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**« RUSSIA AND THE WORLD TRADE  
ORGANIZATION »**

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## Abstract

Russia applied to join the WTO in 1993 and its accession is now making rapid progress, with possible entry in 2004. This paper discusses the economic and political factors associated with the Russian entry to WTO, focusing on tariffs, difficult sectors, services, IPRs and the environment for FDI. The impacts of WTO accession on Russia's domestic restructuring as well as on Russia's relations with the EU are also analysed. While recognising the delicate political conditions, the paper suggests that Russia should seek to comply with the standard requirements for WTO entry, and - subject to some transitional adjustment periods - should allow access to the Russian market for western services sector companies. WTO accession was seen as helpful to Russia in the sense of locking in reforms, and promoting further market-oriented reforms.

**Keywords:** *World Trade Organization, Russia, liberalization, domestic policies, European Union, tariffs, trade preferences*

## 1. Introduction

The Russian Federation first applied to join the WTO in June 1993. In line with the WTO's standard procedures, a Working Party was established to consider the application and oversee the process. By early 2002, the Working Party had met over 10 times to consider an initial memorandum on its trade policy regime submitted by the Russian government, to consider and discuss questions from Working Party members and responses by the Russian side, and to start the process of negotiating specific agreements concerning trade in goods, trade in services, agriculture, and other matters of concern to WTO members. Despite this activity, interest from the Russian side was at best erratic, periods of enthusiasm for the WTO alternating with periods of apparent indifference. Likewise, it cannot be said that there was huge enthusiasm from existing WTO members, especially the major states and trading regions such as the USA and the European Union, to accelerate the Russian application.

This sluggish approach to the WTO has now been superseded by events, both within Russia and in the wider international context. As regards the former, soon after Yeltsin was replaced by President Putin, Russia's interest in the WTO revived, aided by the support of his leading economics minister, German Gref. Membership of the WTO now forms a key plank in Gref's economic programme for the Russian Federation, as a result of which there have been several high-level meetings in Geneva concerning the Russian application. In May 2001 the Russian Federation submitted an updated statement on its trade policy regime (WTO, 2001a), and the current position, noting the huge volume of legislative amendment that WTO accession would entail for Russia, was outlined in Prikhodko and Pakhomov (2001). Many of the practical issues associated with a Russian accession were also discussed in the joint Russian-Canadian study, vanDuzer et al. (2000).

In the wider context, the dramatic and shocking events of September 11th 2001, and its aftermath, the war against the Taliban and Al-Qaeda forces in Afghanistan, have drawn Russia back into a closer relationship with the Western Powers. Russia joined the USA-led alliance formed to defeat the Taliban and provided helpful logistical support to facilitate movements of US military equipment, troops, and aid supplies to some of the countries bordering Afghanistan. As a result, the present Russian leadership is very much in favour with the US Administration and the EU, and one benefit of this is that there is now a far more positive attitude towards an early Russian accession to the WTO. Indeed, a speech by Mike Moore, Director General of the WTO, suggested that negotiations regarding the Russian accession could be completed this year, with entry as early as next year, assuming that the necessary ratification procedures could be completed within such a short time (speech referred to in Russia Journal, 2002a) (though more recent speeches have cast some doubt on this optimistic schedule).

Given this apparent acceleration of the schedule for the Russian accession, it is timely to consider some of the key economic and political issues associated with WTO membership for Russia. After outlining briefly what WTO membership entails, this paper then examines some of these issues under the following headings:

- Why should Russia join the WTO? The political economy of accession
- Outstanding Issues
  - Tariff structure
  - Difficult sectors
  - Services trade
  - Intellectual property rights
  - Investment and capital flows
  - Trade preferences within the CIS
- Impact on Russian domestic policies
- Impact on EU-Russian relations

The paper concludes by offering policy recommendations concerning the trade policy regime that would achieve for Russia its proper place in the world economy, given its current stage of development.

## **2. The WTO and the Accession Process**

### **2.1 The Process**

The Russian Federation is one of around 30 countries which are currently seeking accession to the WTO. Being one of the largest economies among the applicant countries, its accession has great potential to increase trade that would benefit current WTO members as well as Russia itself. On the other hand, its relative size and importance within the CIS, many of whose members are also in the WTO accession process, also mean that Russia's entry terms would have important implications for other countries, and should therefore be considered very carefully. The fact that, like many of the other applicants, Russia is in the midst of a process of economic reform and transition towards a market economy also makes the accession process more complicated than it would be for an already well established market economy.

The WTO was established on 1 January 1995 by building on its predecessor, GATT, and incorporating the Uruguay Round (UR) agreements which introduced new disciplines in areas such as trade in services, trade related aspects of intellectual property rights (TRIPs), and trade related aspects of investment measures (TRIMs). All the UR agreements plus the new strengthened rules of the GATT (known as GATT 1994) form the basis for accession negotiations. Accession to the WTO therefore becomes a more complex and demanding process than the former process of joining the GATT.

The guidelines for the accession process are set out in Article XII of the WTO agreement. Any state or customs territory having full autonomy in the conduct of its commercial relations may accede to the WTO on terms agreed with WTO members. The accession process begins as soon as the applicant government submits a request for accession. The General Council thereafter establishes a Working Party with standard terms of reference. The Working Party is open to all WTO members. The applicant country is then requested to submit a detailed memorandum on its foreign trade regime to be reviewed by the Working Party. Then follows a clarification process between the Working Party and the applicant through questions and replies, both oral and written. This process helps the member states better understand the applicant's trade policy regime and enables them to assess its ability to meet the obligations of a WTO member. It also serves as a

forum for WTO member countries to identify the policies of the applicant country which are not consistent with WTO rules. As the process evolves, the accession negotiations will increasingly focus on the terms and conditions of entry and the commitments to be undertaken by the acceding state.

In parallel with the above process, the applicant and interested individual WTO members hold bilateral negotiations regarding market access in goods and services. Once bilateral negotiations have finished and the Working Party has concluded its review, a mandate is prepared comprising the Working Party's report and the Protocol of Accession, the latter containing the precise terms and conditions of accession. The applicant country is normally then invited to accede to the WTO upon agreeing to the terms of this mandate.

As the accession process involves negotiations between the applicant country and various WTO member countries on specific trade related matters, as well as with the WTO itself, each accession is unique. The WTO does not set any timetables or deadlines. The speed of accession to a great extent depends on the acceding country's ability to clarify its trade policies and make them consistent with WTO requirements. However, it is not unusual for the process to take some years. One of the great difficulties experienced by an applicant country during the accession process is to provide a detailed report on its trade regime in a clear and consistent manner. This is partly due to lack of understanding of certain technical terms such as 'state trading' and the fact of their complex trade policies (Milthorp, 1997).

## 2.2 What WTO Membership Entails

WTO membership involves both rights and obligations. The most important of these rights and obligations of WTO membership are probably best illustrated by its three main principles: non-discrimination, reciprocity, and transparency.

Non-discrimination is the most important principle of the WTO. In trading practice, this is represented by the well-known most favoured nation clause (MFN). The MFN ensures that any trade concessions offered to one country are extended to all WTO member states automatically in a non-discriminatory fashion. There are exemptions to the MFN principle in the case of a free trade agreement (FTA) or a customs union. In the domestic economy, non-discrimination basically means national treatment, i.e. that all firms, whether foreign owned (wholly or in part) or domestically owned, can operate under identical conditions.

Reciprocity is introduced in order to avoid the free-rider problem under the MFN. It requires that any country receiving trade concessions from another country should offer something comparable in return. This requirement is not normally imposed in the case of developing countries.

Transparency refers to the use of different barriers to international trade. The WTO regards tariffs as more transparent devices than non-tariff barriers (NTBs) such as quotas and voluntary export restraints (VERs). Therefore the most acceptable method of protection under the WTO is tariffs. The use of NTBs should be prohibited wherever possible.

The WTO also introduced the Dispute Settlement Mechanism whereby a member country can establish whether another member has been unfair in its trading practices in ways that harm that member. If a complaint investigated through this mechanism is found to be justified, the WTO can require the offending member to desist from its unfair practice, or allows the complainant to introduce compensatory protection.

The benefits of WTO membership are therefore potentially very substantial even if attention is confined to the basic principle of MFN treatment. In the case of the developing countries, they commonly enjoy these preferences without having to offer the same degree of concessions to other

countries. This is also true for the Uruguay Round agreements covering agriculture and services, as developing countries have much longer transition periods than the developed countries. For countries in transition, accession to the WTO also means that they would be able to enjoy important benefits which were not previously available to them. For example, the various restrictive practices still operated by developed countries against state-trading economies like Cuba and North Korea would most likely have to be terminated if these countries became WTO members. But the WTO emphasises that WTO membership is not only about rights but also about obligations. Unless the acceding country is judged to be ready and capable of taking on the challenges and obligations of membership (possibly after an initial transition period), then it is unlikely to gain entry to the ‘club’.

It is generally accepted by the world community that accession of countries in transition to the WTO is highly desirable, moving them from a past characterised by isolationism or bilateral approaches to trade policy towards fuller integration into the world economic system (see Michalopoulos, 1998). However, as Drabek (1996) emphasises, there are some serious difficulties to be faced. These include major shortcomings in terms of economic structure and the institutional framework, a frequently far from completed macroeconomic stabilisation, as well as quite fundamental uncertainties regarding the proper sequencing and speed of trade policy reforms. There is also a significant question over the stability, and even the credibility, both of policies covering foreign trade and investments, and in regard to any commitments that might be entered into in these areas in the course of WTO accession. Faced with these difficulties, it might be possible to offer countries in transition some form of special status or preferences. But Drabek (1997) argues against that approach on the grounds that it tends to “lock in” whatever special conditions might be agreed. His preferred alternative is a defined transition period, by the end of which any given transition economy would have in place the full set of commitments and policies required for WTO membership. The length of the period might need to be based on judgements about the pace of institutional and macroeconomic change, the strengthening of administrative and political structures, and the improving sustainability of economic policies.

### **3. Why Should Russia Join the WTO? - The Political Economy of Accession**

Russia principally exports fuel products (notably oil and gas) and raw materials (diamonds, metals, timber and the like) in exchange for manufactured goods such as transport equipment and processed agricultural produce. In recent years, according to UNECE data, Russia has enjoyed huge trade surpluses, of the order of USD 20-30 billions per year. Table 1 shows exports and imports by principal trading partner, hence illustrating the regional structure of Russian merchandise trade, with the EU and the CIS appearing as principal trade partners. Chart 1 shows essentially the same information for the year 2000, in the form of pie charts for imports and exports. Chart 2 shows the commodity structure of Russian imports and exports in 2000, by broad sector.

Table 1: Charts 1 and 2

Chart 1a: Exports by Main Trading Partner, 2000

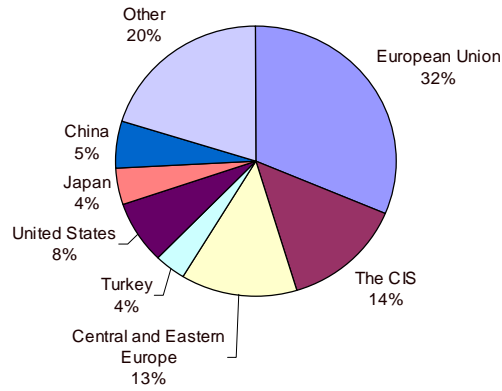
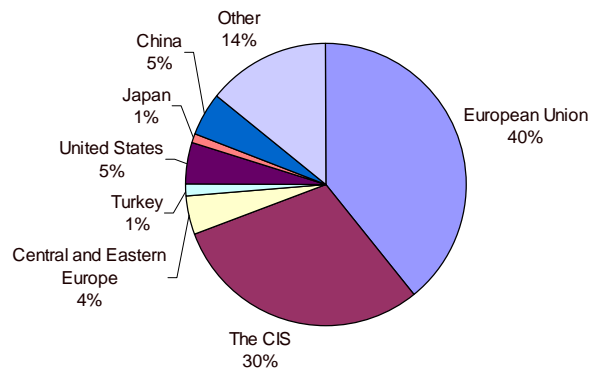
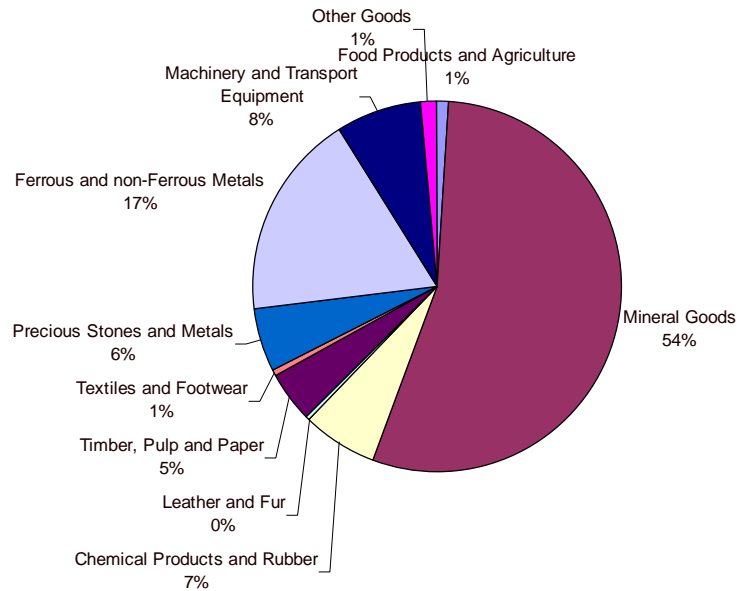


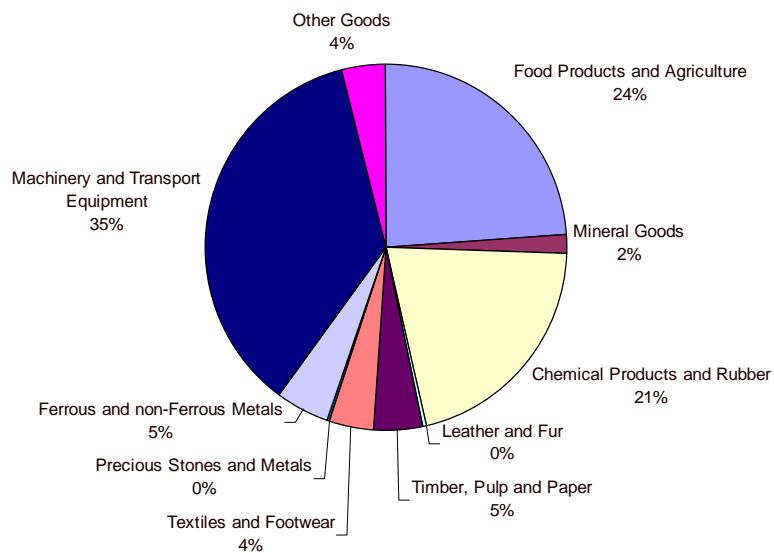
Chart 1b: Imports by Main Trading Partner, 2000



**Chart 2a: Export Structure by Commodity Group, 2000  
(non-CIS trade)**



**Chart 2b: Import Structure by Commodity Group, 2000  
(non-CIS trade)**



Such large merchandise trade surpluses do not suggest a nation in great need of whatever support and benefits would ensue from WTO membership. So why is Russia apparently so interested to join, why is the world community now so ready to collaborate in the accession

process? It is not possible to answer these questions without referring to a rather complex mix of economic and political considerations.

*International community*

Though Russia's economic weight in the world economy is tiny (far less than that of the Netherlands, for instance), she is a major player politically, not least because the country remains a substantial nuclear power, and as the leading successor state of the former Soviet Union. Russia attends many meetings of the G7 powers (the United States, Canada, the UK, France, Germany, Italy, Japan), this group enlarged to include Russia often being referred to now as the G8, and has belonged to international organisations such as the IMF and World Bank for some years. Russia also belongs to most of the more specialist international organisations such as the ILO, the WHO, and the like. It is therefore somewhat anomalous for such a key country not to belong to the WTO.

On the other hand, the Russian government itself has often been ambivalent about membership, and important members of WTO have put up barriers in the way of Russian accession. Russia has desired the benefits of membership while being reluctant to contemplate the possible costs in terms of necessary changes to domestic policies (sometimes perceived as unwanted external interference in Russian concerns), costly industrial restructuring, and a possible flood of foreign goods and services entering the Russian market. These fears are not groundless, but with careful preparation their impact can be limited or spread over a longer period. At the same time, those states that saw Russian accession as "problematic" because of expected difficulties in sectors like steel, agriculture, financial services, and others (see below), increasingly consider that the international community can function better with Russia inside the WTO rather than outside. As explained below, this is not to say that the problems have disappeared, merely that with a more positive approach on all sides, it is expected that they can be resolved.

Since world trading rules are evolving over time, Russia might also prefer to be on the inside, with a significant "voice", than to remain on the outside, able to do no more than respond to changes in the rules agreed by everyone else. This was, after all, part of the argument used in China concerning WTO accession for that country (see Martin and Ianichovichina, 2001).

*Comparison with the accession of China*

Remaining with China, it is worth pausing to sketch the issues that arose in the Chinese WTO accession, and to compare them with the corresponding Russian situation. China signed its WTO Accession Protocol in late 2001 and entered the WTO in December. Like Russia, China has enjoyed substantial trading surpluses in recent years, though in China's case these have resulted from the successful expansion of manufacturing exports - largely from Special Economic Zones and the burgeoning Township and Village Enterprise (TVE) sector.

China's government regards continuing economic growth as critical for its survival, sees WTO entry as a means of strengthening competition in China's domestic markets (and hence as a useful tool in pushing further reforms and structural adjustment), and was convinced by the mid-1990s Asian crisis that there was no realistic alternative to deeper integration in the world economy. A key reason for joining the WTO was to secure more reliable access to the vital US market - before accession, the US renewed China's MFN status annually, and the country had been subject to increasing numbers of anti-dumping allegations originating in the US.

A second factor favouring WTO membership was the prevalence of loss-making state-owned enterprises (SOEs) in China. Many need to be restructured and, if necessary, closed down, but the political and social costs of this are expected to be huge. WTO membership was perceived as an external factor that could assist China's leadership to bring about this type of domestic change by strengthening domestic competition, though it is acknowledged that the process will be slow.

Walmsley et al. (2002) also show, by means of a multi-sectoral, multi-regional and multi-period model, that WTO accession for China will result in large increases in FDI and, over a 10-20 year period, very substantial gains in investment, GDP and general living standards as compared to scenarios in which China remained outside the WTO. GDP, for instance, was expected to be almost 30% higher by 2020 with China inside the WTO. Such large gains come through four principal channels: (a) reduction in the perceived riskiness of investment in China, which implies a rise in the perceived returns; (b) efficiency gains due to the removal or considerable reduction of tariffs and quotas across most sectors; (c) improved productivity in certain key sectors, notably automobiles (due to the high initial protection, including inter-provincial barriers to trade within China, and initial output levels only a fraction of the minimum efficient scale in many plants); and (d) liberalisation of services trade and improved conditions for foreign investment in services.

The key economic factors, therefore, have been market access, locking in reforms through provision of an external anchor (in China's case, to support long-delayed SOE reforms), and improving conditions for FDI. All of these apply with great force to the Russian case. However, we should also highlight some significant political and economic differences between Russia and China in terms of their starting points and recent reform experience, as shown in Table 2. These differences make WTO accession a more difficult matter for Russia than it was for China, not so much in terms of the international environment (which for Russia is now very supportive) but in terms of the domestic politics of accession. The most successful branches in Russia - the primary producers - already face few restrictions in world markets, so they have little to gain from WTO entry; and they may stand to lose if WTO commitments serve to undermine their existing domestic monopoly positions. At the same time, much of Russian industry is uncompetitive and fearful of increased competition from abroad, with the result that many branches lobby for protection and prefer to see WTO accession delayed. The government, in the midst of all these pressures, supports further economic reforms in Russia but ironically does not perceive itself as enjoying the unambiguously reforming mandate of the Chinese government.

**Table 2. Differences between Russia and China**

Factor	Russia	China
Politics	Democratic, following collapse of communist system in 1991.	Communist Party remains in power. No significant political reforms. But ruling party far less ideological than in the past, sees its continuing legitimacy in terms of economic success.
Economy - general	Severe decline in GDP and output in most sectors until late 1990s, modest recovery since then.	Rapid economic growth since late 1970s, but slowing down from mid-1990s. General living standards rising quickly.
Economic structure	Industrial economy with most sectors in need of restructuring and modernisation. Far too few new businesses, lack of dynamism.	Huge shifts out of agriculture into the very dynamic TVE sector. TVE output and exports now exceed that from SOEs.
Trade	Exports dominated by primary produce, notably oil and gas	Exports dominated by manufacturing
FDI	Not very attractive conditions, little FDI thus far.	Substantial FDI to mid-1990s, then a slowdown, recovery since 2000.

*Market access*

Russia perceives itself, sometimes not incorrectly, as a country whose export products are denied access to many potentially important markets. While many developed countries already accord Russia MFN treatment or better, there are numerous exceptions or special cases where particular sectors are treated differently. Some of these are the standard “difficult” sectors like steel, textiles, agricultural and food products where many developed countries regularly maintain restrictive policies. Some countries, such as the United States, have tended to link the granting of MFN status to unwelcome and, indeed, largely outmoded political conditions (freedom of emigration for Russian Jews). As part of its WTO negotiations, it is to be expected that many such conditions would be dropped, or at least that Russian exporters would find themselves competing on equal terms with exporters from other countries.

On the other hand, there is a clear downside to all of this, one that is much less well understood in Russia (though some concerns are expressed in Russia Journal, 2002b). This is the reciprocity aspect of WTO membership. In this instance, what this means is that in exchange for access to the general privileges of WTO membership, Russia will need to open up many of its domestic markets to foreign competition, both in manufacturing and services sectors of the economy. What this might mean in practice, we consider further below.

*Protection against unfair treatment*

Not only does Russia encounter restrictions in its access to certain markets, but even when it does enjoy access it is vulnerable to charges of anti-dumping and other forms of unfair trade practice. Many such charges are brought against Russia by the United States, by the EU, and by other countries. Since countervailing duties or other trade restrictions are often put in place while an investigation is being pursued, the charges can disrupt trade even if they are not subsequently found to be justified. Moreover, Russia remains especially open to such charges due to its continuing designation by many important trading partners as a state-trading economy. For instance, Russian metal producers claim that at least 24 countries have introduced protectionist measures against Russian metal exports, with voluntary export restraints (VERs) being agreed in some cases following anti-dumping allegations (Russia Journal, 2000). Naturally, Russia would prefer to operate in a trading environment in which it was far less vulnerable, and WTO membership is likely to help.

However, the key to better treatment in international trade is being accepted as a normal, market economy country by getting rid of the state-trading designation, and by operating with domestic economic arrangements that do not include numerous hidden subsidies, and the like. Clearly, Russia expects to gain full recognition as a market economy country in the course of its WTO negotiations, but achieving this has not proved a straightforward matter. While the UK and a few others of Russia’s trade partners have been comfortable with the idea of according a market economy status for Russia, both the US and the EU have appeared more hesitant. One of the possible ways forward was for market economy status to be considered sector-by-sector rather than across the board, placing the onus upon Russia in each case to justify any improved status. This approach was not welcomed in Russia, not least because it would have represented scarcely any improvement on the current position. In the event, both the US and EU have recently declared that they are prepared to accord full market economy status to Russia.

Nevertheless, the difficulties over this issue reflect the view by major trade partners of Russia that, despite the country’s enormous moves towards a market economy, accompanied by complex institutional and policy reforms in many fields, very large domestic economic distortions still remain in place, distortions, moreover, that are likely to have a substantial - unfair - impact on the competitiveness of Russian products in the world market.

Probably the most critical of such domestic distortions concerns the pricing of energy - gas, oil, electricity - to Russian producers (and, indeed, to households, though that is of less concern from the international trading standpoint). After rising somewhat through the mid-1990s, Russian domestic energy prices (measured in dollar terms) fell sharply in the wake of the 1998 financial crisis and devaluation, and have not recovered since (OECD, 2002b). They currently stand at a small fraction of the prevailing world market prices for the major types of energy. The result is that there are two kinds of distortion in the pricing of Russian energy: (a) average domestic prices are far too low and are mostly well below any reasonable measure of production costs; (b) the relative price ratio between the consumer price of energy (paid by households) and the producer price (paid by firms) is exactly wrong, with consumers enjoying much lower prices than the already unreasonably low prices paid by firms. Quite aside from the directly damaging effects of such prices in terms of encouraging the profligate use of energy and distorting vital investment decisions, the low prices paid by Russian firms for their energy can readily be used as an argument that virtually anything produced in Russia which is moderately energy-intensive is, in effect, enjoying unfair subsidies. Exactly this line of argument then justifies Russian trade partners in advancing anti-dumping claims and the like. For instance, French aluminium producers, which themselves benefit from cheap hydro-electric power, are opposed to their Russian competitors receiving cheap energy unless this is truly justified by the production costs involved; and most likely it would not be.

Energy pricing is thus an area where Russia is likely to have to offer quite significant steps towards more rational domestic pricing if the country is to achieve the international status it desires as a result of its WTO accession. This is one of ways in which participation in the international trading community has implications for domestic policies. Politically, this could be quite a difficult issue for Russia, with some resenting what will be perceived as undue external pressure on Russia's domestic policies, others using external requirements as helpful levers to push through long overdue domestic reforms.

#### *Attraction of foreign direct investment*

During the 1990s, the Russian Federation attracted remarkably little Foreign Direct Investment (FDI), as compared to the more successful transition economies such as Hungary, Poland and the Czech Republic, and most of what there was has been concentrated in a few natural resource-based sectors (and the associated machinery and equipment), with a little going into hotels and catering establishments mostly in Moscow and St Petersburg, and modest amounts into food processing and a few other sectors.

By the end of 1999, accumulated FDI inflows into Russia amounted to USD 19.9 billions (USD 135 per capita), as compared to inflows into Hungary of USD 19.8 billions (USD 1,967 per capita), Poland of USD 20.4 billions (USD 527 per capita) and the Czech Republic of USD 16.5 billions (USD 1,612 per capita) (see UNECE, 2000). According to BOFIT (2002a), FDI inflows to Russia in 2001 amounted to USD 4 billion (1.3% of GDP), down from USD 4.4 billion in 2000, though Central Bank of Russia balance of payments data report lower totals, somewhat under USD 3 billion in each of the last two years. Whatever figures one accepts, these are extremely small numbers.

The main reasons for such a dismal performance have to do with Russia's domestic policies - in particular the delayed and erratic macroeconomic stabilization, a privatization programme that strongly favoured insiders (workers and managers ) as the new owners, and a poor institutional framework to support banking, financial institutions in general, and investor protection (see Hare, 2001a) - and a variety of political and social problems - notably the prevalence of economic crime and corruption, the influence of interest groups and lobbies, confusion over the respective jurisdictions of Federal and regional authorities, and the prevalence of barter and other forms of

non-monetary transaction. While nominally, Russia has had in place suitable legislation to promote FDI for some years, few investors have therefore felt sufficiently secure in the Russian environment to invest large sums for long periods. Moreover, the serious lack of investor confidence is also apparent amongst Russians themselves, who have organized capital flight on a massive scale throughout the 1990s, amounting to at least USD 10-15 billion per year in recent years.

Clearly, acceding to the WTO would not, in itself, do away with these serious impediments to investment flows. However, by continuing its reform process, and by locking in new institutions and practices through the commitments it will have to make to join the WTO, it is not unreasonable to suppose that the climate for FDI in Russia could improve markedly in the coming years. This might also induce the return of some of the flight capital lost to Russia in the last decade. The government's desire to achieve such a result is certainly a factor behind its renewed enthusiasm for the WTO. The enormous potential benefits in this area are highlighted by comparison with the likely impact of the Chinese WTO accession, analysed briefly above.

#### *Medium and long term promotion of manufacturing*

While at present, Russian manufacturing exports are not of great consequence - either for Russia or for the world economy - sooner or later the country's energy and raw material exports will decline as reserves run out or become increasingly difficult to exploit. Hence even in the medium-term, and certainly in the very long-term, Russia will wish to expand its manufacturing exports across many sectors, new and old. Perhaps eventually, the country will also be able to improve services sufficiently to achieve large exports from these sectors, too, but for time being this cannot be regarded as a very serious option.

Manufacturing, however, has a good deal more promise, though as Soos et al. (2002) explain, the starting point in terms of manufacturing exports to the EU - Russia's largest single market - is rather weak. WTO accession certainly will not "solve" any of the problems of Russia's manufacturing sectors, but it can be regarded as part of a broader package of policies that will gradually help to foster a more supportive environment for business in Russia. On the problems facing some of these sectors we shall have more to say later on.

#### *The domestic political debate on WTO accession*

The politics of WTO accession are quite complex, since most of the economic aspects of the process covered in this paper are linked to interest groups that might support or oppose different proposals. Hence even if an economist might argue that WTO accession should be supported on the grounds that aggregate net benefits for Russia will come out positive - and in the long run, probably large - what always matters for the politics is the distribution of gains and losses. Politics is virtually always about distributive issues, and Russia is no exception to this general rule. In relation to trade policy matters, such distributive issues are often contentious, and the associated political pressures tend to be weighted in favour of potential losers from reforms - for in practice one is often having to compare smallish gains for the great mass of consumers with possibly substantial losses for relatively few, large, vocal producers.

While President Putin and his economic ministers are pushing for early WTO entry, opinion around the country is extremely divided (e.g., see Russia Journal, 2001). Thus a recent survey of companies in the Moscow region carried out for the Union of Goods Producers found that two-thirds regard 2006 or later as an acceptable time frame for WTO entry - most consider themselves unprepared for earlier entry. Many firms in the energy sector and primary produce sectors, already successful exporters, support WTO entry not so much because it will have much impact on their trade, but because they see it as encouraging foreign investment - including in their sectors. Other firms, especially those in declining heavy industry or in remote regions where economic conditions are poor, simply feel threatened. They do not see WTO membership as offering any sort of positive opportunity. As for the Russian population, there is widespread lack of understanding of what WTO

accession might mean, accompanied by suspicions of unwelcome foreign interference in Russian economic policies.

In the financial sector, the banks clearly feel unready to meet foreign competition, and the President of Sberbank has argued for restrictions on the activities of foreign banks in Russia for at least ten years after accession. Other bankers have supported this view. Some senior Duma representatives have urged Russia to accept substantial liberalization in the fledgling insurance market, while the companies themselves feel unready and WTO negotiators representing the EU in particular press for greater openness.

In agriculture, the Federation Council argued in June for the creation of a common market for agricultural produce across the CIS, as a precondition for Russian integration in the world economic system. It was also asserted that Russian agri-business is ready for WTO entry, though presumably this would be on the basis of the high levels of tariff protection currently sought by the Russian negotiating team. A senior official in the Volga region, in a discussion of food security, acknowledged the need to balance consumer interests with helping Russian producers to compete in the market.

Thus overall, the political environment for WTO accession is something of a minefield, through which the government will need to steer a very careful course - to secure accession without being seen to give too much away, and hence avoid alienating important interest groups.

#### **4. Outstanding Issues**

For the Russian Federation, WTO accession will result in important changes in the foreign trading regime, involving substantial changes in tariff rates and structures for many imported products, changes in taxes and other levies associated with exports, some further liberalisation in regard to trade in services, and associated measures of domestic economic policy. The latter will include reforms to enhance the competitive character of domestic markets, rationalisation of parts of the domestic tax system, and measures to allow foreign companies access to the Russian market - as far as possible on the same terms as domestic firms - with rights to trade and invest freely, subject only to the general provisions of the prevailing economic regulatory framework.

According to the very thorough World Bank study edited by Broadman (see Broadman, 1999), there are four basic issues that Russia will need to manage with care in connection with its WTO application. These are: (a) the dispersion of the tariff structure; (b) questions of trade and investment in services sectors; (c) the WTO treatment of state-trading entities; and (d) reform of the policy regime relating to FDI. The first two of these are certainly important, and are discussed further below. But item (c) really has to do with the extent to which Russia will be treated as a market economy country, and this was already referred to briefly above. There is no need to add more here. However, there are some other issues that were barely touched on in Broadman (1999), and bringing these into the analysis gives us the following list of topics to cover in this section: tariffs; difficult sectors (incl. agriculture); services trade; intellectual property rights (IPRs); investment and capital flows; and trade preferences within the CIS.

##### **4.1 The Tariff Structure**

When thinking about trade policy, one conventionally starts with tariffs and other forms of explicit or implicit trade barrier. The Russian foreign trade regime has generally included not only a very complex import tariff structure, with thousands of distinct tariff lines (including both ad valorem tariffs and specific tariffs), but also a variety of licensing requirements and other quantitative restrictions (incl. problems of certification and technical standards), as well as export

duties payable on exports of gas and oil. In countries with weak governments or governments experiencing problems with the public finances - such as Russia during the very turbulent decade of the 1990s when policies in all areas were undergoing rapid change - tariff revenues can provide an important contribution to public sector financing. However, to the extent that this is a valid argument, it is an argument for fairly uniform tariffs that are consistently collected, rather than the rag-bag of diverse rates, with numerous exceptions and exemptions, that characterised Russia until very recently. Tarr (1999) reviews the standard arguments for tariffs and argues for a uniform tariff for Russia on efficiency grounds. Uniform tariffs are less distorting, do not generate excessive rates of effective protection as goods pass through different stages of processing, and are far less susceptible to the corruption that is often associated with highly variable tariffs.<sup>1</sup>

In the late 1990s, the weighted average import tariff in Russia was about 13.6%, not terribly high by international standards though well above the average external tariff of the EU. Given the exemptions and non-collection, the effective rate averaged nearer 10%. At the three-digit product level, the standard deviation of the tariff was about 7%, implying that about two-thirds of Russian tariffs at that level of aggregation were in the range 7% - 20%. Gradually, Russia has been simplifying its tariff structure by reducing the number of rates in use and lowering the average rate. Thus at the start of 2001, over 30 per cent of products were classified into just four categories with tariff rates of 5%, 10%, 15% and 20%. Although a few products, including cars, sugar, alcohol and tobacco will be taxed at rates well above 20%, these changes brought the average rate down to 11-12%.

In its WTO negotiations, Russia is seeking initial tariff bindings at levels well above current effective rates, presumably in order to give itself some room for manoeuvre in the future. Final bound rates - after an expected post-entry transition period of 6-8 years - are being proposed at rates close to current effective tariff levels. The notable exceptions are the sectors of agricultural produce and food products, where the proposed final bound rates remain well above current tariff rates (about 25% as compared to a current tariff of about 15%). However, many WTO members will be seeking to persuade Russia to commit to lower tariffs, by accepting lower bindings right from the start. There is some risk that by demanding excessively high initial bindings, Russia will leave itself open to continuing pressure from domestic industry lobbies seeking protection - hence this approach to the WTO could merely provide a means to delay restructuring even more, which is not to be welcomed.

## 4.2 Difficult Sectors

Sectors can be classified as “difficult” for a number of reasons. They could be sectors requiring major restructuring, for instance, and Russia has many of these inherited from the period of central planning. Also, they could be sectors that many other countries tend to subsidise and protect in various ways, such as agriculture, textiles, aerospace, and so on, where impediments to trade are widespread. In this sub-section I make no attempt at completeness, merely providing brief information and suggestions about a few key sectors.

### *Steel*

An example of a sector that many countries find difficult (and also needing considerable internal restructuring and modernization) is the steel sector, which came to public attention in early March 2002 when the United States - responding to lobbying from its own producers, especially the high-cost, heavily unionised ones - unilaterally imposed tariffs of up to 30% on the major categories of steel and steel products. The EU immediately protested against this US decision and declared it to be in violation of WTO trading rules. As result, the EU has both lodged a formal complaint at the WTO, and in the meantime acted to protect its domestic market for steel by imposing tariffs of its

own. Already suffering severe over-capacity at the level of the world steel market (see OECD, 2002a), these developments in the steel sector cannot but damage the prospects for Russian exports. At present, implementation of these restrictive measures is temporarily deferred.

Russia's steel exports already faced quotas in the EU market (recently cut in response to Russia's insistence on maintaining export duties on scrap iron) and VERs in the US market (the latter in response to allegations of dumping), so the new tariffs make an already uncomfortable situation somewhat worse. Russia is one of the world's leading exporters of steel items, though in value terms they lie behind Japan, and in 2000 Russian exports accounted for under 5% of the world market. Russian producers clearly regard their position in the EU and US markets as unsatisfactory. Interestingly, however, they also acknowledge the dependence of their relatively favourable costs on the current low prices for energy (referred to above), without appearing to appreciate that this is precisely what can be used to justify anti-dumping actions. Like steel producers elsewhere, the Russian companies need to be faced with realistic prices for their inputs, and then to restructure to eliminate loss-making capacity and modernize what remains. It is not enough merely to cite the absence of direct state subsidies (see Shevelev, 2002).

Steel is one of several sectors whose trade has not been well managed by the WTO, due to protectionist pressures in many countries and the perception of the sector as strategically vital. Given this, it would be surprising if the present crisis in the world steel market were resolved through WTO procedures. It is somewhat more likely that the Steel Committee of the OECD might provide a suitable forum for further negotiations. In any event, this will not be an easy market for Russia, regardless of WTO accession.

#### *Vehicles, esp. Automobiles*

Some western car producers do have plants in Russia but they face many practical barriers to expansion and development. Importers face even more barriers, with high import tariffs (25%) plus excise duties depending on engine size (especially hard on imports of large cars from the US), plus the usual VAT applied to most imports (with a few exemptions for children's good and a few other items). In effect, Russia domestic producers of cars enjoy rather high rates of protection, despite which they perform poorly and restructure slowly, if at all. Most have barely started to modernise, and the Russian firms generally lack the technical expertise, the management, and the marketing skills to design and introduce new models that would succeed in the market. This raises a serious question about the appropriate strategy for the industry.

The official Russian view appears to be that the domestic industry should be shielded by import barriers, and given time to restructure and modernise. There are even suggestions that a great deal of public money should be directed towards the industry to assist this process. And in its WTO negotiations, Russia has sought high import tariffs on automobiles, a request that has proved acceptable to major trading partners. Nevertheless, this approach to car industry restructuring and modernisation seems to me extremely unwise - it is not entirely unlike what was attempted in the UK during the 1970s. The UK failed dismally, and so will Russia, in my view. But the UK experience does in fact point the way forward for Russia. For in the UK, many foreign producers set up factories that produced a range of models to world standards, embodying the latest design concepts. Thus despite the failed attempt at state intervention in the 1970s, the UK still has a very successful car industry, albeit one that is almost wholly foreign owned. By creating the right environment for investors, Russia could do the same. What is important, though, is not so much the levels of tariff applicable to the sector, but creating an encouraging environment for foreign investment.

#### *Agriculture*

Russian agriculture did not perform well after the Soviet Union was dissolved in 1991. Climatic conditions are not especially good, with a short growing season in most regions, and hence

very short periods that are ideal for ploughing, sowing and harvesting. At the same time, the main factor behind poor performance is surely the lack of reforms, with incomplete privatization and the failure to establish a market in land among the most significant obstacles to change. The Duma has recently passed measures to legalise the land market, though placing significant restrictions on ownership by foreigners and foreign-owned companies. Even before this step, however, much agricultural land was being concentrated into large farms run by large Russian companies - these farms often owned or leased by the Russian nouveaux riches - and this was enabling agricultural performance to improve. Significant investment was starting to flow into the sector by the late 1990s.

Agriculture is a sector subsidised a good deal in most countries, especially the more developed ones, the EU's CAP being only one of the more extreme instances of this practice. Yet at present, levels of subsidy to the sector in Russia are relatively low, and have been for some years, at least in part due to the inability of the government to make any more money available from its limited budget. This fact is creating difficulties for the Russian position on agriculture at the WTO negotiations. For in determining the acceptable subsidy levels in Russia, other WTO members such as those belonging to the Cairns Group expect the late 1990s to be used as a reference period. Since Russian agricultural subsidies were low then, this would determine a low upper limit to the subsidy levels that Russia should commit to in the course of WTO accession. Conversely, since Russia is perfectly well aware that current subsidies are low, the country is seeking to use the late 1980s as a reference period, this being a period when applied subsidies were far higher than at present.

In some way this is an artificial argument. For even if the Russian position were accepted in Geneva - which must be doubtful - Russia simply does not have the public money available to pay out subsidies at the levels it would then be permitted to apply. Hence in practice the new limits would have virtually no practical effect. In addition, subsidising agriculture is not the way to improve its efficiency. Far more important is to carry through the long delayed reforms in other areas, to do with property rights, improving training and technical standards, establishing an agricultural land market, improving credit conditions, improving infrastructure, developing more effective marketing links for agricultural produce, and creating more effective input markets. While some progress has been made in all these areas, there is still much to be done. Subsidies, on the other hand, would merely delay restructuring and put off developments in these vital areas. Thus on agriculture, it is not easy to support the Russian position on subsidies. On the other hand, their position on tariffs, seeking relatively high tariffs in order to offset the dumping of subsidised agricultural produce by the EU and the USA in the Russian market is far more understandable.

#### *Technical Standards*

These constitute a significant barrier to trade in many sectors, affecting both imports into Russia, as well as exports. The problem is that certification procedures are slow, non-transparent and expensive, and result in approvals that are often only valid for three years rather than for the life of a given product. Recent years have seen some improvement, with about a third of Russia's 22,000 or so technical standards conforming to international standards. However, implementation is not consistent across Russian regions, and a huge amount of work remains to be done in this field. The Russian government plans to put improved legislation to the Duma on this topic, but even so, it is hard to see how full conformity to international norms and standards can be achieved quickly. Thus as part of its WTO Protocol, Russia should be offering full conformity, but everyone needs to accept that implementation might take up to a decade.

#### *Creating a Unified Economic Space*

As was the case with the recent Chinese accession, the WTO will expect Russia to comprise a unified economic space. It was already noted in passing that there is confusion over Federal and regional jurisdictions relating to many matters of economic regulation, and the instance of technical

standards just discussed is but one of many areas where implementation is not uniform across the country. Even more importantly, despite President Putin's partially successful efforts to reassert central control over the "Russian economic space", many regions of Russia operate trade restrictions of diverse sorts, supposedly to protect local firms, the local market, from unwelcome competition - both from other Russian regions and from imports. Most such restrictions are already technically illegal. Economically, they are incredibly inefficient, discouraging the entry of new firms and undermining competition. While often claimed to protect consumers, mostly they protect those inefficient local firms which have successfully lobbied for protection. All these practices, as well as other local rules regarding investment and taxation, are inconsistent with WTO membership.

### 4.3 Services Trade

Services trade represents a small fraction of Russia's total international trade, and is a component in which Russia is consistently in deficit. It is proving a difficult area for Russia as many WTO members wish to see considerable opening of the Russian market - both for trade and for the location of foreign-owned businesses - notably in banking and insurance where existing Russian provision is mostly of extremely poor quality. Also, these sectors are not yet well regulated in Russia. Although likely to meet with some resistance from Russian negotiators at the WTO, since the country wants to give its domestic financial sectors time to improve and become more competitive, my view is that undertaking further reforms to meet WTO access conditions in the services sectors is exactly what Russia needs. Personally, I do not believe that the Russian banking and insurance industries in particular will develop successfully behind protective barriers - they will simply use protection to delay long overdue change and to continue producing bad services for the Russian population and the Russian business community.

Even more importantly, if Russia wishes to attract serious amounts of FDI and other capital inflows, then it needs to have in place a reasonably decent financial sector able to offer incoming businesses the types and quality of service they expect elsewhere in the world. Hence providing a better environment for foreign financial and business services companies to locate themselves and operate in Russia, while it is not a sufficient condition for boosting FDI, is certainly one of the necessary conditions.

Existing WTO members will expect national treatment for their investors in Russian services sectors, and considerable relaxation of the restrictions - currently in place, or proposed in the course of the WTO negotiations - that would limit the share of foreign ownership in many activities.

### 4.4 Intellectual Property Rights

This issue is probably rather less critical for Russia than it was in relation to China's WTO accession, since Russia is apparently far less involved in the production of pirated CDs and videos, the use of unlicensed software, and so on. Nevertheless, it has been estimated that the US alone lost over USD 1 billion in 2000 due to video piracy in Russia, so the matter is not entirely trivial. Moreover, US companies have experienced difficulties over registering even quite well known trade marks in Russia. Although Russia formally adheres to the relevant international conventions regarding copyright, patents, trade marks and the like, its implementation of the rules remains quite uneven. Hence in the accession negotiations, WTO members will be seeking much improved implementation of existing policies.

## 4.5 Investment and Capital Flows

It was already noted above that Russia has attracted very low levels of FDI, while also experiencing serious capital flight. The latter might conceivably be addressed by reimposing tough capital controls, and by requiring export revenues to be deposited in the Russian banking system, but such controls are hard to enforce, relatively easy to evade. In any case, they fail to address the key problem of the Russian transition, namely the very poor investment climate in the country. In a sense this has little or nothing to do with the WTO question, since investment basically depends upon the quality of macroeconomic management in a country, as well as on numerous details of the institutional environment to do with protecting property rights and business contracts, protecting shareholders (esp. minority shareholders), ensuring consistency between Federal and regional levels of government, etc. In all these areas, the Russian record for much of the 1990s was quite abysmal, and has only started to pick up in the last few years, especially since the 1998 crisis and the renewed pro-reform direction taken by the Putin government.

As regards WTO accession, therefore, improving the conditions for foreign direct investment and capital flows is mostly about improving the domestic environment for investment. In other words, if Russia maintains its current, quite well balanced, macroeconomic posture while continuing the microeconomic policy and institutional reforms already referred to, then it should be well on the way to meeting any likely conditions requested by WTO members to do with capital and investment flows.

## 4.6 Trade Preferences within the CIS

Since the disintegration of the Soviet Union in late 1991, the 15 successor states form two distinct groups. First, there are the three Baltic States - Estonia, Latvia and Lithuania - which were quick to turn towards the West, undertake market-oriented reforms, and join the negotiations for EU membership at the end of the 1990s. Given their EU-orientation, these countries are therefore only discussed in Section 6, where we discuss several aspects of EU-Russia economic relations in the context of WTO accession.

Second, we have the Commonwealth of Independent States (CIS), comprising Russia itself and 11 other states: the European group - Belarus, Ukraine, Moldova; the Caucasus - Armenia, Azerbaijan, Georgia; and Central Asia - Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan. Of these states, just three are already WTO members, namely Moldova, Georgia and Kyrgyzstan, most of the others being applicants. Several attempts have been made to develop various forms of economic integration across the CIS or in sub-regions within it, despite which the actual volumes of intra-CIS trade undertaken fell sharply in the early 1990s and have only grown a little since the mid-1990s: from USD 53.74 billion in 1994 to USD 60.98 billion in 2000. As early as 1994, the 12 CIS member states agreed to establish a Free Trade Area (FTA), and only a little later, several states - Russia, Belarus, Kazakhstan, Kyrgyzstan and later, Tajikistan - agreed to form a Customs Union (CU) (see Hare, 2001b). Russia and Belarus have also announced their intention to move towards a complete economic union, and several other groupings of CIS states have been announced. None of these groupings can thus far be claimed to have had much real economic effect, nor would it necessarily be particularly desirable for them to become more effective.

Concerning the effectiveness of these groupings of states, the main problem has been the failure to ratify or implement agreements, the continued use of tariffs and a range of quantitative restrictions limiting trade within the supposed FTA, the failure to agree on and implement a common external tariff in the CU, and numerous bureaucratic, technical and institutional obstacles

resulting in very high transactions costs in intra-regional trade. To cite just one example, it is apparently far cheaper to import Australian wine into Moscow than wine from Moldova (cited in Dyker, 2002a). In any case, the useful analysis of Michalopoulos and Tarr (1997) argues that success in achieving closer integration across the CIS would probably not be desirable. This is because the countries might then tend to be locked into the use of out-dated, Soviet-era technology. Proposals for the CU's external tariff are also not very attractive for those CIS members that have already liberalised trade based on low and fairly uniform tariffs.

Regardless of these considerations, intra-CIS trade will be affected by a Russian accession to the WTO, unless the CIS Free Trade Area is able to secure a derogation from WTO rules during the negotiations. For without such a derogation, Russia would quickly be expected to revert to its normal MFN tariffs in its intra-CIS trade and would no longer be able to subsidise its energy trade within the region. In addition, the current practice of tolerating barter deals and counter-trade in order to enable trade to take place with partner countries lacking credit-worthiness might also be scaled down (see Marin and Schnitzer, 2002). One would expect Russia increasingly to demand normal monetary transactions and payment in convertible currencies as it develops its own institutions to support such practices.

## **5. Impact of WTO Membership on Russian Domestic Policies and Domestic Restructuring**

Whatever the detailed policy changes might be, it is clear that post-accession, Russia's structure of domestic relative prices - affecting both firms and the household sector - will differ markedly from that which prevails now. Many quantitative restrictions impeding trade will also have been lifted, as will various licensing and market access constraints. Domestic subsidies and other, more indirect supports to various industries (such as through directed credits, delayed tax payments, and the like) will have been greatly diminished. The equilibrium exchange rate might well change, too, though a full analysis of that aspect of the problem falls outside the scope of the present paper.

From the standpoint of structural change, the principal implication of the reforms that will have taken place in the Russian Federation in the course of WTO accession will be to increase the profitability of some production activities, and reduce that of others. In response, especially as Russian firms and industries come to be governed more and more by profit considerations, one would expect to see structural change on an enormous scale. Earlier research suggested that a substantial fraction - indeed over 50 per cent - of the industry in the former USSR was highly uncompetitive, on the basis of profitability assessments using world market prices and detailed input-output data for the late 1980s<sup>ii</sup>. In other words, this was the situation as it appeared pre-transition, prior to the major liberalisations and other reforms that were undertaken in Russia from 1992 onwards.

On the other hand, a good deal of the then Soviet and now Russian industry appeared to be quite competitive; in particular, branches such as ferrous metallurgy, non-ferrous metallurgy and engineering came out relatively well. Across the whole region of the economies in transition, as one would expect, energy intensive sectors of the economy appeared highly uncompetitive when evaluated properly in terms of world market prices. This is merely an expected consequence of the policy, maintained since the mid-1970s, of holding domestic energy prices, both for consumers and firms, a long way below the prevailing world market prices. That policy evidently induced a great deal of inefficient investment, and resulted in considerable wastage of energy.

How would one expect an economy to react, when faced with sectors characterised by very different profitability ratios? Even under the most favourable circumstances this is not a particularly

easy question, and the relevant economic theory provides at best some rather ambiguous pointers towards the possible outcomes. Moreover, it is evident that Russian conditions are far from favourable in that any structural change that might be envisaged is superimposed upon a very drastic overall decline of output across all sectors - only since 1998 has aggregate output in Russia started to recover significantly from its post-communist collapse. Hence it is important to ensure that the analysis of structural change per se is carefully distinguished from that of aggregate output decline, since both the causal factors and the associated policy implications in each case are likely to be very different.

Focusing on the economic forces stimulating structural changes, profitability differences typically give rise to two sorts of effect, namely a short- to medium-term effect on market shares, and a longer term impact upon investment. For instance, in the absence of trade restrictions and other barriers, a branch that is loss making or generating relatively low profits can be expected to be losing market share in its home market to import competition, and the share of its production that is exported will also be in decline (if the product was already active in export markets). On the other hand, if domestic entrepreneurs or foreign investors judge that the branch is one with long term promise, for instance because the demand for its output is less affected by the general downturn in the economy than many other branches, or because the income elasticity of demand is high (so demand will recover rapidly with an economic revival), then investment will start to take place in order to modernise the branch and make it competitive. Obviously, if there is no particular reason for taking such a favourable view of the long term position, then investment will not take place and the branch concerned will go into rapid decline as firms go out of business and fully depreciated capital is not replaced.

Arguments along these lines suggest that it might be useful, at least as a starting point for more detailed analysis, to categorise branches of the economy according to the following simple table.

**Table 3. Structural Change in the Short-run and Long-run**

Short-run Profitability	Long-run Prospects		
	Good	Medium	Poor
Good	MS ↑, Inv ↑	MS ↑, Inv. -	MS ↑, Inv ↓.
Medium	MS -, Inv ↑	MS -, Inv. -	MS -, Inv ↓
Poor	MS ↓, Inv ↑	MS ↓, Inv. -	MS ↓, Inv ↓

*Note: MS = market share, Inv. = investment. Arrows denote expected directions of change.*

While Table 3 would enable Russian industries to be classified into nine categories, depending on profitability and prospects, it is important to bear in mind a number of additional points before doing so:

- Geographically, Russia is a huge country, so the assessment of a given branch or sector might not be uniform across the country. Some branches could be highly profitable and/or enjoy good growth prospects in the Russian Far East while being uneconomic in European Russia, and conversely.
- Social and/or political factors - rightly or wrongly - might delay the adjustment of certain branches to market conditions. For instance, mining in much of Russia's Far North is no longer economic and should gradually close, but the resulting devastation of the communities affected cannot yet be politically tolerated. Either alternative economic activities and jobs must be provided or virtually whole communities must be re-located. Either option is difficult and costly.
- Domestic price adjustments during the 1990s have already changed drastically the relative costs and profitabilities of many economic activities in Russia. The

government is well aware that many enterprises are in uneconomic locations or are using out-dated technology that cannot be competitive any longer (if it ever was). As with the previous point, adjustment is costly and painful, therefore slow.

- As discussed above, some important domestic price adjustments are still to occur, notably in the energy sector. These will further promote a drastic round of enterprise and industrial restructuring across the country (in which connection, see Hare, 2002a and 2002b).
- Regardless of the prices nominally in place, it is clearly vital that these prices actually apply to all transactions. Thus the Russian practice of tolerating barter and other non-monetary forms of completing transactions distorts the market and is extremely damaging. Such practices keep alive many firms that should have gone out of business long ago, and discourage entry by new firms since established firms trade through existing networks and alliances, closing the market to newcomers. Likewise, the practice of tolerating non-payment for energy supplies (i.e. not even the payment of existing very low prices) conveys the wholly wrong signal that energy is free. This, too, is very damaging. Fortunately, since 1998 the prevalence of such practices has slowly declined, and Putin's government appears to be determined to continue this trend (on these practices, see Ledeneva, 1998; Seabright, 2000).
- Against this background, the additional changes in relative prices and costs brought about by WTO accession, in particular by the tariff changes and domestic policy reforms likely to be agreed as part of the Accession Protocol, will be quite minor. Russia already has a massive restructuring task to face, and the relevant relative prices will not be much affected by WTO accession. However, what ought to change is various features of the economic environment in Russia that currently impede restructuring as a result of special interest lobbying, weak implementation of economic laws and regulations (especially, but not only, at the sub-Federal level), and the continued influence of ideas that have more to do with old-style central planning than with the management of a modern and dynamic market-type economy.

## 6. Impact of WTO Membership on EU-Russian Economic Relations

The relationships between Russia and the EU, albeit largely structured through the framework of the Partnership and Cooperation Agreement (PCA) that came into force in late-1997, are complex and multi-dimensional. Russian accession to the WTO will introduce an additional dimension and some significant changes to the established relationship. To explain the full complexity of Russian-EU relations, we proceed as follows. First, the main elements of the existing PCA and its likely evolution are outlined. Next we draw attention to some crucial issues for Russia, notably the likely impact of EU enlargement, the situation of the Baltic States, and the special position of Kaliningrad. Against the background of these issues, we are then able to draw some conclusions about the likely impact of WTO accession on this nexus of relationships (see also Gowan, 2001).

### *The PCA and its Evolution*

The PCA establishes the framework for Russia-EU relations for an initial period of 10 years. It envisages policy action and dialogue in four main fields: (a) trade and economic cooperation; (b) cooperation in science and technology and a number of civil sectors; (c) political dialogue; and (d) cooperation on various matters concerning Justice and Home Affairs (e.g. to do with drug trafficking, money laundering, organised crime, etc.) (EU, 2002). Supporting EU-Russian links, the

TACIS programme of technical assistance, operating since 1991, had already granted Russia funding of □2.4 billion up to end-2001.

For the present paper, field (a) of the PCA is what concerns us. It envisages trade liberalization based on MFN treatment and the progressive removal of non-tariff barriers to trade, as well as improvements in the rules governing company establishment in Russia, and provisions to do with intellectual property rights, competition policy, services, and international payments (covering both current and capital accounts of the balance of payments). Bilateral trade agreements regulate trade in particular sectors. Specifically, a Steel Agreement was in force from 1997 to 2001, and its successor is still under discussion; and a Textiles Agreement was reached in 1998, to remain in force for the whole period of the PCA. This structure of agreements about trade is clearly of enormous importance since, as noted above, the EU is Russia's largest trade partner, accounting for about 25% of Russian imports, 35% of her exports. Conversely, Russia is the EU's sixth largest trade partner, accounting for 4.4% of imports into the EU in 2000, and 2.1% of the EU's exports.

Some Russian exports to the EU already benefit from GSP (General System of Preferences) treatment, and Russia has requested that the scope of such treatment be extended. In any case, much of Russia's export trade with the EU already benefits from the liberalization that has already occurred. Remaining restrictions in steel and textiles are likely to be removed gradually. Moreover, 1998 saw a modification to the EU's anti-dumping rules that enabled Russian firms to be regarded as operating under market economy conditions; however, this judgement was to be made on a case-by-case basis, not across-the-board (see Section 3, above, for the current position). Although EU-Russian trade bounced back from a sharp fall around the time of the financial crisis of 1998, EU exports have not returned to their pre-crisis levels. There is some concern in the EU over Russia's maintenance of protectionist policies in sectors such as alcoholic drinks and vehicles (especially automobiles), but such protection is likely to remain in place.

Since 1999, an EU Common Strategy on Russia, valid for four years, has been in effect. Like the PCA, this identifies several policy priorities, the one relevant here involves the "Integration of Russia into a common European economic and social space". Precisely what this term means is far from clear, but however it is interpreted in practice, constructing such a space will become increasingly important for Russia, especially after the expected next phase of EU enlargement (see below) takes the enlarged EU's share of Russian trade to around 50% or even higher.

#### *The Impact of EU Enlargement*

Ever since the start of transition in 1989/90, many Central and Eastern European (CEE) countries have sought full membership in the European Union. The enlargement process has turned out to be far more prolonged and complex than many of the CEE applicants envisaged. The current position, however, is essentially as follows.<sup>iii</sup> Leaving aside Malta and Cyprus, 10 countries from Central and Eastern Europe are currently progressing through the detailed negotiations concerning the various chapters of the *acquis communautaire*. These countries are (moving, roughly, from north to south): Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Romania and Bulgaria.

As of end-2001, most of these countries had closed at least half of the chapters (meaning that agreements had been reached), while the more advanced countries only had a handful of chapters awaiting agreement. Perhaps not surprisingly, chapters that are only being opened this year include those on agriculture, transport, and structural funds. These chapters are particularly difficult not only for the applicant states, but also for the EU itself. Some of the proposals from the EU side will not prove popular, for instance proposals on agriculture will not be well received in Poland since they delay full participation in the Common Agricultural Policy until 2013 (Commission, 2002a). By early 2002, the European Commission had set out its negotiating position on the

financial framework for accession, focusing on the years 2004-2006, as a basis for the final stages of negotiation during 2002 and 2003 (Commission, 2002b).

Nevertheless, the (official) expectation is that negotiations will be substantially complete by end-2002, enabling existing EU member states and the applicant states to ratify a Treaty of Accession during 2003, with new members formally joining the EU in 2004. This already appears a rather tight time schedule, and some slippage is not unlikely. In addition, there must be some doubt whether all ten CEE applicants will be ready to enter at the same time. Bulgaria and Romania, especially, are well behind the others in terms of their progress with economic reforms and in their capacity to withstand competition from the existing EU members (this being among the Copenhagen criteria for accession). However, politically it might prove hard to leave them out and delay their entry. Further, some of the applicant states might not succeed in “selling” EU accession to their populations, so even after all the negotiations some states might not, in the end, accede - this remains to be seen.

Studies of the economic impact of EU enlargement based on multi-sectoral, multi-country (or multi-region) models show that on reasonable assumptions it is likely to be beneficial for all the countries involved (existing member-states and acceding states), with proportionally by far the largest benefits accruing to the acceding countries - presumably because they still have most to gain from increased specialisation and improved access to the large EU market (see Baldwin et al., 1997). These findings are confirmed in a more elaborate model reported in Forslid et al. (2002), a model with 10 regions (groups of countries) and distinguishing 14 productive sectors in each region. This model also shows, in a variety of simulations, that the expected net economic benefit of EU enlargement for the former Soviet Union is virtually zero. Unfortunately, this region of the model includes not only the Baltic States, which as EU entrants are expected to benefit from accession; but also the whole of the CIS. Within the CIS, some countries might be overall gainers, some might be losers, depending on the composition and volume of their trade with the EU. On balance, we can only conclude that for Russia, the direct economic impact is likely to be small.

That said, there will be a few sectors that could be hard hit by enlargement. For instance, Russia’s sales of nuclear fuels to some of the accession states might disappear completely, since the Russia fuel and the associated transport arrangements for it do not comply with EU regulations (see Dyker, 2002b).

The enlarged Community will, however, offer Russia a somewhat simpler and more liberal trading environment, since the new entrants to the EU will apply the EU’s Common External Tariff to the bulk of Russia’s exports. Hence Russia will face a unified set of trading conditions, rather than the EU as it is now plus the 10 applicants each applying different tariffs to Russia. Since for industrial sectors, most EU tariffs are rather low, Russia will tend to benefit overall from these changes. On the other hand, bilateral trade agreements that Russia has with some of the applicant states will most likely fall by the wayside in the course of the enlargement process, and in a few instances this might marginally disadvantage Russian interests.

Also, there is an expectation that the new EU frontier, soon to adjoin Russia proper (i.e. excl. Kaliningrad, on which see below) not only in Finland as at present, but also in Estonia and Latvia (but not Lithuania, as that country will border Belarus), will be a relatively “hard” frontier, with rather tighter border controls (incl. a new visa regime) than have normally been in place between, say, Latvia and Russia hitherto. Such controls might impede normal cross-border flows of workers in each direction, and might also increase the transactions costs associated with trade (see Batt, 2001). However, one should probably not make too much of this point as the Finland-Russia border has been the EU frontier since the last EU enlargement in 1995, and Russia has not been especially vocal in complaining about the border controls there. Hence it appears that workable

solutions can be found, and the Finnish model - based on a visa regime but with very quick processing and a flexible approach to local cross-border traffic - could usefully be extended..

#### *The Baltic States*

The three Baltic States were first to declare their independence from the Soviet Union in 1990 and 1991, they immediately declined to have anything to do with the CIS, and announced their intention to adopt a strong western orientation, including the intention to seek both NATO membership and EU membership. Estonia was first to adopt radical market reforms, Latvia and Lithuania both being somewhat more cautious. All three countries have large Russian minorities and have also served as transit routes for Russian exports, important due to the lack of ice-free ports in Russia itself (but Russia is now building new port facilities near St Petersburg). Hence the shift of the Baltic States into the EU's orbit has been viewed as problematic for some years, though the EU has been at pains to stress that normal trade and personal links with Russia should not be damaged thereby. In fact, as part of the enlargement discussions, the EU has pressed the Baltic States not to adopt policies that discriminate against their Russian minorities - language and citizenship laws in particular have been highly controversial in this regard. On balance, I would suggest that the EU's approach in the Baltics has been helpful to Russia rather than damaging.

#### *The Special Position of Kaliningrad*

Kaliningrad (formerly Königsberg) became part of the Soviet Union as a result of the Potsdam Agreements that determined the political configuration of Europe after the Second World War. Following the dissolution of the Soviet Union in 1991, this oblast', isolated from the rest of Russia, was nevertheless retained as part of the Russian Federation. The Kaliningrad oblast' is bounded by Lithuania to the north and east, Poland to the south, so that following EU enlargement it will be entirely surrounded by EU member states (plus the Baltic Sea, of course). Within Russia, Kaliningrad was declared a Free Economic Zone in the mid-1990s, with the intention of attracting foreign investment and promoting the region's development. Such efforts have proved unsuccessful, largely due to the generally poor investment climate in Russia alluded to earlier, though a handful of significant projects has done well. Kaliningrad itself suffers from high levels of crime, shocking pollution, and a local administration that is considered to be inefficient and ineffective even by Russian standards.

Even if Russia as a whole does not form part of a wider free trade area with the EU, it would make good economic sense for the Kaliningrad oblast' to do so, subject to suitable safeguards to prevent Russia from taking unfair advantage of such an agreement. It must be debatable, however, whether such a special status for Kaliningrad would be acceptable to the EU given the military importance of Kaliningrad as the Headquarters of the Russian Baltic Fleet. Nor would it be politically acceptable to Russia, since it might be seen as the start of a process of gradual disengagement of the region from the rest of the country. Although in the context of Russia's wider negotiations for WTO accession, the Kaliningrad question ought to be regarded as relatively minor, it has actually become a highly emotive issue for Russia. Russia seeks visa-free transit between Kaliningrad and the rest of Russia, which is proving difficult for the EU or the Baltic States to accept. But if Kaliningrad becomes the touchstone for EU-Russia relations, failure to resolve this matter satisfactorily could impact on other important aspects of their relations, including trade.

#### *WTO Accession*

Through the PCA, the European Union is already pressing Russia to adopt and implement much of the domestic economic legislation that will be needed as part of any plausible WTO agreement. In this sense, WTO accession and Russia's political and economic links with the EU are, to a very large extent, mutually reinforcing. Further, as we have just seen, EU enlargement is likely to simplify and improve the environment for foreign trade along Russia's western border, and EU policies towards the Baltics are, on balance, helpful to Russia's interests (though Kaliningrad

remains a thorn in the side, as just noted). WTO accession itself is not likely to impose conditions on Russia that would be contrary to EU interests, not least because those sectors where the EU has special interests - such as agriculture, iron and steel, and a few others - are not particularly effectively regulated at WTO level. Hence overall, Russian membership of the WTO is more likely to improve than to damage Russian-EU economic relations by providing a more rules-based framework within which to manage the relationship and any disputes that might arise therein.

## 7. Conclusions and Policy Recommendations

In this concluding section of the paper, I shall organise the discussion under three headings:

### 7.1 What Should Russia be Offering in its WTO Negotiations?

Official announcements have indicated that basic agreement on the main issues needed to enable Russia to accede to the WTO could be completed this year, with entry possible in 2003. My own view is that many of the outstanding issues are still too complex and controversial, and that such rapid progress is therefore unlikely. However, I think it is quite possible that Russia could join the WTO in 2004. Moreover, I believe that it is very much in Russia's interests to do so as early as it can.

In its negotiations, the Russian government has to balance two partly opposing considerations: (a) what offers does it judge will be acceptable to existing WTO members? and (b) what does it think it can sell to the Russian business community, the Russian Duma? The latter is especially delicate as much of the economic thinking in Russia still derives from the mind set of central planning, emphasising protection, state controls, limitations on competition, and so on. Understanding of what a market economy really entails for the Russian domestic economy is developing, but is still far from universal. This is partly why attempts to influence Russian domestic policies via the WTO process are often perceived as "interference", regardless of the objective merits of the policies being proposed. However, much of the domestic reform that would be entailed by adherence to WTO principles is what Russia should be doing anyway. So if issues are presented in the right way, the WTO process could be seen as supporting an on going reform process, rather than interfering.

Assuming that such a positive approach can be sold, the Russian offer to WTO should be along the following lines:

Goods. Go for a uniform tariff schedule or a schedule with only a few basic rates and very few additional excise charges, with the average MFN tariff rates no higher than at present. Accept tariff bindings at or only slightly above the tariff rates currently in force. Abandon most non-tariff barriers to trade, including a major simplification of licensing and certification rules and procedures; this should also include much tougher control over the trade restrictions imposed by sub-Federal levels of government. Limited and/or temporary special treatment for difficult sectors such as steel, automobiles, commercial aircraft, etc. Agree to reform public utility and other sectors where domestic prices currently distort industrial competitiveness. Continue the process of conforming to international technical standards and strengthen implementation.

Services. Agree to freedom of establishment and national treatment for foreign firms in sectors such as business services, insurance, banking and like, while improving domestic regulation. Introduction of such measures could be phased in gradually, over agreed transition periods, especially as regards foreign ownership of key service sector businesses.

Agriculture. Accept the late 1990s as the reference period for determining permitted subsidy levels, since Russia cannot afford to pay the higher subsidies it claims to want, and agriculture will

not become more efficient under a subsidy regime. Introduce other domestic reforms needed to support improvements in agricultural efficiency, including the development of an agricultural land market. Legal steps to protect the property rights position of those large farms already operating as successful commercial entities.

**Investment and Capital Flows.** Agree to national treatment for firms wishing to locate and invest in Russia, with far fewer restrictions on sector of operation, ownership shares, location, and the like, than exist at present. Otherwise, Russia should merely continue the existing programme of reforms intended, among other things, to improve the general investment climate in the country.

**Regional Alliances.** If Russia and the CIS partners wish the CIS Customs Union to be recognised by the WTO, this should be asked for in the negotiations. But as noted above, the Union is ineffective and not particularly beneficial to its members. Hence I would not recommend this approach.

In return for the above, WTO members should offer Russia unambiguous and across-the-board market economy status (as the US and the EU have already announced their intention to do), and should remove many of the QRs still in place to limit their imports from Russia.

## 7.2 How Will WTO Accession Affect Russia?

The short answer to this, especially in the short-run, is “not very much”. The trade regime, in so far as it concerns the level and structure of tariffs is unlikely to change drastically upon WTO accession. Given the pressures for wide-scale restructuring across the Russian economy, resulting from the reforms already undertaken during the 1990s, it is really hard to see that WTO accession could exert more than a small additional pressure for change.

However, in the longer term there will be substantial, and mostly highly beneficial and desirable effects. First the commitments associated with WTO accession will serve to lock in and reinforce Russia’s market-oriented reforms. Among other things, this fact alone will be good for investor confidence.

Second, loosening up key services sectors by permitting foreign firms to operate in Russia with full national treatment will do more to improve these sectors than the slow and erratic reforms seen in recent years. Russian firms will come under huge competitive pressure and many will fail - as they should! But some will prove able to adapt and compete, and they will become some of the Russian success stories of the next decade or two. The point is that we don’t know which of the existing firms will prove to be the winners - so there is no way that any form of government intervention or selective support would pick out the right companies, except by pure chance. Hence the importance of trusting to the market mechanism.

Third, in industrial sectors such as car production, aerospace, pharmaceuticals, food processing and many others, there are again some Russian firms capable of competing internationally, especially if they receive injections of the right kind of modernising technology, management expertise, marketing skills, and so on. But again, we have no way of knowing in advance which firms will succeed, and Russian government support programmes, if pursued, are likely to waste a great deal of money. It is far better, in my view, for Russia to join WTO, improve the general investment climate in the country, and welcome foreign investors to assist in the restructuring of major industries.

Fourth, it is worth noting a general observation based on a study of many countries around the world, namely that resource-rich countries tend to exhibit poorer economic performance, slower growth than resource-poor countries. Hence from the point of view of its long-term growth and development, Russia is almost certainly disadvantaged by its rich natural resources - it becomes an

economy of rents rather than an economy of innovation and productive investment. To change this, it is therefore even more important than already suggested to change the investment climate and create conditions for enormous amounts of new firm formation (Russia has about a fifth the number of firms that it should have!), including firms with foreign partners, foreign investment. The conditions associated with WTO accession can only be helpful here.

### 7.3 How Will WTO Accession for Russia Impact on EU-Russia Relations?

Since WTO accession will, to a large extent, merely require Russia to introduce further reforms along the lines already envisaged in the existing PCA, accession is likely to provide a good working framework for further improvements in EU-Russia relations. Moreover, EU enlargement, as we suggested above, ought to be a helpful factor, too, since the trade regime that Russia faces in Europe will be simplified, will generally involve lower tariffs than at present, and will cover over half of Russian foreign trade.

Some difficult areas still unresolved concern the status of Kaliningrad, issues of the possibly “hard” EU border following enlargement, and policies regarding sensitive sectors that currently receive special treatment within the EU - such as agriculture and steel - and will continue to do so. These difficulties will not go away, nor will they be “solved” by WTO accession. But in my view the combination of WTO accession, EU enlargement, and further developments in the framework of the existing PCA between the EU and Russia should enable all these matters to be managed reasonably well.

## References

Notes: 1. A few items below are marked as restricted. Such documents are not quoted in the above text, and any information in them is used only if it can be supported by at least one other public source.

2. The Russian government has established a very useful website associated with its WTO application. The site, which is in both Russian and English, contains many useful papers and documents related to WTO accession. The web address is: [www.wto.ru](http://www.wto.ru)

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## Annex 1: Russian Foreign Trade

**Table 1. Russian Merchandise Trade by Trading Partner, 1998 to 2000**  
(billion USD)

Exports to:	1998	1999	2000
European Union (15)	22.3	22.6	33.0
The CIS	13.7	10.7	14.6
Central and Eastern Europe	9.08	8.84	14.1
Turkey	2.16	2.37	3.88
United States	6.01	6.02	7.91
Japan	2.89	3.77	4.58
China	3.64	4.22	5.77
Other	13.5	14.3	21.4
Total Exports	71.3	71.8	105.2
Imports from:	1998	1999	2000
European Union (15)	22.8	15.1	17.8
The CIS			13.7
Central and Eastern Europe	3.52	1.88	2.02
Turkey	1.35	0.59	0.64
United States	3.58	1.84	2.09
Japan	0.98	0.48	0.57
China	1.84	1.50	2.23
Other			6.45
Total imports			45.5

Sources: UNECE Economic Survey of Europe, various issues; WTO International Trade Statistics 2001.

### Endnotes

i. Corruption opportunities arise when customs officials are offered bribes in order to classify a product into a product group where it would attract a lower tariff than it ought to have. See Hare (2001b).

ii. See Senik-Leygonie and Hughes (1992), Hughes and Hare (1992). For the technical details of the methodology, based on the calculation of domestic resource costs (DRCs) for each sector, see Hughes and Hare (1991). Note that if a sector has a negative DRC, it means that the value of its output in world prices is less than the value of the produced inputs used to generate the output. If such a sector were shut down, GDP measured in world market prices would increase. For the USSR/Russia, over 20% of industry was in sectors with negative DRC at the start of transition.

iii. This is not the place for a detailed account of the twists and turns of EU enlargement. But see Mayhew, 1998; Grabbe and Hughes, 1998. In addition, much documentation, including assessments of the individual applicants and their progress with the negotiations can be found on the website of DG Enlargement. The web address is:

[europa.eu.int/comm/dgs/enlargement/index\\_en.htm](http://europa.eu.int/comm/dgs/enlargement/index_en.htm)

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