positions and *idées fixes*. He was also, once president himself, spared a boss as vain, emotional, intrusive and unpredictable as Boris Yeltsin. He was able to speak openly of Russia as a weak and poor country, if only temporarily, and hence to approach diplomacy in a spirit of realistic negotiation, rather than bluff and posture. It is hard to fault the foresight of Nikolai Sokol, of the Monterey Institute of International Studies, who predicted in April 2000, when Putin had been in power a mere four months as acting president, that:

Putin is likely to manoeuvre Russia into a position where the West will have to choose between admitting Russia into the Western community of nations ‘as is’ or isolating it, and paying the price. The central challenge rests with the words ‘as is’. Some of Putin’s policies will be seen by the West as positive, others as negative, but he will refuse to change the latter, and the West will have to decide which component is more important.

A pragmatic, cool-headed policy oriented toward Russia’s interests (including Russia’s interest in a robust market economy) will present a far greater challenge to the West than Yeltsin’s emotional oscillations between friendship and confrontation. Putin will most likely seek the former but will not shy away from the latter. Most important, he will position Russia in such a way that it does not bear the blame for confrontation, or its consequences. The burden of choice

will be on the West. While, in the end, the West may obtain what it wants from Russia, the interim could be painful and costly. To paraphrase a Russian saying, love us 'as imperfect – when you're perfect, everyone loves you anyway'.¹

¹ Nikolai Sokov, 'Foreign Policy under Putin', Ponars memo, no.101, Harvard Mass, 2000.

Putin had given an early outline of his priorities in December 1999, three days before he became acting president, when he inaugurated a new Russian government internet site with a text called 'Russia at the Edge of the Millennium'.² In this paper he defended the principle of moving Russia towards a market economy. He made the observation, much quoted since, that it would take Russia 15 years to reach the per capita GDP of Portugal today, even if Russia could maintain its exceptionally high 1999 growth rate of about 8 per cent a year.

But at the same time, Putin said, the successive shocks of *perestroika* and Yeltsin-era reforms meant that Russia had reached the limits of its capacity to absorb "political and social upheaval, cataclysms, and radical transformations". One of the main problems of the past decade, he said, was that Russia had been "groping its way forward, at random, without a clear idea of the objectives and the limits which had to be set to ensure Russia a position in the world as a highly developed, enlightened and great country." Russia's future, he said, would depend on the success with which it could combine the principles of a market economy and the fundamentals of democracy with what he called "the realities of Russia".

Putin's position might be compared in a very basic way with that of Deng Xiaoping when the latter took power in China 20 years earlier. Although the concrete circumstances were very different, the main imperatives were the same. Like Deng at the time, Putin wants to build a strong country, which means, first and foremost, building a strong economy. To achieve this over-riding aim, Putin has been willing to do business with any foreign country that could pay. He

has appointed himself chief salesman for Russia's arms and energy industries, lobbying for their interests on his constant foreign trips.

He has also been prepared to do business with Russia's home-grown tycoons. Despite the easy populist gains that would have come from renationalising some of the assets privatised cheaply and fraudulently by the 'oligarchs' during the Yeltsin-era, Putin has decided this would be too disruptive to an economy just starting to revive. He told the tycoons they could hold on to their companies, but only if they invested more in Russia, paid their taxes and stayed out of politics. Finally, Putin has moved WTO entry up the political agenda – seven years after Russia had first lodged its application, in a bout of unfounded optimism about the speed with which the economy could be stabilised.

Putin came to power equipped with some of the Soviet-era geopolitical outlook that saw the US as a perpetual threat to Russia. But he also recognised that Russia was too weak to challenge the US directly. It would only lose if it did so. But its weakness also made genuinely friendly relations with the US, as between equals, unlikely. The course he adopted was to pursue 'correct' relations, dealing pragmatically with issues as they arose rather than trying to have a grand strategy towards the US. In June 2000, he endorsed a 'foreign policy concept' for Russia, which included this less than overwhelming assessment of prospects for relations with the US:

The Russian Federation is prepared to overcome considerable latter-day difficulties in relations with the US and to preserve the infrastructure of Russian-American co-operation which has been created over almost ten years. Despite the presence of serious and in a number of cases fundamental differences, Russian-American interaction is the necessary condition for the amelioration of the international situation and the achievement of global stability.

The Putin government also recognised that Russia would have to compete in the international economy, regardless of its feelings towards other players in that economy. Developing the Russian economy was unthinkable, according to the foreign policy concept, without broad integration in the world economy. Meanwhile, Russia should ensure protection of its national interest by seeking the strongest possible role in international economic organisations. These, Putin predicted, would become ever more important as the interdependence of states continued to grow, and with it the need for more effective management of a globalised financial and economic system.

By early 2000, Russia's mood towards the US was closely matched by the mood of the US towards Russia. The incoming Bush administration saw no need to court Russia, or even to give it a central place in its foreign policy. It decided to deal with Russia as a contingent factor in other policy areas such as proliferation, arms control and NATO. Celeste Wallender, writing in February 2001, captured succinctly the mood of Russian-US relations in those pre-

³ Celeste Wallender, 'The multiple dimensions of Russian threat assessment', Council of Foreign Relations, April 2001. rapprochement days. Russia, she said, was coming to terms with an international system across which American unipolarity coexisted with multilateral institutions such as the WTO, regimes such as non-proliferation, and groupings such as the G-8, all of which are "overwhelmingly influenced, if not quite determined" by American power and preferences. Russia wanted to play more of a part in that system, but for that it needed US backing – which was not easily given.³

The US, Wallender continued, should expect from Putin a foreign policy that was "activist and assertive", but also pragmatic in its readiness to make deals and accept compromise in pursuit of primary economic objectives. However, because such deals would come at a time when Russia was weak relative to the US and to the international system, those agreements would be seen as favouring the US or the West disproportionately. "They are, therefore,

unlikely to serve as building blocks for a general improvement in US-Russian relations". Wallender's prediction that Russia would make pragmatic deals from a position of weakness proved strikingly accurate when applied to the foreign policy pursued by Putin after September 11th. It remains to be seen whether the Russian and US governments are correct in insisting that these compromises can serve, none the less, as the building blocks for a general improvement in US-Russian relations.

The September 11th watershed

Putin insists that he saw big common interests with the US long before September 11th, but needed the right circumstances in which to pursue them. When Barbara Walters of ABC television asked him in November 2001 whether his "strategic and historic choice" to ally Russia with the West would cause him political difficulties at home, Putin replied that "this is a choice that Russia made for itself quite a long time ago. Unfortunately it was not noticed by everybody."⁴ Putin's answer was clearly tailored to a western audience. Just three months before this interview took place, he had signed a 20-year treaty with China's Jiang Zemin, a treaty that both sides claimed marked a watershed in their relations. It committed them, on paper at least, to consult one another on foreign policy; refuse alliances with third countries damaging to one another; and in Russia's case explicitly support Chinese policy towards Taiwan, a potential flash-point in relations with the US. For Russia, trying to balance its foreign policy between East and West, the treaty was politically far more constraining than it was for China, whose interests in the West are almost exclusively economic.

It is impossible to imagine Putin signing such a treaty after September 11th 2001. In practical terms, therefore, September 11th did mark a big change in Russian behaviour – and one to which the US responded. Russia's political support for the US war in Afghanistan produced, in the words of Anatol Lieven, "a

⁴ Collected in 'Johnson's Russia list 5531'. November 7th 2001, www.cdi.org.

⁵ Anatol Liven, *The Secret Policemen's Ball*, in *International Affairs*, vol 78 no. 2, London, 2002.

tremendous surface warming in relations between the US and Russian administrations".⁵ The question was how to deepen that warmth, especially if there were limits to the willingness of Russia and the US to alter their positions on issues that had previously divided them – such as Russia's close ties to Iran, Iraq and North Korea.

Russia proved the more flexible of the two. Having accepted a US military presence in Central Asia against the instincts of his generals, Putin calmed them down again, though with much more difficulty, when the US announced it would train and equip government forces in Georgia, another former Soviet state in which Russia still has military bases. Putin also announced the closure of Russian military facilities in Cuba and Vietnam – moves which made good economic sense for Russia, but which doubled as friendly gestures to the US. The US, on the other hand, was unwilling to offer Russia concessions on the main security issues dividing the countries. It announced in December 2001 that it would withdraw from the 1972 anti-ballistic missile (ABM) treaty to develop a national missile defence system, ignoring Russia's dogged insistence that the treaty was vital to world peace. It continued to support the eastward enlargement of NATO. It made one gesture to save Putin's face by signing a treaty on reducing strategic nuclear missiles, which Putin was able to portray as a success for Russia. However, the terms of the treaty were very much US-dictated, especially a clause that allowed both sides to store surplus warheads instead of destroying them – something that Russia, unlike the US, cannot easily afford.

Perhaps slightly embarrassed by the ease with which it was cashing these strategic gains, the US declared that the real value of improved relations for both sides would lie in economic co-operation. Here the US government was more willing to make gestures, although these were neither big nor lucrative for Russia in the short term. In 2002 the US reclassified Russia as a 'market

economy' for trade policy purposes, even though, to Russia's great dismay, the Bush administration could not persuade Congress to revoke the 1974 Jackson-Vanik amendment, which still makes Russia 'most favoured nation' – status in bilateral trade conditional on an annual decision by the president and Congress. The US also offered to increase trade financing for Russia, which had been cut back after the 1998 rouble devaluation and debt default. It agreed to a so-called energy dialogue, aimed at encouraging Russian oil companies to increase production and exports, to sell oil directly into the US market, and to buy US-made capital goods financed by US export loans.

In this context Putin's bid to join the WTO was something US could support unreservedly, at least as a matter of principle. "It is in our nation's interest that Russia be a part of the WTO", said Bush during his visit to Moscow in May 2002. The US has not, however, supported Russian demands to protect key industries during long transition periods after accession. On the contrary, part of the reason the US wants Russia in the WTO is because its own firms – especially in the insurance, pharmaceutical and aviation sectors – seek greater access to the Russian market. It may well be that the US will gain more in the short term from Russia's WTO entry than Russia does itself. At any rate, the issue could scarcely be better arranged from the US point of view. Russia wants to join the WTO, and the US can offer wholehearted support because it stands to gain itself.

The WTO in the Russian imagination

Putin's most frequent public argument in favour of WTO membership is that adherence to WTO norms will change Russia for the better. But he also makes a second argument, that only by joining the WTO will Russia be able to influence the workings of that organisation in Russia's interests. The model here may be Russia's membership of the United Nations Security Council, where it has mastered the intricate diplomacy needed to maximise the

value of its veto. Putin has described the WTO as an “instrument” which countries must learn to use.

Similar logic has caused Russia to lobby its way into what is now the G-8, and has given rise to periodic bouts of speculation about whether Russia might one day seek to join NATO or the EU. Russia hates any sense of exclusion and it is quick to suspect conspiracies against its interests, especially in places where it is not represented. For Russia, the fact that every other big economy in the world has joined the WTO constitutes a powerful argument for accession. So too does the fact that other members of the Commonwealth of Independent States, the Russian-dominated club of former Soviet countries, are already in the WTO. Russia is not accustomed to lagging them in anything.

Putin has, in short, a very political view of the WTO. It may well be a far-sighted one since the WTO has long moved beyond being a framework for liberalising trade. Its rules already cover numerous aspects of commercial activity, from agriculture to intellectual property. They dictate the duty Switzerland can impose on steel imports, tell countries how to regulate their telecoms sectors and determine the duration of patents. The Doha trade round will extend these rules into even more areas. As Philippe Legrain, an adviser to former WTO chief Mike Moore, has argued the WTO is becoming “a regulator of the would-be global economy”.⁶

⁶ ‘Prospect’,
London,
November
2001.

An overly political view of the WTO risks neglecting the high degree to which WTO membership is technical and rule-based in nature. It is open to question whether Russia in general, and Putin in particular, have given full weight to this. Russia may be influenced by its experience with the International Monetary Fund, which became a big lender to Russia during the Yeltsin years. Russia believes with hindsight that during the 1990s it was able “to somehow play the IMF game, but still manipulate the IMF”, according to Clifford Gaddy, a US economist. Russia may now be

viewing the WTO in a similar spirit, he says, as an organisation it can manipulate. If so, Russia is likely to be disappointed. In Gaddy's view:

Russia's never had a problem in adopting reform policies. It's always had a problem, and still does, with accepting – with full implementation – those reforms, which means accepting the consequences of reform. The story of Russian reform for ten years has been to adopt the policy, pretend to carry out the policy but actually not fully implement it because the consequences were simply too dire ... A lot of people assume that if Russia says it wants to join the WTO, that means it wants to play by WTO rules and be judged by WTO referees in the same way everybody else is. I think that's not true. What Russia wants to do is join the WTO, ultimately to some extent on its own terms.⁷

⁷ Interview
with
RFE/RFL,
April 27th
2001.

The goal of 2003

In the course of 2002, Putin's hopes of an early Russian entry into the WTO appeared to be fading. In August Russia's chief negotiator, deputy trade minister Maxim Medvedkov, said in an interview that Russia had exhausted its scope for negotiation. Russia might well have to postpone a review of its position until after the presidential elections in early 2004. Medvedkov warned that allowing for debate and ratification of any agreement, 2007 might be a more realistic target for Russian entry. However, the autumn saw renewed momentum in the accession negotiations. And Putin could add to this by lobbying the WTO issue more actively himself, at heads of government level, rather than treating it as a practical task delegated to his government.

But equally, it may suit Putin to accept a ‘rebuff’ from the WTO that can be blamed on other countries' selfishness. He has been accused at home of bowing too easily to the West since September 11th. A tough line with the WTO could be his proof that Russia is prepared to

insist on defending its national interest where necessary. It would also shield him from attacks by his main political opponents, the Communist Party, who would find it easy enough to portray WTO entry as source of yet more closures and job losses in Russian industry.

A rebuff would also fit rather nicely into the Russian electoral cycle, which includes parliamentary elections in December 2003 and the presidential one in spring 2004. Putin himself does not face any serious challenges. But his personal popularity is not transferring durably to the political parties loyal to him. It would be embarrassing for Putin if the Communists did better than his own supporters in the parliamentary polls. And it would be very damaging if they did well enough to threaten the Kremlin's control of the Duma (lower house of parliament).

That could yet happen. As of August 2002 the Communists remained the single most popular party in Russia, with an opinion poll rating of 34 per cent, against 26 per cent for the centrist coalition loyal to Putin. And the political tides are favouring the Communists. Putin's move this year to allow the buying and selling of agricultural land across Russia for the first time since 1917 has frightened many people in the countryside, who think it will lead to job losses. Proposals to raise household charges for gas, heating and other services have angered urban residents, accustomed to the system of heavily subsidised utilities inherited from Soviet days. The last thing Putin needs, in electoral terms, is an issue that would help the Communists strengthen their support in the industrial workforce and even among factory owners. Early WTO entry could be just such an issue.

Putin also seems to have begun taking on board the arguments of sceptics at home, who insist that Russia is not ready for the technical demands of WTO membership. He has worried aloud this year that Russia has too few civil servants specialised in international trade. There were only a few dozen of them to steer Russia's WTO bid, he said, whereas China had a thousand. Clifford

Gaddy has made a similar but more general point with his observation that

... almost every industrial country in the world is better at playing by [world trade] rules than Russia, for very good reasons, because they've been playing by those rules for quite a long time. Russia's completely new to this game.⁸

⁸ *Interview with RFE/RFL, April 27th 2001.*

Among Russian industry, the opposition to early WTO entry comes, naturally enough, from the most protected sectors. The most influential single figure in the opposition is Oleg Deripaska, boss of the Basic Element group and also of Russian Aluminium, which controls 70 per cent of Russia's primary aluminium production. Deripaska is less worried about the effect on his aluminium interests, which would probably be neutral, than on the automotive interests he controls through Basic Element. He owns Russia's second-biggest car company, GAZ, and a majority of the country's bus production. The automotive lobby wants high duties on imported foreign cars, and especially second-hand cars, which compete on price with new, Russian-made cars. It also fears that a lowering of protection would reduce the incentive for foreign carmakers to invest in local manufacturing joint ventures with Russian partners.

The food and agriculture lobby opposes early WTO entry, unless Russia is guaranteed the freedom to subsidise its farms massively. Russia cannot actually afford to do so, but for it to insist on preserving the possibility is good populist politics. The financial sector fears the loss of protection that currently shuts foreign firms out of much of the insurance industry. Russian banks and insurance companies are tiny by international standards. Their popular trust was severely compromised by the financial crash of 1998, when many Russian banks defaulted on their obligations to retail depositors as well as foreign lenders. Foreign banks and insurance companies could, in short, clean up in Russia, if they decided the market was worth their attention, and if they were allowed to operate freely.

Support for WTO entry, on the other hand, is thinly spread. The steel industry is in favour: it is a low cost producer at home, and it wants easier market access abroad. Some leaders of the oil industry, such as Mikhail Khodorkovsky, the boss of Yukos, also favour WTO entry, even though it will not directly affect trade in oil. Like Putin, they think it will accelerate the development of the Russian economy, and make life generally easier for Russian companies operating internationally.

Putin could, if he wanted, override objections from industry. The days are gone when business leaders dictated policy as they did under Boris Yeltsin. Today Russia's tycoons understand the need for the government to set policy, and they know the Kremlin has the resources to drive them out of business and even out of the country – as it did with Boris Berezovsky and Vladimir Gusinsky, two Yeltsin-era 'oligarchs' critical of Putin.

But if, on the other hand, Putin decides that the sceptics have something to their argument, and that Russia may indeed lose more than it gains from early entry, he is undoubtedly pragmatic enough to adjust his course. There would be a small diplomatic cost to Putin, in that he would be disappointing the US. But in domestic terms, there would be almost no political cost to him if he decided to accept or engineer a postponement of WTO entry, and there could well be some gains.

6 Why the WTO matters for Russia

Paul Hare

Introduction

This chapter analyses what Russia's WTO entry means not only for Russia itself, but also for the EU and Russia's other trading partners. It compares Russia's situation with that of China before its accession in 2001. It highlights the remaining hurdles, not least the tricky mixture of support for and opposition to WTO accession that now characterises Russia's domestic political scene. The chapter concludes by outlining a number of recommendations for the final stages of the accession talks.

WTO accession is not merely a technical exercise; most aspects of the process are heavily politicised. As with all trade agreements, WTO entry will produce winners and losers. The biggest winners are the consumers, who gain access to cheaper and more varied goods and services, and domestic firms that suddenly find they are able to compete not only in the domestic market, but also internationally. The trouble is that the winners are rarely visible before the end of the negotiations. The losers, although fewer in numbers, are more easily identified and hence better organised and more vocal. They include unstructured companies with outdated technology and sub-standard production lines, and the current recipients of state support, who fear that they would be unable to survive in the WTO's more market-based regime.

China's and Russia's accession compared

Since Russia is still in the process of shaking off the remnants of central planning, many commentators have compared its WTO

preparations with that of China, which also tries to combine significant state control with elements of a free market economy. China joined the WTO in December 2001, after more than 13 years of negotiations. Since Russia's accession preparations only gathered steam after Putin came to power in 2000, they may have a long time to go yet. However, while there are some similarities between China's accession and that of Russia, the differences prevail. Like Russia, China has enjoyed substantial trade surpluses in recent years. But unlike Russia, where this is mainly due to a weak exchange rate and high oil prices, China has been very successful in expanding its manufacturing exports.

The Chinese authorities see strong economic growth as critical for ensuring political stability and their own survival. They regarded WTO accession as a way of intensifying competition in their domestic market and thus pushing further reforms and structural adjustment. In addition to WTO accession as an anchor for domestic reforms and a way of improving conditions for foreign direct investment (FDI), China was also keen on the benefits in terms of market access. By 1997, the time of the Asian economic crisis, China was convinced that there was no viable alternative to deeper integration in the world economy. However, its status as a non-WTO member entailed considerable obstacles. The US – a key market for Chinese exports – renewed China's MFN status annually and imposed an increasing amount of anti-dumping duties on Chinese exporters just as these were becoming more competitive.

All three reasons – locking in reforms, encouraging FDI and securing market access – apply with great force to Russia, which is keen to diversify its exports away from raw materials and into manufactured goods. However, there are also significant political and economic differences between the two countries (see table 1),

Table 1: Preconditions for WTO entry: Russia and China compared

ISSUES	RUSSIA	CHINA
POLITICS	Democratic presidential system since the collapse of Communism in 1991. Governments tend to be weak and vulnerable to sectoral and regional lobbying. Central government strengthened under Putin.	Communist Party clings to power, but has become far less ideological. Economic success is a key source of legitimacy in this unreformed autocratic system.
ECONOMY-GENERAL	Output collapsed in most sectors after 1991. Modest recovery since 1998, helped by steep devaluation and high international commodities prices. Widespread poverty, wealth concentrated in a few hands.	Extremely rapid growth rates since the late 1970s have given way to more modest ones in recent years. Growth has translated into rapidly rising living standards for many.
ECONOMIC STRUCTURE	Industrialised economy but most sectors in dire need of restructuring and modernisation. Overly dependant on raw materials and energy. Lack of dynamism. Very low rate of new business formation.	Massive shift of resources from agriculture into the dynamic town and village enterprises kick-start growth. Export success based on huge investment in special economic zones.
TRADE	Exports dominated by primary products, notably oil and gas.	Diversified export base, dominated by manufacturing.
FDI	Very difficult business environment keeps away foreign investors.	Substantial FDI until mid-1990s. Ensuing slowdown partially reserved since 2000.

which render WTO accession more difficult for Russia. Russia's political international environment is in many ways more favourable than China's in the run up to accession. The US has backed Russia's WTO bid in return for Russia's support for the US-led war against international terrorism after September 11th 2001. The sluggish world economy, however, makes it more difficult for Russia to agree on acceptable entry conditions, as many industries are currently lobbying their governments for increased protection.

In terms of domestic politics, Russia will find it difficult to assemble a broad and strong coalition in favour of WTO membership. In China, the producers of cheap manufactured exports, often backed by western capital, had a strong interest in WTO membership. Russia's key economic actors, however, are raw material producers. They already face few international trade restrictions and have little to gain from WTO entry. They may even stand to lose if WTO commitments undermined their existing domestic monopoly positions. Russia's industrial sector, meanwhile, is largely uncompetitive and fearful of further trade liberalisation. Many branches are now lobbying for continued protection from the government and would like to see WTO accession delayed, if not put off indefinitely.

The political economy of Russia's WTO accession

Why should Russia join the WTO? A look at its trade accounts suggests that it might reap only limited benefits from membership. Russia exports mostly raw materials, namely oil, gas and fuel products, as well as precious metals, timber and iron. In exchange, it imports mainly manufactured goods, such as machinery, consumer goods, cars and food products. Since the world markets for raw materials are liberalised compared with those for manufactured goods, the majority of Russian exports face few trade restrictions in other countries. In fact, Russia has been running massive trade surpluses in recent years, in the order of \$20-50

billion per year. Nevertheless, both Russia and the international community have a strong interest in Russia's WTO accession. Why?

For the international community, political arguments weigh as heavy as economic ones. Russia's economic importance for the world economy is limited – the size of its economy is comparable to that of the Netherlands, if measured at market exchange rates. Politically, however, the country plays a much larger role on the world stage. As the leading successor to the Soviet Union, Russia remains one of the world's key nuclear powers. And it is well integrated into the global network of international organisations. It attends the G7 meetings of the world's most developed economies (now G-8). It belongs to international financial organisations such as the International Monetary Fund and World Bank, as well as more specialised ones, such as the International Labour Organisation and the World Health Organisation. It is therefore an anomaly that it remains outside the WTO. Russia's trading partners are increasingly coming round to this view. Russia, meanwhile, considers that, since the WTO is evolving over time, it would be better off having a voice inside than watching passively from the sidelines. Active involvement was also one of China's main reasons for joining the WTO, and this will gain in importance as the new Doha round of multilateral trade talks progresses.¹

While the Russian leadership is clearly committed to WTO accession, the domestic politics of accession are much more complex. Most businesses are sceptical. According to a recent survey among Moscow-based companies for the Union of Goods Producers, two-thirds regard 2006 or later as an acceptable time frame for WTO entry. Most consider themselves unprepared for earlier entry. The all-important energy sector tends to support WTO entry although it has little to gain in terms of market access.

¹ Will Martin, Elena Ianchovichina, 'Implications of China's Accession to the World Trade Organisation for China and the WTO', in Peter Lloyd and Chris Milner (eds), 'The World Economy: Global Trade Policy 2001', Oxford, Blackwell Publishing, 2001.

Instead, oil companies are hoping for a much-needed boost to foreign investment. On the other end of the spectrum are Russia's declining heavy industries, often based in remote regions. They fail to see WTO membership as a new opportunity and simply feel threatened. Other sectors with strong reservations include financial services and food producers.

Among the population at large, there is a widespread lack of understanding of what WTO accession entails, combined with suspicion of foreign interference in Russian economic policies. External competition is seen as an immediate threat rather than an opportunity for long-term growth. Russians will not change their mindset easily. Other countries' positive experience with WTO accession carries little weight, since many believe – rightly – that Russia faces a particularly hard struggle to complete its economic reform and establish markets that can withstand international competition; and – wrongly – that Russia is not subject to the same economic laws as other countries.

Will WTO accession boost foreign investment?

Despite a decade of market-oriented reforms, Russia has received remarkably little foreign direct investment (FDI), especially if compared with the central and eastern European transition economies, such as Hungary, Poland and the Czech Republic (see table 2). While investors in these countries were not shy to buy or build manufacturing capacity on a grand scale, Russia's FDI has concentrated on two areas: consumer-oriented services (shopping malls, western-style hotels) and the exploration of oil and gas. Only very modest amounts went into manufacturing sectors such as machinery or food processing. This means that Russia is missing out on some of the main benefits of FDI, namely the transfer of advanced technology and know-how.

Table 2: Stock of foreign direct investment, end-2001

	\$ billion	As per cent of GDP*
Poland	42.4	21.3
Czech Republic	26.8	27.1
Hungary	23.6	43.4
Russia	22.0	7.7

* end 2000. Source: UNCTAD *World Investment Report 2002*

The reasons for this dearth of foreign money are related to domestic policy failures: macro-economic stabilisation was delayed and erratic; privatisation was messy and strongly favoured 'insiders' (workers, managers and home-made tycoons) over foreign buyers; the institutional framework for investment has remained very poor, especially with regard to banking and finance and the legal protection of property rights. In addition, Russia has suffered from a variety of political and social problems, notably widespread crime and corruption; the strong position of domestic interest groups and lobbies; confusion over the respective jurisdictions of federal and regional authorities; and, in the past, the ubiquitous use of barter and other forms of non-monetary transaction. While Russia has had FDI-promoting laws in place for years, few foreigners have felt sufficiently secure in this environment to invest large sums for longer periods. They often point to massive capital flight out of Russia as a sign that not even Russian businessmen are prepared to invest in their own country.

Although WTO membership entails legal adjustments and reforms that go way beyond international trade in goods, it would be overly optimistic to assume that Russia's accession would result in rapid improvements in the investment climate. Over time, however, foreign investors may well take heart if WTO accession is seen to lock in reforms while reducing the risk associated with investments in Russia.

Issues that could stall accession talks

WTO accession will require an overhaul of Russia's foreign trade regime, including substantial changes in tariff rates and structures for many imported products; adjustments to taxes and other levies on exports; and further liberalisation of trade in services. It will also require a host of accompanying measures in various areas of domestic policy, such as improving the conditions for competition in the domestic market; cleaning up the tax system; and facilitating foreign companies' access to the Russian market.

Tariffs

Countries such as Russia, with a weak and poorly funded government, often rely on tariff revenue as an important source of public revenue. However, this is not an argument against tariff reform. It is not only the overall level of tariffs that impedes foreign trade, but their complexity. Russia's foreign trade regime has, until very recently, been characterised by a complex system of import tariffs, with thousands of distinct tariff lines riddled with exceptions and exemptions; a variety of licensing requirements and other quantitative restrictions on imports, such as certification requirements and technical standards; and export duties for oil, gas and certain metals. What Russia needs are fairly uniform tariffs that are consistently collected.² Uniform tariffs create fewer distortions for the economy, do not discriminate against goods at different stages of processing, and generate fewer opportunities for corruption.

² David Tarr, 'Design of tariff policy in Russia', in Harry Broadman (ed), 'Russian trade policy reform for WTO accession', World Bank discussion paper no. 401, 1999.

The weighted average import tariff in Russia was about 13.6 per cent in the late 1990s – not terribly high by international standards although well above the average external tariff of the EU. In fact, numerous exemptions and very poor collection resulted in an effective tariff rate closer to 10 per cent. Nevertheless, the tariff system's complexity resulted in long delays and created ample opportunities for corruption. It became one of the biggest obstacles

for businesses, local and foreign alike. In recent years, Russia has gradually simplified its tariff structure. By the start of 2001, over 30 per cent of products were classified into just four categories (5, 10, 15, and 20 per cent), with higher tariffs only levied on a few items such as cars, sugar, alcohol and tobacco. The average tariff rate came down to 11-12 per cent.

In WTO negotiations, the applicant country has to agree to a maximum tariff rate for each category of goods (tariff binding). Russia has demanded the right to raise its initial tariff bindings well above current effective rates and to lower them back to current levels gradually over 6-8 years after accession. In some sectors, notably agricultural and food products, final bound rates are supposed to stay at their elevated levels (about 25 per cent, compared with the current 15 per cent). Many WTO members want Russia to commit to lower tariff bindings from the start. High initial bindings would give Russia ample room to respond to industrial lobbies by raising effective tariffs towards the allowed maximum. They would thus allow Russia to defer much-needed industrial restructuring and deprive the economy of some of the benefits associated with WTO accession.

Difficult sectors

Some sectors have presented more problems in the accession process than others. The problems are partly on the Russian side, for example with those sectors that need major restructuring. Or they could be associated with Russia's trading partners, for example when trade liberalisation is discussed for sectors that generally enjoy high degrees of subsidies and protection in the West, such as agriculture, textiles or aerospace:

- ★ **Steel:** This is one of the markets in which the WTO has failed to achieve substantial liberalisation. Steel producers around the world enjoy exceptionally high levels of protection and subsidies. In this system, Russian steel exports have faced multiple trade barriers. The EU has imposed quotas, which were tightened further in 2002 in response to what the EU sees

as Russia's unfair trade policy in the sector (Russia has imposed export duties on scrap iron to ensure cheap inputs for domestic production). The US has used the threat of anti-dumping action to coax Russia into 'voluntary' export restraint agreements. Following a highly restrictive steel agreement in 1999, Russian steel exports to the US effectively collapsed. In March 2002, the situation deteriorated further when the US decided to impose tariffs of up to 30 per cent on major categories of steel and steel products. In October 2002, however, the US International Trade Commission ruled in favour of Russian steel exporters in a pending anti-dumping investigation. And in November the EU launched a new initiative to tackle global overcapacity. Nevertheless, Russian steel producers are likely to face a difficult trade environment for years to come. The decision by the US and the EU to reclassify Russia as a market economy could help to protect Russian metals producers against anti-dumping action. However, the EU argues that low Russian energy prices represent an illegal subsidy to Russian exporting companies. Under WTO rules, the EU and others can therefore still impose sanctions on energy-intensive Russian exports such as steel.

- ★ **Cars:** A few western car producers have bought or set up production facilities within Russia, but they face many practical barriers to expansion. Importers, however, fare even worse. Import tariffs on new and used vehicles stand at a high 25 per cent. Importers also have to pay excise duties based on engine size, which keeps out large US vehicles, plus the value-added tax that is applied to most imports. With a view to WTO accession, Russia's car producers have lobbied hard for even higher protection. Despite its cosy domestic position, the Russian car sector performs poorly. Restructuring has been sluggish and modernisation has hardly begun. Most firms lack the technical, management and marketing skills to successfully design, develop and sell new models. The size of individual enterprises is generally well below what is considered efficient for the sector.

The government is struggling to devise an appropriate strategy for the car industry. Its main ingredients are continued protection from foreign competition and public funding to promote restructuring and modernisation. Russia's trading partners in the WTO appear to have accepted the request for continued high tariffs on imported cars. However, it seems highly unlikely that the Russian car industry will restructure successfully without massive injections of foreign investment and expertise. The key to transforming the sector is – as for many other sectors – a more supportive climate for investment.

- ★ **Agriculture:** Agriculture collapsed in line with the rest of the economy after 1991. Farm-sector reform has been slow and most agricultural production still comes from Soviet-style collective farms. Although most farm land was privately owned by the end of the 1990s, the absence of secure ownership rights and a functioning land market made it almost impossible to consolidate land into more efficient units or use it as a security in borrowing. Some large, privately-owned farms have nevertheless managed to turn a profit, and investment in the sector picked up strongly in the late 1990s. In 2002 the Duma finally passed a law that officially allows Russians to buy and sell farmland (foreigners can lease it), but it may still take years until the land market functions properly.

Russia's current levels of state support for agriculture are low in comparison with most developed countries. However, there are various indirect subsidies, such as cheap energy, subsidised loans, free housing and free seeds. Most of these are provided at the regional and local level, which renders the overall picture with regard to state support opaque. Russia will have to agree a maximum level of state support before WTO entry. WTO members, especially the Cairns Group of large agricultural producers, want the reference period for setting subsidy levels to be the late 1990s. Russia argues that these levels were

exceptionally low, and that the late 1980s were a more ‘normal’ period, when farm support was far above its current levels. Even if the Russian position prevailed, budget constraints would prevent Russia from raising subsidies in practice. In any case, Russia should not rely on subsidies to help its farm sector. It should establish a functioning land market, open new financing opportunities to boost investment, and provide training for agricultural producers in areas such as marketing and effective production.

Russia’s position on agricultural tariffs appears more plausible. The authorities argue that high tariffs are required to offset the ‘dumping’ of subsidised agricultural products by the EU and the US. Russia bemoans that the EU and US positions on agriculture are shaped by double standards. Both heavily subsidise their own farm sectors. This stimulates surplus production, which is then dumped on the world market, thus harming agricultural producers in less developed countries. At the same time, they expect other countries to keep subsidies low and their markets open.

Technical standards

Technical standards, such as safety requirements, constitute a significant barrier to Russian imports and exports. Certification procedures are slow, non-transparent and expensive. Approvals are often valid for only a number of years, rather than for the lifetime of the product. The government has started to clean up regulations, and about one-third of Russia’s 22,000-odd technical standards are now in line with international ones. But much work remains to be done to improve the legal framework and ensure that implementation is more consistent from region to region. As part of its accession strategy, Russia should offer full conformity with international norms, but its trade partners should accept that implementation might take up to a decade.

Creating a unified economic space

As in the case of China, the WTO will expect Russia to ensure that its economy functions as a single, unified space, where rules are applied and implemented across the board. However, there is still confusion over federal and regional jurisdictions. The implementation of commercial legislation varies widely from region to region. More importantly – despite President Putin’s efforts to reassert control over the ‘Russian economic space’ – many Russian regions still impose various trade restrictions at their regional borders or retain local tax or investment rules, often in an attempt to protect local firms. Economically, these internal barriers are incredibly inefficient, discouraging the entry of new firms, undermining competition and encouraging the creation of local monopolies. Although most of them are illegal under Russian law, they persist. Since they are inconsistent with WTO membership, the government will have to step up its efforts to turn Russia into a unified economic space.

Trade in services

Services represent a tiny fraction of Russia’s international trade, with many more services imported than exported. The WTO wants Russia to open its market both for trade in services and for foreign businesses that wish to operate in Russia, especially in the underdeveloped and poorly regulated banking and insurance markets. Although Russia argues that its fledgling service sector should be given more time to develop before full competition is introduced, the kind of market opening that WTO membership entails may be exactly what the country needs. Protection may simply allow Russian banks and insurers to continue providing poor services. This does not only hamper the transfer of household savings into productive investment. It also creates an additional impediment to foreign investors, who need an efficient financial framework to operate in the country. The WTO expects Russia to introduce ‘national treatment’ for foreign services companies, which rules out regulatory requirements over and above those applied to local firms. It also expects Russia to relax or abolish

restrictions on the share and form of foreign ownership in the banking and insurance markets.

Intellectual property rights

The protection of intellectual property rights is less critical in Russia's WTO accession than it was in the case of China, which used to be a major producer of pirated CDs, videos and software. Russia formally adheres to the relevant international conventions for copyright, patents, trademarks and the like. But it does a poor job enforcing the rules in practice. The US alone lost an estimated \$1 billion in 2000 due to video piracy in Russia. Western companies have often found it difficult to register and protect even the best-known brands in Russia. The existing WTO members will therefore put much emphasis on the enforcement of existing intellectual property legislation in Russia.

Trade preferences within the CIS

Like Russia, most other members of the Commonwealth of Independent States (CIS) have applied for WTO membership, but only three have so far been successful, namely Moldova, Georgia and the Kyrgyz Republic. The accession of these three countries highlights the political nature of the process. Their rather rapid entry into the trade club probably owed less to their ability to comply with WTO technical and legal requirements than to the fact that, as small, underdeveloped economies, they did not elicit much opposition from the major trading nations within the WTO. Russia is clearly in a different category.

The CIS members have made several attempts to deepen economic integration, be it in the CIS as a whole or among smaller groups of CIS members. The WTO permits regional trade agreements on certain conditions, but it is not clear whether CIS projects are compatible with WTO rules. Nevertheless, the actual volume of intra-CIS trade fell sharply in the early 1990s and has recovered only slowly since then. In 1994 the 12 CIS member-states agreed to establish a free trade area. Soon after that Russia, Belarus,

Kazakhstan, the Kyrgyz Republic and later, Tajikistan resolved to form a customs union.³ Russia and Belarus have announced their intention to establish a full economic union, though no firm timetable has been set. None of these plans has been very successful. The countries concerned have failed to ratify the agreed deals, dismantle intra-CIS trade barriers or introduce a common external border tariff in the case of the customs union. Bureaucratic, technical and institutional hurdles keep the costs of intra-regional trade high. For example, Moscovites still find it cheaper to import wine from Australia than from Moldova.⁴

There is a more fundamental question whether deeper integration within the CIS is actually desirable. Given their common legacy of central planning, CIS trade links may help to prop up uncompetitive industries, outdated technologies and inefficient commercial relations. Much intra-CIS trade relies on Russia's continued willingness to supply them with energy at subsidised prices – a practice that would clash with WTO rules. WTO accession may well provide Russia with an opportunity to rationalise its economic links with the other CIS members.

The economic impact of WTO membership

Uncertainty about the impact of WTO membership on Russian industry lies behind much of the political controversy surrounding Russia's application. Those who expect to be losers – to face tougher competition or even be forced out of business – naturally oppose accession. Potential winners in growing and competitive sectors tend support it. However, WTO accession is not the only or even the key factor in this process. Industrial restructuring has been under way for almost a decade and the Russian economy has undergone massive structural change. Resources have been shifted from uncompetitive to competitive sectors, from industry into

³ Paul Hare, 'Trade policy during the transition: Lessons from the 1990s' *The World Economy*, vol 24(4), 2001.

⁴ Cited by David Dyker, 'Making sense of post-Soviet economic space – free trade and beyond in the CIS', *University of Sussex and Ritsumeikan University*, Draft, 2001.

services, and from declining regions to prospering ones. The interesting question is therefore not whether WTO accession will foster structural change – of course it will – but rather how far it will add to the existing pressure for restructuring. In my view, the answer is rather little. A brief overview of the context in which WTO accession will occur should make clear why:

- ★ The move from state controlled to market-set prices has already changed drastically the relative costs – and thus profitability – of economic activities. The Russian government is aware of the need to continue price liberalisation. But these adjustments are painful, particularly for uncompetitive industries in remote locations, and are therefore likely to be slow.
- ★ Until 1998, Russian companies often resorted to barter and other forms of non-monetary payments while running up massive arrears by not paying their bills to their suppliers, the local utilities or the tax authorities.⁵ These practices – hugely

⁵ *Alena Ledeneva, 'Russia's economy of favours, Cambridge', CUP, 1998, and 'How Russia really works', CER, May 2001.*

damaging to economic efficiency – are rapidly disappearing and the Putin administration is determined to support this welcome trend.

- ★ Russia's geographical size means that some industries are profitable in one region but not in another. It also means that restructuring has to take into account the social and political realities of the region concerned. Take mining, for example. Although the industry is no longer economically viable in the far north, closing down the mines would cause economic and social devastation in a region where there are few alternative employment opportunities.

The additional price adjustments and competitive pressures associated with WTO accession will be rather minor compared with the changes described above – although the 'WTO factor' could be used as an argument for protecting firms or sectors that are already

struggling to adjust. WTO entry will and should increase competitive pressures in the Russian market. Companies that are able to adapt and compete will be Russia's business success stories of the next decade or two. Others will have to close down and free up scarce resources for better use elsewhere. The government simply cannot know which ones will be the winners and therefore should not try to intervene in the selection process.

While the short-term economic costs of WTO accession should be small, Russia may well reap tangible benefits – depending on the kind of accession terms that are agreed and the length of transition periods. If Russia binds its tariffs at, or slightly above, current levels, it would preserve the existing degree of trade liberalisation. Industrialists could no longer lobby for higher protection, and would have to concentrate on becoming more competitive. Moreover, WTO rules that aim at a level-playing field for local and foreign companies in Russia's domestic market could strongly support existing policies to improve the competitive environment. WTO accession may also have a profound impact on those features of the business environment that currently impede restructuring, such as the power of interest groups, weak implementation of existing laws, and the continued influence of ideas that have more to do with central planning than with modern management.

In the medium and longer term, WTO accession will have substantial and mostly beneficial effects for Russia. First, the commitments associated with WTO accession will lock in and reinforce Russia's market-oriented reforms. This will strengthen investor confidence, since it will reduce the risk that a change of government could result in serious reform reversals. Second, allowing foreign companies full access to the Russian services sector will do more to improve banking, insurance and other services than the slow and erratic domestic reforms of recent years. Third, many Russian firms from sectors such as cars, aerospace, pharmaceuticals and food processing, should be able to compete internationally, provided they have access to investment capital,

modernising technology, and management and marketing expertise. Fourth, economic studies have shown that resource-rich countries tend to grow more slowly over the long run than those without large natural resources. Russia's oil and gas wealth might be a blessing in the short term, but in the long run it risks turning the country into an economy dominated by huge conglomerates, corruption and profiting, rather than innovation and investment. Russia already suffers from a dearth of small and new companies, which have been the driving force for growth in many other transition economies. WTO accession should help to boost competition, provide new financing opportunities and improve the general investment climate, all of which would help to stimulate small business growth.

Implications for EU-Russian relations

The ten-year Partnership and Cooperation Agreement (PCA), signed in 1997, was designed as a general framework for EU-Russian relations. It institutes a political dialogue and envisages co-operation in trade and economics; science, technology and other civil sectors; and issues falling under the EU's Justice and Home Affairs heading, such as drug trafficking, money laundering and organised crime.⁶ The EU has supported these links through the TACIS assistance programme, which transferred some €2.4 billion to Russia between 1991 and 2001.

⁶ David Gowan, 'How the EU can help Russia', CER, January 2001. European Commission, 'The EU's relations with Russia', February 2002, europa.eu.int/comm/external_relations/russia/.

In the area of economic co-operation and trade, the PCA envisages trade liberalisation based on most-favoured nation treatment and the progressive removal of non-tariff barriers to trade, as well as improvements in the rules governing company establishment in Russia, intellectual property rights, competition policy, services, and international payments. Special bilateral trade agreements exist for steel and textiles. The EU is concerned about Russian trade protection in sectors such as alcoholic drinks and

cars but, as discussed above, these barriers are likely to remain in place even after WTO accession.

The EU is planning to admit ten new members in 2004, eight of which are formerly planned economies in Central and Eastern Europe. The economic impact of EU enlargement will be largely positive, with the new member-states reaping most of the gains. The impact on third countries, including the CIS, will be more mixed, depending on the composition and volume of their trade with the EU. For Russia, the overall impact will be small but positive. The enlarged EU will offer Russia a more unified and liberal trading environment. The new entrants will replace their individual tariff structures with the EU's common external tariff, which is both simpler and lower than current tariffs, especially for industrial goods. Most Russian producers stand to gain from both lower tariffs and a more unified and simpler business environment. But some sectors, such as suppliers of nuclear fuels or agricultural producers, may well lose out. Also, Russian steel and chemical producers would suffer if existing EU anti-dumping measures were extended to the new member-states.

The Baltic states represent a special case. Trade links with Russia are more important to them than the other candidate countries, which is partly a legacy of the Soviet Union, but is also the result of the sizeable Russian minorities that live in Estonia and Latvia in particular. The Baltic states are also important transit routes for Russian exports, especially since Russia until recently had no ice-free port of its own for shipments to Europe (it opened a new port near St Petersburg in 2001, which is fed by a new oil pipeline called the Baltic Pipeline System). The EU has been at pains to stress that trade and personal links with Russia should not be damaged by Baltic EU accession.

In 2002, the position of the Russian enclave Kaliningrad threatened to turn into the most contentious issue on the Russian-EU agenda. Kaliningrad, bordered by Lithuania to the north and east and

Poland to the south, will be entirely surrounded by EU member-states after enlargement. Russia has insisted on visa-free transit between Kaliningrad and the rest of Russia. The EU has argued that this would allow illegal immigrants to slip into the EU's Schengen area of borderless travel. Although the status of Kaliningrad is not a crucial issue in the context of Russia's WTO accession, it soured relations between Moscow and the EU and threatened to influence on-going trade negotiations. In November 2002, the two sides found a compromise that will allow Russians to continue travelling to and from Kaliningrad with relative ease. However, the episode illustrated that Russia still prioritises political issues over economic ones in its dealings with the EU.

Through the PCA, the EU has been trying to persuade Russia to adopt and implement much of the domestic economic legislation that will now be needed for WTO accession. In this sense, WTO accession and Russia's political and economic links with the EU could be mutually reinforcing. Furthermore, EU enlargement is likely to simplify and improve the environment for foreign trade along Russia's western border. Conversely, Russia's WTO accession itself is unlikely to harm EU interests, not least because the sectors that the EU considers 'sensitive', such as agriculture or steel, are not very effectively regulated at WTO level. Overall, Russian membership of the WTO is more likely to improve than to damage Russian-EU economic relations by providing a rules-based framework for managing the relationship and any disputes that might arise.

Conclusions and policy recommendations

Russia initially hoped to conclude accession talks in 2002 to enter the WTO by 2003. This timetable has now slipped, but 2004 may still look like a possible accession date. Although the large number of outstanding issues may well cause further delays, Russia should still join the WTO as soon as possible. Meanwhile, the Putin government has to balance two, partly conflicting,

considerations: What accession terms will be acceptable to existing WTO members? And: What can it plausibly sell to the Russian business community, the Duma and the public at large? Much economic thinking in Russia still derives from the mindset of central planning, emphasising protection and state controls. An understanding of how market forces will affect the Russian economy is developing, but is still far from universal. This is partly why attempts to influence Russian domestic policies through the WTO process are often perceived as 'interference', regardless of the objective merits of the policies being proposed. However, many of the domestic reforms that are necessary for WTO entry will have to be carried out anyway. If the issues are presented in the right way, the WTO process could be seen as supporting an on-going reform process, rather than interfering with the 'normal' working of the economy.

Historical legacies apart, Russia does of course have other reasons for being wary of WTO membership. The experience of the 1990s showed that the social costs of transition were extremely high. Wages have plummeted, open unemployment has risen from zero to almost 10 per cent of the labour force, social support systems have collapsed, and poverty has become rampant in many areas. While I argued above that the additional impact of WTO entry on the Russian economy would not be large, this view cuts little ice with many of Russia's policy-makers and industrialists. With their backs already against the wall, many producers see WTO entry as fraught with dangers. Industrial lobbies are using the 'threat' of WTO accession as a lever to argue for more state support and trade protection. If WTO entry is to occur any time soon, the government will have to convince them that the WTO will not harm their interests, and might even help them to become more competitive and expand their exports around the world.

Assuming that such a positive approach can be sold, Russia should offer the following accession term to its WTO partners:

- ★ **Goods.** Go for a uniform tariff schedule, or one with a limited number of basic rates and very few additional excise charges. Accept tariff bindings at, or only slightly above, the tariff rates currently in force. Abandon most non-tariff barriers to trade. Significantly simplify licensing and certification rules and procedures and impose much tougher control over trade restrictions at sub-federal levels of government. Keep special protection for ‘problem’ sectors (steel, automobiles, commercial aircraft) to a minimum, and make them strictly temporary. Agree to a realistic reform schedule for public utilities and other sectors where domestic prices currently distort industrial competitiveness. Continue the process of taking over international technical standards and strengthen implementation.
- ★ **Services.** Agree to freedom of establishment and national treatment for foreign firms in key services sectors, such as banking, insurance and business services. Gradually phase-in market opening over pre-agreed transition periods, especially regarding foreign ownership of key service sector businesses, while at the same time continue improving domestic regulation.
- ★ **Agriculture.** Accept the late 1990s as the reference period for maximum farm subsidy levels. Russia cannot afford to pay the higher subsidies it claims to want, and agriculture will not become more efficient under an extensive subsidy regime. Introduce other domestic reforms needed to boost farm-sector efficiency, in particular speed up the establishment of a functioning agricultural land market. Legally protect the property rights of those large farms already operating as successful commercial entities. Use import duties to offset some

of the implicit subsidies in US and EU food exports even if this might prove difficult to defend in the negotiations.

- ★ **Investment and capital flows.** Agree to national treatment for firms wishing to locate and invest in Russia. Significantly reduce restrictions on foreign investment with regard to sector of operation, ownership shares, or location. Meanwhile, continue on-going reforms designed to improve the investment climate. In the medium and longer term, this aspect of WTO accession will make the greatest difference to Russia’s economic performance.

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Glossary of trade policy terms

Doha round: The WTO's ongoing round of multilateral trade talks, launched in November 2001 in Doha, Qatar; scheduled to conclude in January 2005, with a mid-term review at the WTO's ministerial conference in Mexico in September 2003.

Dumping / anti-dumping measures: WTO rules prohibit dumping – the sale of goods in a foreign market at a price below production costs or a price kept artificially low by state subsidies. WTO members are entitled to retaliate against dumping if they can prove that it harms domestic producers. Governments often abuse these rules to shield domestic producers from low-cost foreign competition.

Foreign direct investment (FDI): Cross-border investment by buying controlling shares in existing companies or building new plants or services companies. Many WTO rules matter directly or indirectly for FDI.

General Agreement on Tariffs and Trade (GATT): A multilateral trade agreement signed in 1948 and expanded in repeated rounds of multilateral trade negotiations; it was transformed into the WTO in 1995.

Market economy status: WTO members can apply different trade policies to countries classified as non-market economies. In particular, they can more easily impose anti-dumping duties on exports coming from such countries. They can claim that goods are exported 'too cheaply' by using 'comparable' prices in third countries, rather than looking at the actual costs in the country in question.

Most favoured nation principle: If a WTO member lowers trade barriers for the imports from one country, it has to do so for all other WTO members as well. There can be no discrimination between goods coming from different WTO countries.

National treatment: Under WTO rules, foreign companies operating in the market of a member-state must be subjected to the same rules and policies as national firms.

Systemic issues: WTO accession involves changes to a country's trade policy regime (tariffs and non-tariff barriers), as well as a host of internal legislation, such as competition rules or industrial subsidies. The latter are referred to as systemic issues.

Tariff binding: Every new WTO member is obliged to set maximum values for all import tariffs, which is referred to as tariff binding. Actual tariffs can be lower than the maximums agreed.

Uruguay round: The biggest-ever round of multilateral talks, from 1986 to 1994, extended the WTO's remit to new areas, including trade in services, foreign investment, intellectual property rights and agriculture.

Working party: The group of individual WTO members that conducts multilateral accession negotiations with the WTO applicant.

Working party report: At an advanced stage in the accession negotiations, the working party draws up a draft report as the basis for the eventual terms of accession of the new member

World Trade Organisation (WTO): In 1995, the GATT was transformed into the WTO by adding a permanent institutional structure and a strengthened dispute settlement mechanism

For further information on the WTO see <http://www.wto.org> or the Russian government's site <http://www.wto.ru>



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RUSSIA AND THE WTO

**Katinka Barysch, Robert Cottrell, Franco Frattini,
Paul Hare, Pascal Lamy, Maxim Medvedkov and
Yevgeny Yasin**

President Vladimir Putin wants Russia in the World Trade Organisation. Membership would reinforce his pro-western foreign policy. It would boost Russia's long-term growth prospects and open the country's backward services sector. And it would show foreign investors that Russia can play by international rules. However, fearful Russian industrialists are lobbying against early entry. And Russia's trading partners are slow to drop their protectionist barriers. This pamphlet explores the political conflicts and economic uncertainties surrounding Russia's WTO accession.

Two of the authors are intimately involved in the accession process: **Pascal Lamy** as EU trade commissioner and **Maxim Medvedkov** as Russia's chief negotiator. Two eminent economists – **Paul Hare** from Edinburgh and **Yevgeny Yasin** from Moscow – offer a more detached view. **Robert Cottrell**, Moscow correspondent of the Financial Times, looks at the politics of accession.

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