



**DIRECTORATE-GENERAL FOR EXTERNAL POLICIES**  
**POLICY DEPARTMENT**



**THE ECONOMIC  
SIGNIFICANCE  
OF RUSSIA'S ACCESSION  
TO THE WTO**

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DIRECTORATE-GENERAL FOR EXTERNAL POLICIES OF THE UNION

**DIRECTORATE B**

POLICY DEPARTMENT

STUDY

**THE ECONOMIC SIGNIFICANCE  
OF RUSSIA'S ACCESSION TO THE WTO**

**Abstract**

This report considers Russia's recent accession to the WTO, assessing the implications that accession is likely to have on Russia's domestic economy and on its economic relations with the EU. The first section argues that despite the fact that Russia has experienced a fundamental transformation over the past two decades it faces a number of serious challenges. Overcoming these challenges successfully is likely to require the implementation of a significant economic reform package, with WTO accession representing only a small part of what is required. The second section outlines the most important commitments made by Russia as part of the accession agreement. A third section describes the likely effects on the Russian economy of accession. It is argued that the most important effects will be felt through increased flows of foreign direct investment in business services sectors. However, serious benefits will only accrue to Russia if it improves its investment climate. A fourth section argues that the nature of EU-Russia relations is unlikely to change dramatically unless the Russian economy experiences significant structural transformation. The conclusion suggests that WTO accession should be part of broader economic reform package if it is to result in any serious improvement in Russia's investment climate.

This study was requested by the European Parliament's Committee on International Trade.

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## EXECUTIVE SUMMARY

- Russia has experienced a fundamental transformation over the past two decades and now exhibits many characteristics that are common in other countries of a similar level of income, such as imperfect quality of governance, unhealthy close relations between state and business, etc. However, in other respects, Russia is far from normal. It is the world's largest energy producer, suffers from a number of negative legacies associated with decades of central planning, and appears to possess a much poorer quality institutional environment than countries with similar levels of income. If policy makers are able to find the formula to unleash Russia's investment potential there is a strong chance that the Russian economy can continue to progress along the path of positive transformation that it began just over twenty years ago, enabling it to deal with the myriad challenges confronting the country. WTO accession has the potential to help Russia along in this process.
- In order to achieve accession to the WTO, Russia has made a number of significant commitments and has agreed to apply all WTO provisions, with recourse to only a small number of transitional periods in especially sensitive areas. These commitments include: measures related to industrial goods, such as tariff reductions; measures related to agricultural goods, including tariff reductions and efforts to reduce technical barriers to trade; measures to improve market access in services, especially business services; measures to freeze or reduce export duties in a wide range of products; measures to ensure the protection of intellectual property rights; and measures to reduce of trade-related investment tools.
- The economic effects of WTO accession are unlikely to be significant in the short-term. However, in the medium- to long-term accession has the potential to contribute to faster GDP growth and welfare gains across much of the Russian economy. This potential will only be fulfilled, however, if accompanying reform of the domestic economy and business environment is carried out. Thus, for WTO accession to have any meaningful level of transformative effect on the Russian economy it will have to part of a much broader and ambitious reform package.
- Economic relations between the EU and Russia are currently characterised by asymmetries in size and production profiles, with the role of EU energy imports central to the economic relationship. WTO accession is unlikely to change the basis of the relationship between the two economies. Overall, the gains for the EU from Russia's accession are likely to be relatively modest. Although it is likely that, as Russia's largest trade and investment partner, EU firms will gain most from greater access to the Russian trade and investment markets. However, any significant shift in the volume and composition of trade and investment between the two countries will be contingent on positive developments in the Russian economy, including a robust and sustained rate of economic expansion and a resumption of vigorous economic reform.
- Overall, Russia's imminent accession to the WTO can mean as much as its leadership wants it to mean. If the President-elect, Vladimir Putin, implements a package of wider economic reform, WTO accession may act as a useful anchor to domestic reform. If, however, significant economic reform is not the agenda, WTO accession is unlikely to have a significant impact on the Russian economy.

## **1. INTRODUCTION**

On the 16<sup>th</sup> December, 2011, Russia's 18-year wait to join the WTO began to reach an end when WTO members invited Russia to join the organization, thus bringing to an end the rather anomalous absence of the world's largest country from the regime governing global trade. All that remains is for the Russian legislature, the State Duma, to ratify the Protocol of Accession. Thirty days after ratification, Russia will officially become a WTO member. Russia's accession will mean that in the future all of the world's major economies will be part of the WTO.

The protracted nature of Russia's accession to the WTO was due to a number of factors, ranging from fluctuations in the political will for accession in Moscow, to resistance from WTO members who failed to reach bilateral agreements with Russia. The process was further complicated in June 2009 when Russia announced the formation of a customs union with Belarus and Kazakhstan. Nevertheless, all remaining problems were resolved by the end of 2011.

In joining the WTO, Russia will have committed to bringing its trade laws and practices into compliance with WTO rules. These commitments include non-discriminatory treatment of imports of goods and services; binding tariff levels; ensuring transparency when implementing trade measures; limiting agriculture subsidies; enforcing intellectual property rights for foreign holders of such rights; and forgoing the use of local content requirements and other trade-related investment measures.

Russia will, in the future, be accountable to other WTO members, through WTO dispute settlement procedures, for fulfilling its WTO commitments. Likewise, Russia will be able to hold other WTO partners accountable for adhering to WTO rules, thus minimizing discrimination against Russian producers on world markets. Moreover, Russia will in the future play an important role in shaping the development of the international trade regime.

Many in Russia also hope that WTO membership will act as an external anchor for domestic economic reform. It is hoped that WTO accession will make Russia a more attractive location for foreign investment, which will in turn boost access to superior technology and practices for Russian firms, thereby helping Russia along the path of economic modernization. It is also anticipated that the injection of increased competition on domestic producers will encourage productivity growth in the Russian economy.

This study will examine the likely effects of Russia's accession to the WTO, focusing on the implications for Russia's domestic economic development, and also on the likely impact that membership will have on economic relations between the European Union (EU) and Russia. The first section offers an overview of the basic characteristics of the Russian economy. The next section describes the commitments made by Russia as part of the accession agreement. A third section considers the implications of WTO accession for the Russian economy, while the fourth section examines what accession will mean for EU-Russia economic relations. Finally, a concluding section summarises the main arguments and offers several proposals for EU policy makers.

## **2. THE RUSSIAN ECONOMY: AN OVERVIEW**

### **2.1 Basic characteristics**

Because of its large population, vast territory, and huge natural resource endowment, Russia is one of the most important economies in the world. Although its population has shrunk over the last two decades, at its current level of over 140 million, Russia has the largest population in Europe and the

eighth largest in the world.<sup>1</sup> At market exchange rates, Russia's gross domestic product (GDP) of just under \$1.5 trillion made it the world's eleventh largest economy in 2010. Using purchasing power parity (PPP) estimates, the Russian economy is even larger: with a GDP of around \$2.7 trillion it is the world's sixth largest economy. Russia's per capita income level of \$10,440 in 2010 make it what the World Bank describes as an upper middle-income country.<sup>2</sup> This figure is higher still using PPP estimates, with an income level of around \$19,000. Between 1999 and 2008 the Russian economy grew at a rate of roughly 7 per cent per year, making it one of the world's fastest growing large economies for that period. However, Russia fared exceptionally badly during the recent global financial crisis, experiencing a drop in output of nearly 8 per cent in 2009. Growth resumed in 2010, but the rate of expansion has moderated to around 4 per cent per year, significantly below the pre-crisis trend rate of growth.

## **2.2 Institutional features**

In the sense that the majority of decisions on the allocation of economic resources are not made by the state, but instead by individuals, households and corporations, Russia is a market economy. While the 1990s was a period of tumultuous change for Russia, the foundations for a market economy were put in place. According to data from the European Bank for Reconstruction and Development (EBRD), the private sector accounts for around two thirds of GDP. Given that, little over twenty years ago, Russia was the core component of the world's most powerful socialist economy, this is an impressive transformation.

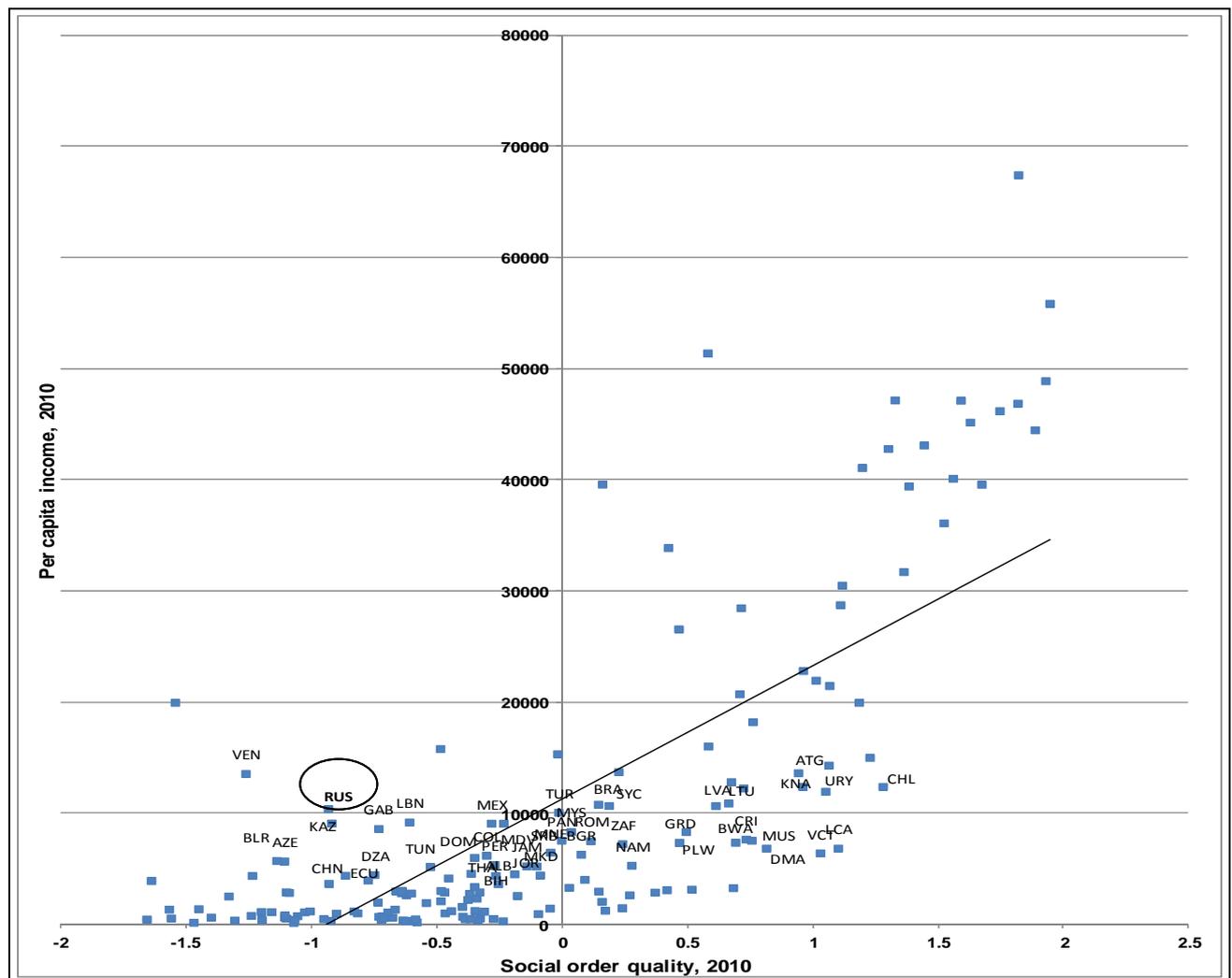
Russia, however, is a rough and imperfect version of a market economy and can be best described as a limited access order (LAO; see North, Wallis and Weingast, 2009). LAOs are societies in which organizations limit market entry and competition to ensure that individuals or organizations (whether it be the state or firms) with market power can accrue rents. The creation of rents by states in LAOs is a consequence of the purposeful creation of differential access for individuals or organizations to the goods and services that the state can provide, such as enforcement of property rights and contracts, legal systems, etc. LAOs tend to exhibit relatively low levels of governance and democratic control, weak standards for the rule of law, and higher levels of corruption. The state, because of its role in the creation and distribution of rents, tends to be active in controlling or influencing significant portions of the economy.

In Russia, while the private sector accounts for the majority of economic activity, the state controls or exerts a high level of influence in a number of strategically important sectors of the economy, such as oil, gas, and finance. As a result, the institutional environment in Russia is not one which is wholly supportive of business activity, leading to a number of negative outcomes, including high barriers to entry which weaken competitive tendencies within the economy, poor performance in innovative activities, relatively low levels of private investment, and, ultimately, lower rates of growth than would otherwise be possible. Although a poor institutional order is quite common in middle-income countries, Russia's situation appears especially poor. From a sample of the World Bank's upper middle-income countries, Russia's social order quality is better than only three other countries: Azerbaijan, Belarus, and Venezuela (Figure 1).

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<sup>1</sup> All data, unless otherwise specified, are taken from the World Bank Development Indicators database.

<sup>2</sup> In 2011 there were 54 such countries according to the World Bank. Upper middle-income countries have per capita income levels of between \$3,976 and \$12,275. Russia is, therefore, located towards the upper end of its income group.

**Figure 1.** Social Order Quality and Per Capita Income Levels, 2010<sup>3</sup>

Source: Bank, *Governance Indicators* (2012); World Bank *Development Indicators* (2012)

### 2.3 International trade and investment

Whilst making the transition to a market-based economy, Russia has become more closely integrated with the wider global economy. A country's integration with the global economy can occur along three main dimensions: through international trade in goods and services; through cross-border capital flows; and through cross-border flows of people (i.e., migration). Because of their relevance to Russia's accession to the WTO, this section considers the first two of these dimensions.

The role of trade in the Russian economy is comparatively high: the sum of imports and exports as a proportion of GDP (a common measure of trade openness) was 52 per cent in 2010. This is comparable to other large, open economies such as China (55 per cent), France (53 per cent), Turkey (47 per cent), and India (46 per cent). Russia is, therefore, quite an open economy for a country of its size. Compared

<sup>3</sup> The social order measure is a composite index utilizing three of the six World Bank Governance Indicators: voice and accountability, rule of law, and control of corruption. Scores range between - 2.5 (the lowest level on each indicator) to +2.5 (the highest level on each indicator). The composite score is a simple un-weighted average of the three component indicators.

to some advanced economies, Russia is less open than the EU (79 per cent, but which comprises a number of small countries), but more open than the USA (28 per cent) and Japan (29 per cent).

Russia's trade structure has been quite stable for some time. In terms of exports, around 80 per cent of its merchandise exports are primary and resource-based products, such as hydrocarbons, metals and minerals, with a very limited share of medium- and high-technology goods in Russia's export profile (Cooper, 2006; Connolly, 2008). As the world's largest energy producer, this should not be a surprise. Russia tends to import processed goods, especially capital and consumer goods. Although domestic services growth has been relatively high, the role of services in Russia's trade profile has been less impressive, with the ratio of services trade to GDP declining from 10 per cent in 2000 to just over 8 per cent in 2010.

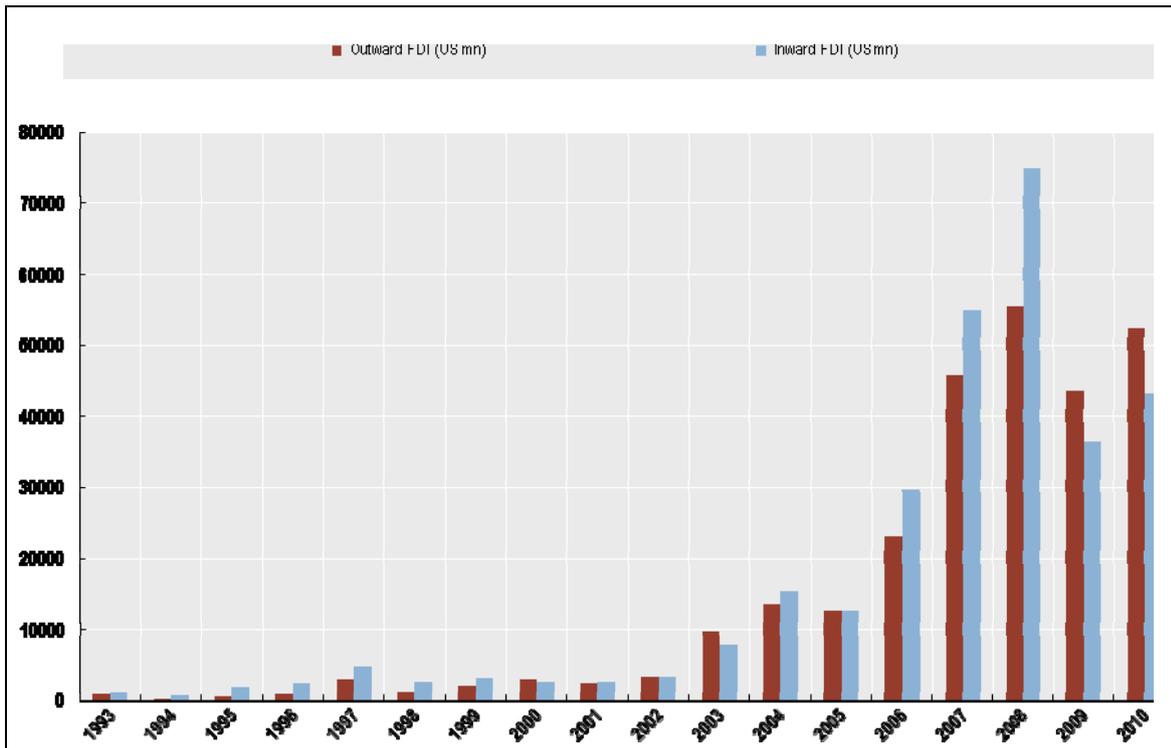
Integration with the global economy has seen a significant shift in the direction of Russia's trade. On the one hand, the majority of Russia's trade continues to take place with the EU, with the EU accounting for around half of Russia's exports, and 43 per cent of Russia's imports in 2010, levels comparable to that observed in the past two decades (IMF, 2012).<sup>4</sup> However, the role of former Soviet countries in Russian trade has declined dramatically in recent years. In 1995, CIS countries accounted for 19 per cent of Russia's total exports and 29 per cent of Russia's total imports. By 2010, this had declined to just 7 and 9 per cent respectively (IMF, 2012). In place of the CIS, exports to fast growing emerging economies like China, India and Turkey have grown rapidly, while imports from China alone now constitute around 18 per cent of Russia's total imports, up from just 2 per cent in 1995 (IMF, 2012).

Flows of foreign direct investment (FDI), both inward (IFDI) and outward (OFDI), have grown substantially in the last twenty years (Figure 2). The dismal performance of the economy in the 1990s caused inward flows of FDI to remain low until 2003. Thereafter, flows of both IFDI and OFDI grew at a rapid rate, reaching a peak in 2008 before the onset of severe recession caused FDI flows to almost half. This reversal in fortunes can be attributed to "sluggish local demand, declining expected returns of ventures related to natural resources, and the drying-up of round-tripping FDI" (UNCTAD, 2010). The sectoral composition of IFDI varies quite dramatically with each year, but in recent years the three most popular sectors have been mining and quarrying, manufacturing, and financial intermediation (Rosstat, 2012). Moscow City and the surrounding region account for the largest proportion of IFDI, followed by resource rich regions, such as Sakhalin and Omsk.

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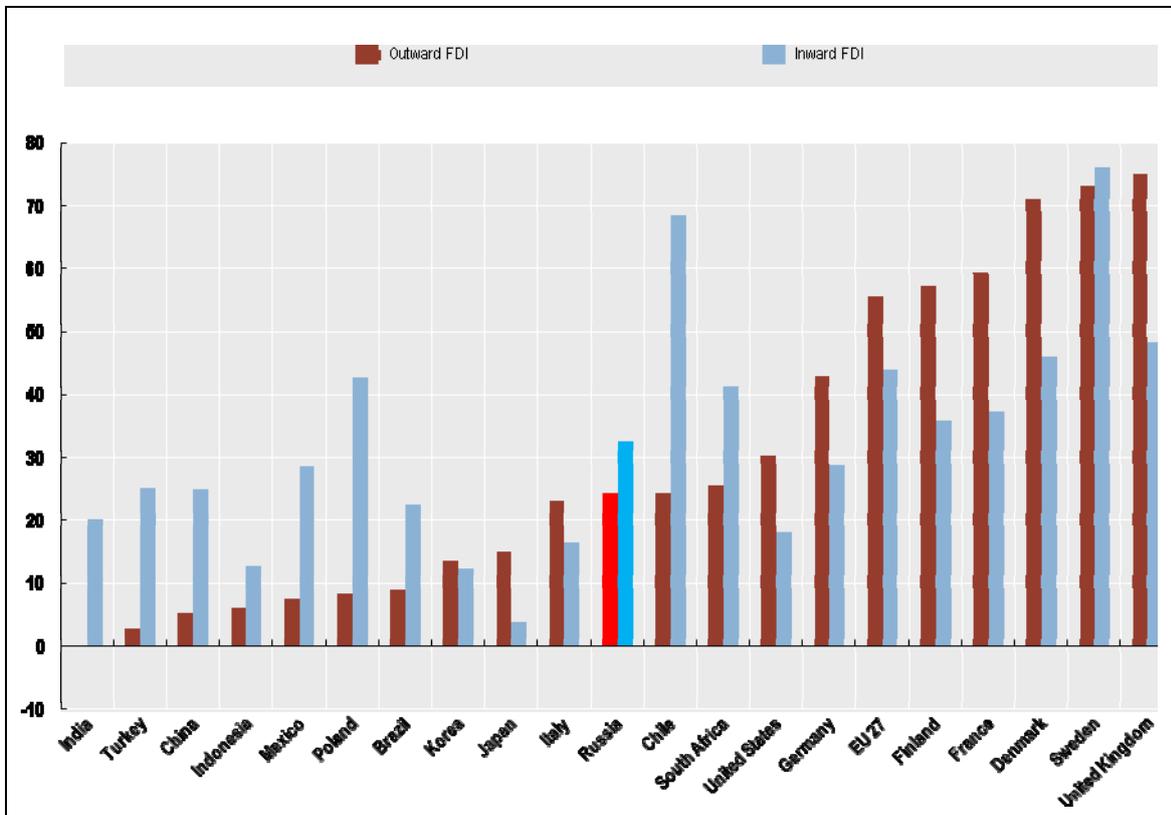
<sup>4</sup> More details on EU-Russia economic relations are contained in Section 4.

**Figure 2.** Russia’s Flows of Inward and Outward Foreign Direct Investment, 2000-2010



Source: Central Bank of Russia, *Balance of Payments* (March, 2012)

**Figure 3.** FDI Stocks as a Percentage of GDP: Russia Compared, 2010 or Latest Available Year



Source: OECD, *Factbook* (2012)

The growth in IFDI flows over the past decade has caused IFDI stocks to rise and strengthened Russia's comparative international investment position (Figure 3). Indeed, Russia's share of global FDI exceeds its share of global GDP, whether measured at market exchange rates or purchasing power parity (Hanson, 2010). In 2010, Russia's stock of IFDI was 32.7 per cent of GDP, a ratio that exceeded many large emerging economies, including Brazil, China, India, Indonesia, Mexico and Turkey, as well as some more advanced economies, such as Korea and Italy.

What is perhaps most striking is Russia's unusually high ratio of OFDI to GDP. Russia's ratio of OFDI is considerably higher than nearly all other emerging economies as well as advanced economies like Japan and Italy.<sup>5</sup> Large Russian enterprises are active in the acquisition of foreign companies, usually as Russian energy or metals firms acquire 'downstream' assets ('market-seeking' OFDI), or because of the desire to acquire foreign technologies or technological capabilities and know-how ('technology-seeking' OFDI).

Russian firms have also shown a desire to engage in joint ventures (JVs) with foreign firms, again, usually as a means to accessing foreign technologies. Prominent examples include Boeing's JV with VSMPO-Avisma, the collaboration between Sukhoi and Finmeccanica in the development of the Superjet 100 airliner, and Gazprom's Achimgaz JV in western Siberia with the German energy group, Wintershall.

## 2.4 Domestic economic structure

Russia's economic structure is shaped by several important factors, including: *geography*, especially its huge natural resource endowment; the *legacies of central planning*, such as the economically irrational location of production across Russia (e.g., Hill and Gaddy, 2003); and *market-generated changes in economic behaviour* since 1991, such as the rise in importance of the service sector and the decline in, for example, the textile industry. It is possible to make several observations on the basic contours of Russia's domestic economic profile.

First, agriculture still accounts for a relatively large share of Russia's economic output. At 4.7 per cent, Russia has a larger share of agriculture in total value added than the EU-27 average of 1.7 per cent (OECD, 2012).

Second, the share of industry is also comparatively high, accounting for 27.3 per cent of value added in Russia and only 18.7 per cent in the EU. On the one hand, the socialist legacy of over-industrialisation is important (other post-socialist countries register higher than average shares for industry). It should be noted, however, that industry does include energy and other mining activities; as such, it is not surprising that the share of industry is so high in Russia given its position as the world's largest energy producer.

Third, service sector activity is, as a proportion of total value added, closing in on levels observed in the EU. In 2010, services accounted for 68 per cent of total value added in Russia, compared to the EU average ratio of 79.7 per cent, and ratios of 50 per cent for China and 49.7 per cent for Indonesia.

Thus, it is clear that over two decades of economic transformation in Russia has resulted in an economy that is closer in structure to its rich EU neighbours than it is to some other large, low- and middle-income countries. Where Russia does appear to diverge quite notably from richer countries is the market structure of Russian industry. Here, large enterprises account for a large proportion of output and employment. For example, according to Expert, a Russian business publication, the 100 largest

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<sup>5</sup> It should be noted, however, that Russian companies invest far more than is normal (by international standards) in tax havens, such as the British Virgin Islands, Bermuda, Cyprus and Switzerland. Some of this OFDI is then repatriated in the form of IFDI, thus inflating the 'real', non-Russian FDI flows, both inward and outward.

enterprises accounted for nearly 60 per cent of Russian GDP in 2007. Nevertheless, small and medium enterprises (SMEs) have, despite the sometimes perilous business environment, grown at a brisk rate in recent years: according to OPORA data, the number of active SMEs in Russia has almost doubled from 843,000 in 2001, to over 1,600,000 in 2009, accounting for over 20 per cent of GDP.

## 2.5 Immediate challenges

If Russia has made remarkable progress in recent years, there remain a large number of serious problems that must be confronted in the near future. In particular, the severe recession of 2008-09 prompted the leadership into publically acknowledging the urgent need for economic modernization and diversification.<sup>6</sup> This shift occurred as a number of challenges facing the Russian economy became more apparent, including:

- average productivity levels in the economy remains low by international standards, notwithstanding wide regional and sectoral differences (McKinsey, 2009);
- the role of the state in the economy increased gradually since 2002, weighing down on productivity and competition;
- the dependency ratio is projected to rise from 2010 onwards as the labour force shrinks;<sup>7</sup>
- the era of fiscal stability appears to be at risk after federal spending rose amidst current and planned increases in expenditure, especially in the military and social (public sector wages, pensions and other transfers) spheres;<sup>8</sup>
- continued weak competition in many product markets, with the OECD (2009) estimating that the share of highly concentrated markets in Russia increased from 43 per cent to 47 per cent between 2001 and 2007;
- the financial system remains poorly developed, restricting access to finance in the economy (Connolly, 2011a);
- the shortage of modern infrastructure is reaching levels which might constrain economic growth (Gurieiev, 2010).

Added to Russia's well documented institutional weaknesses, the list of challenges facing the Russian economy looks extremely daunting. However, there is a common solution to most of these problems: a sustained increase in the level of private investment. Higher private investment should, all things being equal, facilitate the diversification and modernization of the economy, relieve the pressure on the level of industrial capacity utilization, raise productivity levels, enable a smaller and older population to generate higher levels of output; and facilitate a faster rate of entry of firms which will generate

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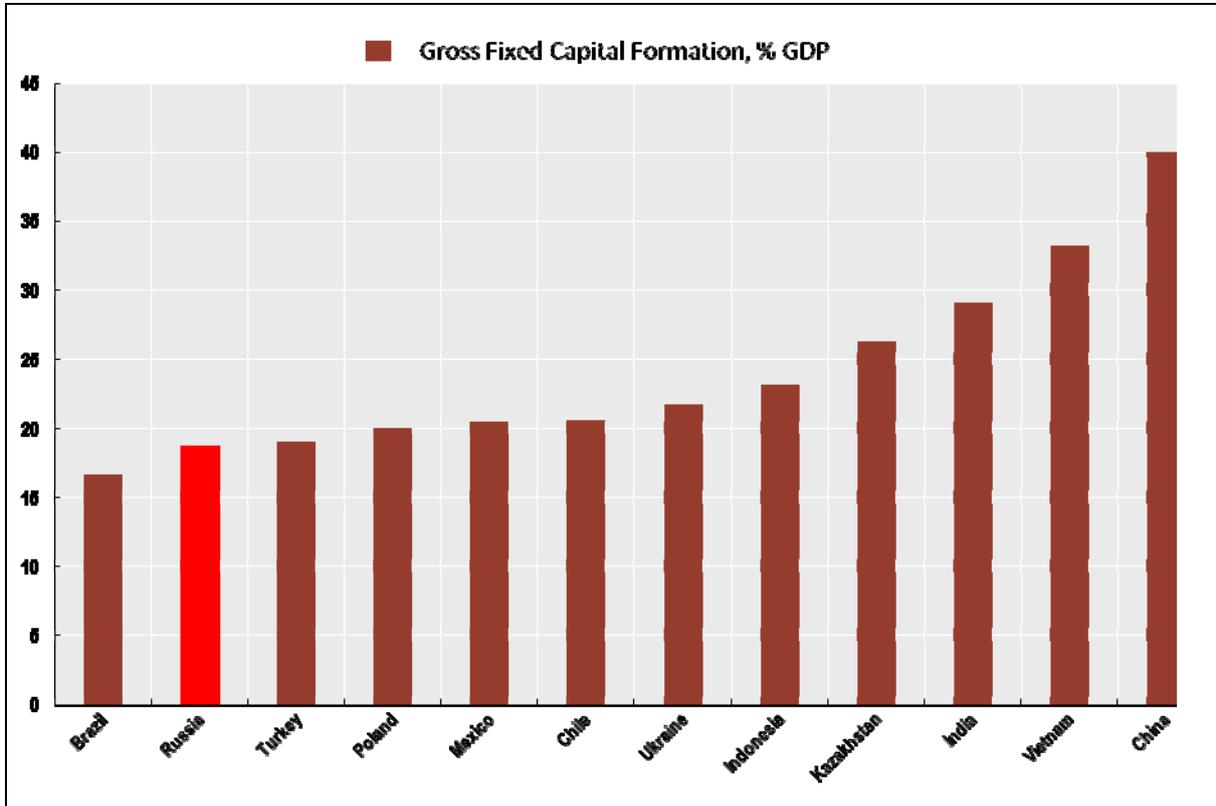
<sup>6</sup> See, for example, Medvedev (2009a and 2009b).

<sup>7</sup> The dependency ratio is a measure of the portion of a population which is composed of dependents (people who are too young or too old to work). The dependency ratio is equal to the number of individuals aged below 15 or above 64 divided by the number of individuals aged 15 to 64. In 2010, the dependency ratio in Russia was 0.39, the lowest level in over 50 years. However, it is projected to rise each year until 2055 when it is expected to reach 0.73. Data taken from United Nations Population Division (2012).

<sup>8</sup> In 2011, the central government fiscal balance was in surplus by 0.8 per cent of GDP. Russia also has one of the lowest levels of central government debt in the world (c.10 per cent of GDP). However, the Russian budgetary balance is highly sensitive to fluctuations in the price of oil, Russia's primary export product. In 2009 and 2010, when oil prices were considerably lower than they were in 2011, Russia exhibited a significant budget deficit. Moreover, because of costs associated with an ageing population and public spending promises made by Vladimir Putin during the 2012 election campaign, the level of public expenditure is expected to rise sharply, exceeding 40 per cent of GDP within a few years. Given that public spending was just 31 per cent of GDP in 2006, this represents a considerable increase.

increased competition. Unfortunately, the level of investment in Russia is low when compared to other emerging economies (Figure 4). Raising the level of private investment is, therefore, one of the most important challenges confronting policymakers in Russia today. It is also highly relevant to this report because WTO accession has the *potential* to cause a rise in investment, both foreign and domestic.

**Figure 4.** Gross Capital Formation, 2000–2010 Average (percent of GDP)



Source: World Bank, *Development Indicators* (2012)

## 2.6 Positive aspects of transformation

Whilst the Russian economy is confronted by many challenges, there are a number of positive developments that should not be overlooked. First, at around 4-5 per cent, Russia's current rate of GDP growth is considerably higher than the EU average. If relative growth rates persist, the Russian economy will become larger than the major EU economies over the next few decades (O'Neill, 2011). Second, despite low competition and the poor investment environment, parts of Russian industry have made considerable progress with increasing numbers of firms engaging in productivity enhancing and innovative activities (Kuznetsov et al, 2011). Third, as noted above, SME activity has grown rapidly and is contributing to a gradual 'spontaneous' diversification of the Russian economy. Fourth, although the financial system is underdeveloped it has, in recent years, shown signs of improvement and, with private sector credit to GDP ratios among the lowest in the world, there is much scope for credit expansion in the future (Connolly, 2011a). Fifth, Russia has among the lowest public sector debt to GDP ratios of the world. Sixth, Russia possesses the world's third largest stock of foreign currency reserves. Seventh, Russia's population is, at least compared to countries of a similar income level, relatively well educated.

## 2.7 Summary

To sum up, the Russian economy has experienced a fundamental transformation over the past two decades. In many ways, Russia is, in a statistical sense at least, a normal country. This means that Russia exhibits many characteristics that are common in other countries of a similar level of income, such as imperfect quality of governance, unhealthy close relations between state and business, etc. However, in other respects, Russia is far from normal. It is the world's largest energy producer, suffers from a number of negative legacies associated with decades of central planning, and appears to possess a much poorer quality institutional environment than countries with similar levels of income. If policy makers are able to find the formula to unleash Russia's investment potential there is a strong chance that the Russian economy can continue to progress along the path of transformation that it began just over twenty years ago, enabling it to deal with the myriad challenges confronting the country. WTO accession has the potential to help Russia along in this process. However, as is argued in subsequent sections, whether this potential is unlocked will largely be determined by decisions made within the Russian policy elite.

## 3. WTO ACCESSION: RUSSIA'S COMMITMENTS

Negotiations on the terms of Russia's accession to the WTO began in 1994 when Russia filed the 'Memorandum on the Foreign Trade Regime' that began the process for General Agreement on Trade and Tariffs (GATT)/WTO accession. Russia completed most bilateral negotiations by 2009 and resolved the final outstanding issues with Georgia in November 2011. In order for Russia to accede to the WTO, it has agreed to comply with the terms of all WTO agreements, including GATT 1994, the General Agreement on Trade in Services (GATS), and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). By the time that negotiations were completed at the end of 2011, Russia had agreed to apply all WTO provisions, with recourse to only a small number of transitional periods. The main terms and conditions negotiated through Russia's bilateral discussions with individual members and through negotiations with the Working Party are summarised below.<sup>9</sup>

As part of the accession, Russia concluded 30 bilateral agreements on market access for services, and 57 such agreements on market access for goods. The main commitments can be grouped under the headings of: (1) measures related to industrial goods; (2) measures related to agricultural goods; (3) market access in services; (4) export duties; (5) intellectual property rights; (6) trade-related investment measures; and (7) other commitments.

### 3.1 Measures related to manufactured goods

The aggregate tariff level in Russia was already quite low (for all goods, around 10 per cent), something that was the result of trade liberalisation in the early 1990s. On average, the final legally binding tariff ceiling for the Russian Federation will be 7.8 per cent compared with a 2011 average of 10 per cent for all products.<sup>10</sup> The ceiling average for manufactured goods will be 7.3 per cent, down from the 9.5 per cent average today on manufactured imports. Just under 40 per cent of Russia's tariff lines will have their final bound rates implemented upon accession, and over 80 per cent will have their final bound rates implemented within 3 years. In addition, Russia has also committed to eliminating all industrial

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<sup>9</sup> A full description can be found at: [http://www.wto.org/english/thewto\\_e/acc\\_e/a1\\_russie\\_e.htm](http://www.wto.org/english/thewto_e/acc_e/a1_russie_e.htm).

<sup>10</sup> WTO members are required to set limits or *bindings* on tariff rates. Frequently the *bound* tariff rates are higher than the actual or *applied* tariff rates, allowing the country some flexibility in its tariff policies but also providing exporters to the market assurances that tariffs will not exceed established ceilings.

subsidies, or to at least ensure they are not dependent on exportation or favour local goods over imports. The main commitments are outlined in Table 1. The effective reduction in prices of imported goods is expected to benefit Russian consumers of such products, while exposing Russian producers to greater competition. As a result some producer lobbies in Russia have resisted the imposition of competitive pressures during the negotiations, and are likely to press for other, non-tariff forms of protection in the future.

**Table 1.** Binding tariff rates in selected manufacturing sectors of the Russian economy according to the terms of the WTO accession agreement<sup>11</sup>

Category of goods	Average bound tariff after full implementation period (per cent)
Automobiles	12
Wide-bodied aircraft	7.5
Narrow-bodied aircraft	12.5
Aerospace engines	5
Machinery	7.2
Construction equipment	5.5
Electrical machinery	6.2
Medical equipment	4.9
Medicines	5.0
High-tech equipment	4.4
Chemicals	5.2
Plastics	6.2
Steel products	6.0
Agricultural equipment	5.6
Consumer goods	2.0
Textiles, apparel, footwear, and travel goods	11.0
Information technology products	0.0

Of the sectors described in Table 1, two industries in particular were given more time to adjust to lower tariffs: automobile and civilian aircraft manufacturers. The agreement states that the tariff rate for *automobiles* will be reduced to 12 per cent (from 15.5 per cent). Russia has committed to implementing reducing tariffs in full within seven years of accession that includes a commitment to eliminate preferential tariffs for carmakers making large investments in Russian-based production by July 1<sup>st</sup>, 2018. This was an especially important issue during negotiations because, in January 2011, Russia introduced tougher rules for foreign automobile manufacturers planning new ventures in Russia. These rules raised the local component requirement from 30 per cent to 60 per cent, imposed a \$500 million minimum investment threshold, and raised the production threshold from 25,000 to 300,000 vehicles. Several European car manufacturers had already agreed to these terms, largely because the gains of access to Russia's large and growing car market outweighed the costs imposed by the new rules. On the part of the Russian government, this rule was, and remains, a central component of Russian industrial policy aimed at reinvigorating domestic automobile manufacturing. As a result, preserving the new rules for seven years was an important part of the Russian negotiating position;

Russia also agreed that the tariffs for wide-body aircraft would be no higher than 7.5 per cent (from 20 per cent), tariffs on narrow-bodied aircraft no higher than 12.5 per cent (from 20 per cent), and tariffs on aerospace engines an average of no higher than 5 per cent (from 10 per cent). Russia has committed to reducing tariffs by half within 4 years of accession, and in full within seven years. As in the case of the automobile industry, the Russian government has for some time considered the development of the civilian passenger jet industry as an area requiring state support. Regional jets, such as that being produced by Sukhoi, are considered a priority. Therefore, the phased introduction of new tariffs gives Russian civilian passenger jet manufacturers a short window of protection in which the Russian government hopes it is possible to develop a competitive range of products;

Other sectors in which the terms of the accession agreement will likely weaken the industrial policy instruments at the disposal of the Russian government include medicines, hi-tech instruments, and information technology equipment. All three areas have, in recent years, been identified by the Russian government as areas in need of protection so that strong domestic production capacities might be developed. In all three areas, import penetration is already very high, and, as a result the scope for large increases in imports are already largely exhausted. WTO membership means that any efforts to stimulate what are government priority areas will have to be in line with existing rules. This may constrain Russian efforts to forge ahead in high-technology sectors. Other areas not identified by the Russian government as potential objects of industrial policy that are already characterised by high import penetration include consumer goods, textiles, apparel and footwear.

### **3.2 Measures related to agricultural goods**

Russia currently applies high tariffs and tariff-rate quotas (TRQs) on agricultural imports.<sup>12</sup> This is due to the fact that Russian agricultural producers have, in many sub-sectors at least, been vociferous opponents of competition from foreign producers. Russia inherited a desperately weak agrarian sector from the Soviet Union, and the sector has suffered from many years of unclear property rights and chronic underinvestment. Consequently, import barriers – of both a tariff and non-tariff nature – have played an integral role in sustaining what remains an important and comparatively employment intensive sector of the Russian economy (see section 1.4). Indeed, there has been much evidence that Russia has systematically applied sanitary and phytosanitary (SPS) controls, which are ostensibly used to protect the health and safety of consumers from food contaminants, as protectionist measures. Russia has, under the terms of the accession agreement, committed to reduce tariffs for agricultural goods. The average tariff ceiling for agriculture products will be 10.8 per cent, lower than the current average of 13.2 per cent (see Table 2 for a summary). Russia has also committed to adhere to the provisions of the WTO Sanitary and Phytosanitary (SPS) Agreement when imposing measures to protect human, animal, or plant life or health, with the main objective being to prevent WTO members from using such measures as disguised protectionism. Whilst gains from the reduction of cumbersome sanitary and phytosanitary controls for export of food to Russia will not arise automatically, they should emerge over time as a result of concrete complaints made by foreign companies to the WTO. Previously, these complaints had little effect, but now they can be raised in the WTO, which has a recognized and well-functioning arbitration process and can levy substantial penalties.

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<sup>11</sup> Cited figures are effective upon the completion of the full implementation periods for each category of goods.

<sup>12</sup> TRQs allow countries to establish a specific volume of products that can be imported at a relatively low tariff rate, but impose much higher tariffs on imports over the quota.

**Table 2.** Binding tariff rates in selected agricultural sectors of the Russian economy according to the terms of the WTO accession agreement<sup>13</sup>

<b>Category of goods</b>	<b>Average bound tariff after full implementation period (per cent)</b>
Dairy products	14.9 (from 19.8)
Cereals	10 (from 15.1)
Oilseeds, fats, and oils	7.1 (from 9)
Wood and paper	8.0 (from 13.4)
Sugar	\$222/t (from \$243/t)
Wine	12.5 (from 20)
Breakfast cereals	10 (from 15)

In addition, tariff-rate quotas (TRQs) will be applied to beef, pork, poultry and some whey products. These are considered to be especially poorly performing sub-sectors of Russia's agricultural economy, and concessions made by Russia during accession negotiations have been subject to considerable resistance from the agrarian lobby. Imports entering the market within the quota will face lower tariffs while higher duties will be applied to products imported outside the quota. The in-quota and out of quota rates are listed below with the out of quota rates in parentheses:

- For beef 15 per cent within a quota of 530,000 tonnes (and 55 per cent);
- For pork zero within a quota of 400,000 tonnes (and 65 per cent). The TRQ for pork will be replaced by a flat top rate of 25 per cent as of 1 January 2020;
- 25 per cent within a quota of 350,000 tonnes (and 80 per cent) for some selected poultry products;
- 10 per cent (and 15 per cent) for some whey products;
- Some of these quotas are also subject to member-specific allocations

In general, agriculture is among the sectors that is considered to be most at risk from WTO accession, although some sub-sectors within agriculture are better prepared than others. For example, Russia is extremely competitive in the production and export of grain. Some advantages of experience on the local market will also remain and there are many products that will not be profitable to import even after tariff reductions. Prices for basic foodstuffs, such as milk, grain, sunflower oil, and sugar, are already level with world price levels, and the businesses importing the goods would have to pay the costs of transportation. As such, it would not make sense for firms to import, say, grain for use on the Russian market.

On the other hand, live-stock farmers are likely to be most negatively affected by the accession terms, especially pork and poultry farmers, as well as dairy product producers. It is possible that the Russian government will choose to use subsidies to support distressed farmers. There is certainly scope for this

<sup>13</sup> Cited figures are effective upon the completion of the full implementation periods for each category of goods.

as the accession agreement calls for Russia to half permitted subsidies from a maximum of \$9 billion in 2012 to \$4.4 billion in 2018. This should not be too onerous since Russia currently spends only around \$5.6 billion on agricultural subsidies. Moreover, only around half of Russia's current subsidies to the agricultural sector are in so-called "green box" areas (i.e., indirect spending on, for example, infrastructure), leaving Russia with plenty of scope to expand its indirect subsidies. In addition, the Russian government may acquiesce to demands from the agrarian lobby to forgive outstanding debts owed by farmers, or to extend the zero tax rate on farm profits which is currently due to expire in 2013. The government has indicated a willingness to privatise sections of the agricultural sector, with stated commitments including the privatisation of 100 per cent of United Grain Company by 2012, as well as privatising 50 per cent plus one share of Rosagroleasing (aka Rosagrolizing) no sooner than 2013. Should such privatisation be carried out alongside increased indirect spending, it is possible that the worst fears of the agrarian lobby will not be realised.

### **3.3 Services**

Russia has made specific commitments on 11 services sectors and on 116 sub-sectors. Some of the most notable commitments in service sectors include:

- *Telecommunications*: the foreign equity limitation (49 per cent) would be eliminated four years after accession. Russia agreed to apply the terms of the WTO's Basic Telecommunications Agreement. Russia also agreed to eliminate the government monopoly on land-line long distance services and to allow foreign-owned telecommunications companies to operate in any telecommunications sector;
- *Insurance*: foreign insurance companies would be allowed to establish branches nine years after accession;
- *Banking*: foreign banks are permitted to establish subsidiaries. There will be no cap on foreign equity in individual banking institutions, but the overall foreign capital participation in the banking system of the Russian Federation would be limited to 50 per cent (not including foreign capital invested in potentially privatized banks). Such limits should not be viewed too dimly, however: foreign banks' share of total Russian assets is currently around 18 per cent (Connolly, 2011a), well below the current 25 per cent limit. Clearly the old limit did not act as a binding constraint on foreign involvement in the Russian banking system, so the new increased limit is unlikely too, either. One can argue that the foreign banks that want to operate in Russia are already there, and there were no particular restrictions placed on their arrival. Banks such as Unicredit, Citibank, Raiffeisen, and Rosbank, which now belongs to Societe Generale, are already among the top fifteen banks in Russia;
- Russia refused to allow foreign banks to open branches in Russia, but will allow foreign banks to open subsidiaries (so-called "daughter" banks) which come under the regulatory control of the Russian central bank. Russia has agreed to discuss the issue of bank branching upon the initiation of negotiations for membership of the Organization of Economic Cooperation and Development (OECD).
- *Transport services*: Russia has made commitment to open up its market in maritime and road transport services, including the actual transportation of freight and passengers. Imported goods will now be charged the same freight rates as domestic goods, something that it is a significant concession given the monopolistic position of Russian Railways and the distances involved in accessing Russian markets;

- *Distribution services*: Russia will allow 100 per cent foreign-owned companies to engage in wholesale, retail and franchise sectors upon accession to the WTO;
- *Professional services and business services*: Russia has agreed to increase market access for foreign providers of professional services and business services, including lawyers, architects, accountants, engineers, health care professionals, advertising, and market and management services. It will permit foreign-owned companies to establish 100 per cent owned business service companies in Russia. As is discussed in section 3, opening up in the area of business services have been estimated as offering the greatest prospects for welfare gains in Russia.

### **3.4 Export Duties**

Russia maintains export duties on hydrocarbons, scrap metals, raw materials, and other strategic materials. Export duties will be fixed for over 700 tariff lines, including certain products in the sectors of fish and crustaceans, mineral fuels and oils, raw hides and skins, wood, pulp and paper and base metals. One area of particular concern to the EU, and especially Finland, was the introduction, in 2007, of export duties on raw lumber to give an advantage to Russian domestic lumber processors. Bilateral negotiations resulted in Russia agreeing to abandon a planned increase from 25 per cent to 80 per cent in export duties and instead to establish export quotas with export duties ranging from 13-15 per cent, depending on the type of lumber. Russia will also cut export duties on ferrous waste and scrap from (the lower of) 15 per cent or 15 euros per tonne in the year of accession to 5 per cent or 5 euros per tonne over 5 years.

### **3.5 Intellectual property rights**

The lack of intellectual property rights (IPR) protection has been identified as a weak feature of the business climate in Russia for some time. IPR protection was an important issue in Russia's bilateral negotiations with the EU. Intellectual property owners, such as software creators, movie companies, and music producers, view WTO accession as an opportunity to secure Russian commitments to stronger IPR protection. Russia has committed to:

- lower the threshold for taking action against trademark counterfeiting and copyright piracy;
- take actions against the operation of websites (with servers located in the Russian Federation) that promote illegal distribution of content protected by copyright or related rights;
- investigate and prosecute companies that illegally distribute objects of copyright or related rights on the Internet;
- strengthen border enforcement against piracy;
- fully apply the provisions of the WTO Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS) including provisions for enforcement, without recourse to any transitional period.

So far, Russia has redrafted section IV of its Civil Code to address intellectual property issues. A new court is to be created (by July 2013) that will deal exclusively with IP matters, employing 30 judges recruited to specialising in this area. Elsewhere, a law passed in October 2010 obliges Russian producers of generic drugs to negotiate agreement with the patent holders when using clinical trial data. The commitments made to improving the formal legal protection of IPRs is laudable; however, as discussed in section 3, ensuring that Russian practice conforms to the formal rules is far from assured. This is the

case in a number of other WTO members (China, for example), so Russia is not an entirely unusual case in this respect.<sup>14</sup>

### **3.6 Trade-related investment measures (TRIMS)**

The WTO TRIMS agreement is intended to prevent members from employing restrictions on foreign direct investments that distort trade in goods. Such measures include local content requirements that require that a certain level of inputs (raw materials, parts) used by foreign-invested firms be of domestic origin. The TRIMS agreement also prohibits WTO members from using trade-performance requirements, for example, requiring foreign direct investors to export specific shares or amounts of their output. As a result of negotiations, Russia has agreed to ensure that all laws, regulations and other measures related to the Agreement on Trade-Related Investment Measures would be consistent with the WTO provisions. All WTO-inconsistent investment measures, including preferential tariffs or tariff exemptions, applied in relation to the existing automobile investment programmes and any agreements concluded under them would be eliminated by 1 July 2018. No other trade related investment measures inconsistent with the WTO Agreement may be applied after Russia's accession to the WTO. The industry most affected by this commitment will be the automobile industry as there are currently a range of local-content requirements in place aimed at promoting domestic automobile production (see section 2.1).

### **3.7 Other commitments**

*Aviation:* Russia will amend the rules on aircraft leasing to ensure that foreign-made aircraft can qualify for the same benefits and are as attractive to Russian airlines as Russian-made planes. However, Russia does not plan to join the WTO Agreement on Trade in Civil Aircraft. The EU did manage to secure the elimination of over flight charges in which payments by foreign airlines were made to the Russian carrier, Aeroflot.

*Energy:* Energy is largely outside the purview of WTO agreements. As a result, the commitments presented here refer to the restriction of subsidies and dual pricing practices more generally. Nevertheless, during the accession negotiations, the EU expressed concerns about the Russian government policy on subsidizing natural gas prices for domestic users. They argued that such subsidies gave Russian producers in energy-intensive industries, such as steel production, an unfair advantage over foreign competitors. Russia agreed to price natural gas at market prices to commercial users, but will still be able to subsidize prices to households and other non-commercial users.

## **4. IMPLICATIONS FOR THE RUSSIAN ECONOMY**

The commitments made by Russia described above are considerable. In return, Russia will benefit from greater certainty in its trade relations with other WTO members. Russia will be able to appeal to the WTO if it believes that another WTO member has violated those rules. Of course, Russia will also face constraints on economic policy in the future as it will not be able to, for example, set arbitrarily high tariff rates on imports or exports of sensitive products beyond its bound rates or quantitative restrictions on exports and imports. The scope for employing industrial policies to promote economic modernisation will also be reduced, although not entirely eliminated.

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<sup>14</sup> IPR issues are discussed in more depth in sections 3 and 4.

The implications for the Russian economy can be categorised along several dimensions. First, will accession generate a boost for significant domestic economic reform that will improve Russia's business environment? This is important as WTO accession will only really have the desired effect if accompanying domestic reform is also undertaken. Second, what is Russia's capacity to comply with membership obligations? This is linked to the first question, but is also subtly distinct: even if the leadership demonstrate a desire to reform, will they possess the capacity to ensure reforms are carried out on the ground? Third, in light of the above two points, what are the likely economic effects for Russia of WTO accession? Fourth, what role can we expect Russia to play as an international trade actor in the future?

#### 4.1 Will accession boost economic liberalisation in Russia?

One of the most widely anticipated effects of Russia's accession to the WTO is the resumption of domestic economic reform. Russia underwent substantial and painful economic reform in the 1990s, resulting in wide-scale liberalisation and mass privatisation. Since 2004, however, the role of the state in the Russian economy grew, and some of the earlier hard fought reforms were rolled back. In particular, the Russian state exerted more influence over so-called 'strategic' sectors of the economy, especially in the oil, finance and defence sectors. During this period, Russia's standing on numerous indicators of economic freedom and performance remained relatively low (Table 3). In short, as the economy experienced de-liberalisation the business climate deteriorated, and even as the economy expanded at an impressive rate up until the summer of 2008, the poor state of the Russian business environment was, if not entirely ignored, at least not treated as something that required urgent action by policy makers.

**Table 3.** Russia: World Bank Governance Indicators, 2000 - 2010 (percentile rank, 0-100)

	2000	2005	2010
Voice and accountability	33.7	27.9	20.9
Political stability	13.9	13.9	18.4
Government effectiveness	26.3	38	41.6
Regulatory quality	29.9	50	38.3
Rule of law	16.3	19.6	26.1
Control of corruption	15.6	23.9	12.9

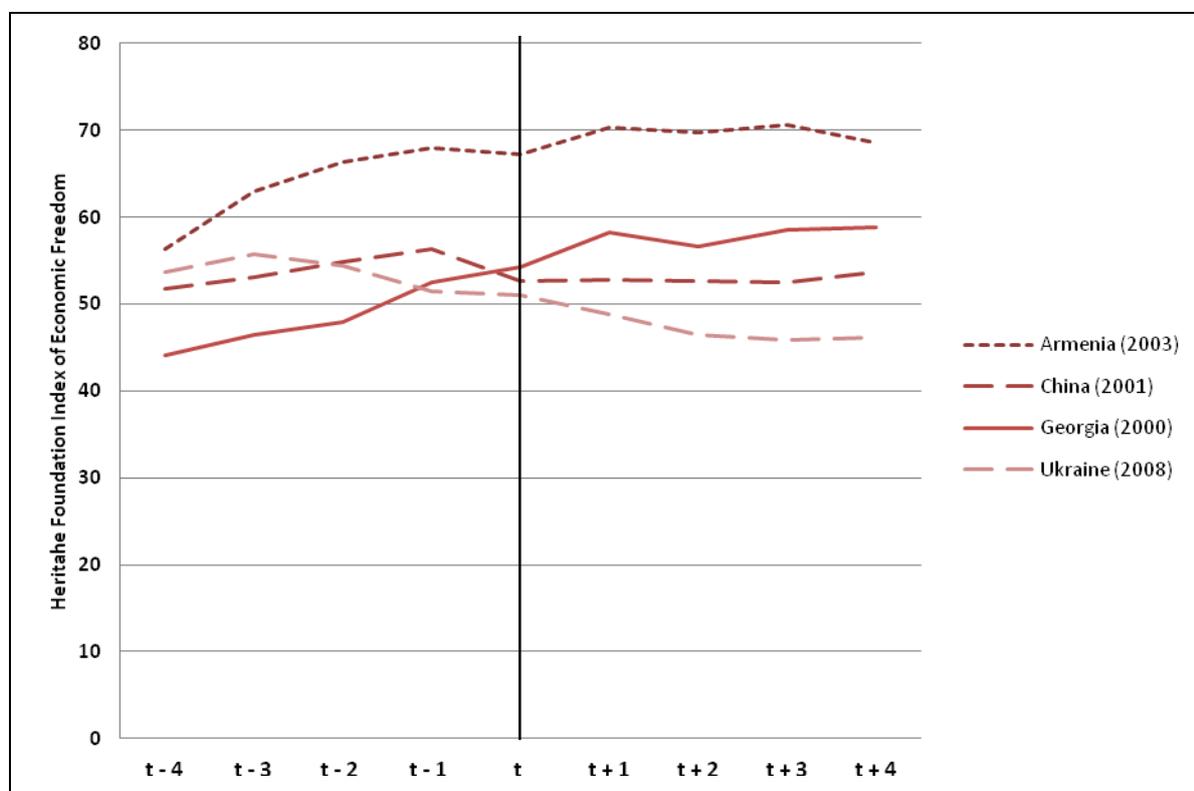
Source: World Bank, *Governance Indicators* (2012)

Russia's comparatively poor performance during the Great Recession led many in the ruling elite to conclude that Russia's vulnerability was caused by its technologically backward and natural resource-oriented economic structure.<sup>15</sup> In response, a new agenda for economic modernization was

<sup>15</sup> It is by no means clear that Russia's poor performance during the Great Recession can be explained by its economic structure alone. There is cross-country evidence that, if anything, countries that are more reliant on natural resource exports experienced milder growth decelerations during the recession (Connolly, 2012). Instead, it is likely that Russia's particularly poor performance can be explained by a combination of: exposure to the drop in commodity prices; poor institutional characteristics; and an openness on its capital account that is unusual for an economy of its stage of development.

constructed. President Medvedev began to publically berate the prevailing system of political economy, arguing that unless Russia weaned itself off its hydrocarbon dependence and diversified its economy it would find itself at a “dead-end”. This initiated intense discussion in official circles, culminating in the publication of the “Forward Russia” (*Vyeporod Rossiya*) article by President Medvedev (2009a) that provided a damning indictment of Russia’s existing economic environment. Recent speeches and articles by the President-elect, Vladimir Putin, also acknowledge that Russia suffers from a dependence on natural resources and too much corruption (e.g., Putin, 2012). A recently updated document, endorsed by the government, outlines a strategy for Russia’s socio-economic development to 2020 (*Strategiya-2020*) and envisages a series of reforms aimed at modernising the Russian economy, including the resumption of privatisation, increased spending on education and infrastructure, and improving the investment environment more generally (Minekon, 2012).<sup>16</sup> It is, on the whole, a cautiously progressive document, but it is by no means clear that the government is committed to following even its relatively restrained recommendations.

**Figure 4.** Trends in Economic Freedom Before and After WTO Accession in Selected Ex-Socialist Countries



Source: Heritage Foundation, *Index of Economic Freedom* (2012)

For some, Russia’s accession to the WTO will support the progressive elements within the Russian elite, with the WTO acting as an anchor for a new burst of economic reform in which, for instance, the

<sup>16</sup> Tensions exist within the Russian policy elite over how the country should move towards a more modern economy. Broadly speaking, a more liberal group - associated with Dmitri Medvedev, Igor Shuvalov, and perhaps former Finance Minister, Alexei Kudrin - views modernisation in broad terms, i.e., applying to all spheres of life in Russia, including the political. A more conservative group - associated with leading government figures like Vladimir Putin, Igor Sechin, and Sergei Ivanov - appear to view modernisation in more limited terms, i.e., applying only to economic, and more precisely, technological, modernisation, with limited or no appreciation of the need for wider political and social modernisation.

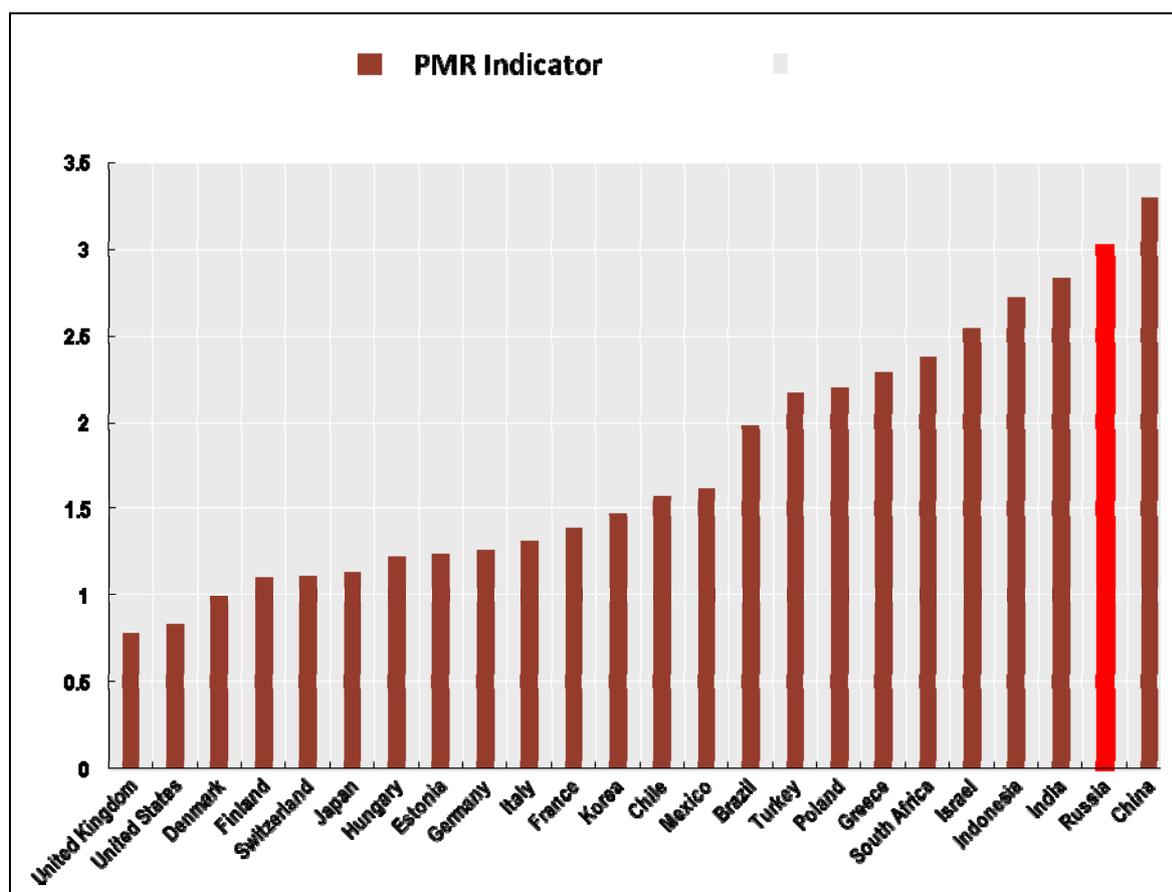
progressive suggestions of the type envisaged in the *Strategiya-2020* will be implemented under a reinvigorated Putin leadership. But what evidence is there to suggest that WTO accession will support economic reform in Russia? If WTO accession is to exert a positive independent effect on economic reform in a country, we might expect it to occur either before the date of accession, as a country liberalises to achieve accession, or immediately after accession, as the effects of accession negotiations take hold. Figure 4 shows the experience of four ex-socialist economies and the effect that WTO accession negotiations and then accession had on the Heritage Foundation's 'index of economic freedom' (IEF). The data cover the four years immediately before and after accession.

Whilst this is only a small sample, the trends show that, in these cases at least, neither negotiations to join the WTO nor actual accession appears to have a decisive effect, in either direction, on economic freedom. It is true that in Armenia and Georgia economic freedom increased in both the period before and after accession, but the reverse is true in Ukraine where economic freedom decreased before and after accession. China, a country in which WTO accession is often considered to have exerted a positive effect on domestic economic reform, fluctuated around roughly the same level for both the four years before and after accession. It is highly likely that any progress or otherwise in domestic economic liberalisation is driven by domestic political factors. Therefore, if the experience of these countries means anything for Russia then it is probably that WTO accession will, by itself, be unlikely to act as the catalyst for a surge in domestic economic reform. Instead, what is likely to be of crucial importance is the political appetite for reform amongst both Putin and, more importantly, the wider ruling elite.

#### **4.2 Russia's capacity to implement membership obligations**

It is plausible that Putin's new term may presage renewed efforts at economic reform in Russia. However, even if this were to occur, there is still the important issue of whether or not the Russian state possesses the administrative capacity to implement either new economic reforms, or, at a more minimal level, the legal commitments made as part of the accession agreement. Russia's low ranking on indicators measuring corruption and the rule of law all suggest that the low quality of public administration might prevent Russia from doing either. Indeed, the role of the state in the Russian economy is particularly pernicious, with officials and those close to them using their positions to both extract kickbacks and expropriate assets from Russian businesses on a frequent basis (see Table 1). The data presented in Table 1 are further supported by a wide range of other international measures that illustrate that the quality of public administration and legislation are comparatively poor (including the World Bank's Ease of Doing Business Index, the World Economic Forum's Global Competitiveness Report, and many more).

Such corrupt practices as informal collusion between state officials and well-connected businessmen permeate every level of Russian society, from the federal level to regional and local levels. In all instances this collusion and the use of public office and laws to benefit private interests is used to stack the economic rules of the game in favour of well-connected incumbents. As a result, taxation demands, regulatory requirements, and selective enforcement of contracts, all help well positioned firms and state officials to keep the barriers to entry high across many Russian markets. As a result, Russia scores extremely badly on the OECD's product market regulation (PMR) index (Figure 5). This indicator measures how formal regulation influences (i) state control of business enterprises; (ii) legal and administrative barriers to entrepreneurship; and (iii) barriers to international trade and investment. It is indicative that only China scores worse than Russia on this measure, thereby illustrating just how corrosive the influence of low state administrative capacity is on the functioning of large parts of the Russian economy.

**Figure 5.** Product Market Regulation Index in Selected Countries, 2008

Source: OECD, *Product market regulation index* (2012)

It is unclear whether these tendencies towards atrociously low state administrative capacity are getting better, worse or staying constant over time. What is certain is that Russia's current position is especially poor, even amongst a sample of other middle-income countries (see Figure 1). It is therefore, by no means clear that the commitments made as part of the accession can be implemented, or for that matter, can any potential economic reforms undertaken by the new president. In those areas where the rules are clear and the scope for official interference is relatively limited (e.g., tariffs), Russia is likely to be more successful in carrying out its commitments. But in areas where higher levels of state administrative capacity are required (e.g., SPS, IPRs, and TRIMs) Russia may not be able to fulfil its commitments, even if the federal government is, at least on a formal level, willing.

### 4.3 Likely economic effects of WTO accession

Russia's accession to the WTO is unlikely to have any significant impact on Russia's economic performance, at least not in the short term. During the accession negotiations, Russia worked through a large number of technical details concerning changes to its customs duties. However, many of these measures have already been implemented and others will be in the near future. Moreover, the overall accession agreement does not envisage structural changes that will substantially alter economic behaviour and performance in Russia. It is, however, plausible that gains to Russia will accrue over the medium- and long-term.

**Table 4.** Summary of Estimates of Impact of WTO Accession on Russian Economy

<b>Economic indicator</b>	<b>Improved market access for Russian exporters</b>	<b>Removal of Russian barriers to FDI</b>	<b>Tariff reduction in Russia</b>	<b>Total Impact</b>
GDP increase	0.3	2.5	0.6	3.3
Unskilled labour	0.1	3.2	0.5	3.8
Skilled labour	0.6	3.0	1.7	5.5
Capital	-0.5	1.1	1.1	1.7

Source: Adapted from Aslund (2007) using data derived from Jensen et al., (2004); Rutherford et al. (2004, 2005)

Several *ex ante* studies on the potential impact of WTO accession have quantified the effect on growth, incomes and welfare in Russia. The results are summarised in Table 4. The overall conclusions of these studies are that, in the medium term, welfare gains to Russia from WTO accession will approximate up to 7.2 percent of consumption (and 3.3 percent of Russian GDP). In the long run, gains could reach 24 percent of Russian consumption (or 11 percent of GDP), but this is based on the assumption that significant improvements in Russia's investment climate occur over this period. The gains envisaged by these studies can be grouped under three categories: (1) gains from *imports*, i.e., from greater competition and improved resource allocation as a result of Russian tariff reduction; (2) gains from *exports*, i.e., because of improved market access for Russian producers, due to more favourable treatment of Russian exporters in anti-dumping cases; and (3) gains from FDI, i.e., from the liberalization of barriers to FDI, both in the services sectors and, as the investment climate improves, in industry.

#### 4.3.1 Effects on Russian imports and domestic competition

WTO accession will affect Russian imports in two ways: through the reduction in import tariffs, and through the introduction of greater competition in Russian product markets as foreign firms gain greater access to the Russian market. Because import duties on many items will fall as a result of WTO accession, imported goods should become cheaper. In addition, the greater openness and liberalization in foreign trade that comes along with WTO membership should also increase competition from imported goods on the Russian market. Both lower prices and increased competition should benefit Russian consumers. Reduced prices for imported machinery and capital goods should benefit Russian firms. Although the study is quite dated, Yudaeva et al (2002) estimated that the effects of lower tariffs on the average Russian consumer would approximate a reduction of 16 per cent for major consumer products. This is consistent with more recent studies that estimate that around 18 per cent of the total gains from WTO accession will come from the reduction in tariffs.

If significant gains from increased imports will accrue to Russian consumers, Russian producers will also gain from the presence of increased competition. Product market competition is a driver of productivity growth by spurring innovation either directly or indirectly, through what Joseph Schumpeter termed processes of "creative destruction". In Russia, the empirical evidence suggests that openness to foreign competition boosts domestic productivity growth (Aghion and Bessonova, 2006; OECD, 2009). The effect is considered strongest in firms that are closer to the technological frontier. For less productive firms, the threat of entry tends to reduce the incentive to innovate by reducing their "life expectancy" and thus shortening their time horizons. Sectors in which producers are far from the technological

frontier, and therefore less likely to adapt and more likely to suffer from import competition, include light industry, mechanical engineering, machinery, food processing, textiles and clothing, building materials, and agriculture (especially beef and pork production). In business service sectors, such as telecommunications and financial services, Russian firms that are not either part of joint ventures with foreign firms are likely to suffer (e.g., Jensen et al., 2006).

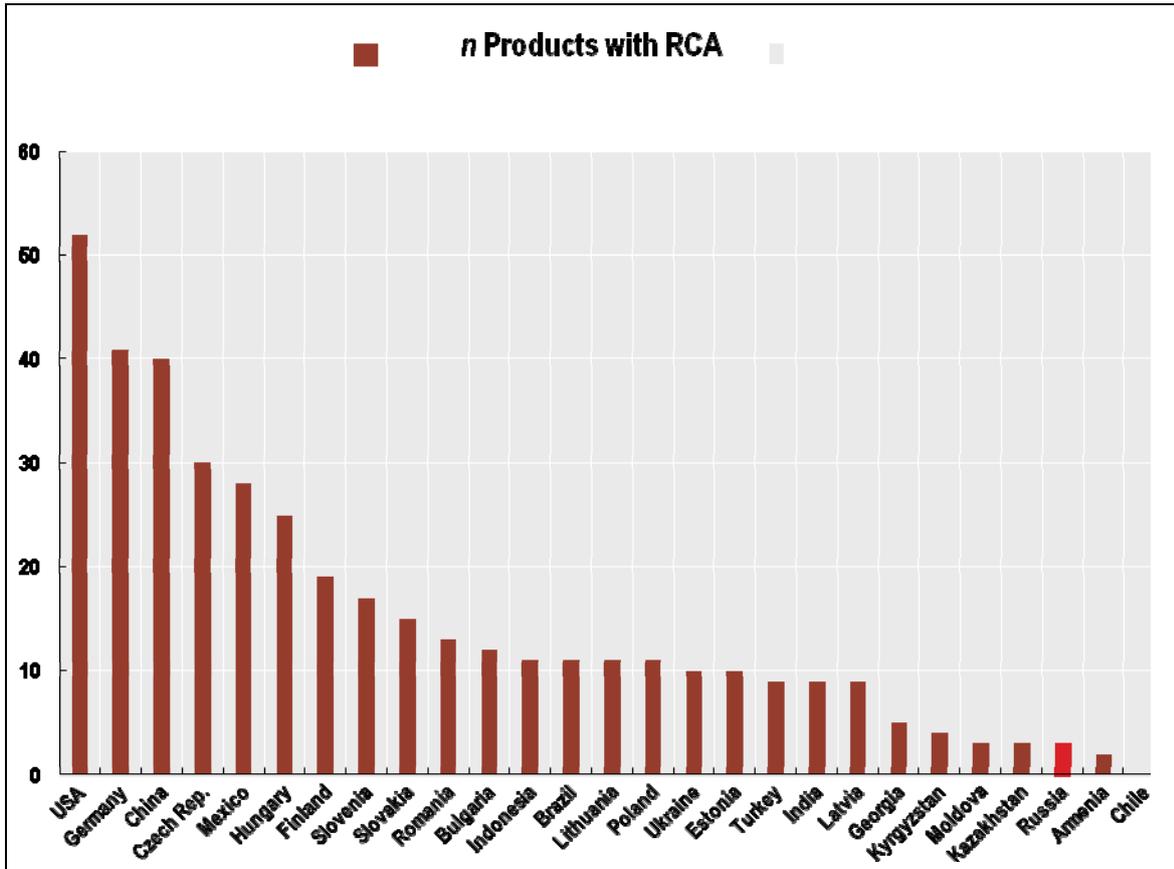
#### 4.3.2 Implications for Russian exports

The studies cited above estimate that around 10 per cent of the gains from WTO accession will come from improved market access for Russian exporters. This is a rather modest gain, and is due to the fact that, on the whole, Russia is not competitive, in both industrial and services exports. A number of recent studies show that Russia enjoys Revealed Comparative Advantage (RCA) in only a few industrial activities (Cooper, 2006; Connolly, 2008, 2012b).<sup>17</sup> Apart from hydrocarbons and some other raw materials (such as precious metals and timber), Russia only exhibits a comparative advantage in a few medium- and high-technology products, such as military equipment, nuclear reactors and other power generating machinery. These are traditional Soviet manufactured products, presently exported by Russia to the markets that were developed in the Soviet era. The only industrial activity in which Russia has managed to achieve RCA during the post-Soviet period is in microscopes. Here, NT-MDT, a company that specialises in scanning probe microscopes, is ranked second in terms of sales volumes on the world market (Connolly, 2011b). Russia's low levels of competitiveness in higher value-added industrial activities compares unfavourably with many other large low- and middle-income economies, including Brazil, China, India, and Turkey. Moreover, with the exception of Information Technology (IT) and some financial sector activity in the former Soviet states, Russia is not competitive in international services trade, either (Figure 6).

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<sup>17</sup> The Balassa Revealed Comparative Advantage (RCA) index is the ratio of the share of a product group *i* for country *j* and the share of the exports of the product group *i* in the total export for a group of countries (Balassa, 1965). The RCA index indicates whether or not country *j* has a comparative advantage within a certain product *i*. The index for country *j*, product *i*, is  $RCA_{ji} = 100 (X_{ji}/X_{wi})/(X_{jt}/X_{wt})$ , where  $X_{ab}$  is exports by country *a* (*w* = world) of product *b* (*t* = total for all products). Values higher than one indicate a comparative advantage in that product.

**Figure 6.** RCA in High-Technology Exports at the 4-Digit Level: Russia Compared, 2008-10 average (maximum = 83)



Source: UN Comtrade (2011); author's calculations

In addition to the lack of competitiveness in many areas of Russia's merchandise and services industries, Russian exporters are also unlikely to reap large benefits from WTO accession because Russia has already negotiated most favoured nation (MFN) status or better with nearly all its significant trading partners. Whilst Russian exporters will now benefit from legal provisions in antidumping cases (accounting for nearly all the 10 per cent welfare increase estimated), it is unlikely that the antidumping procedures will benefit Russian exporters to the extent that they will experience significantly increased market access abroad. Nevertheless, some sectors, such as ferrous and non-ferrous metals, and some basic chemicals may expand their market shares abroad.

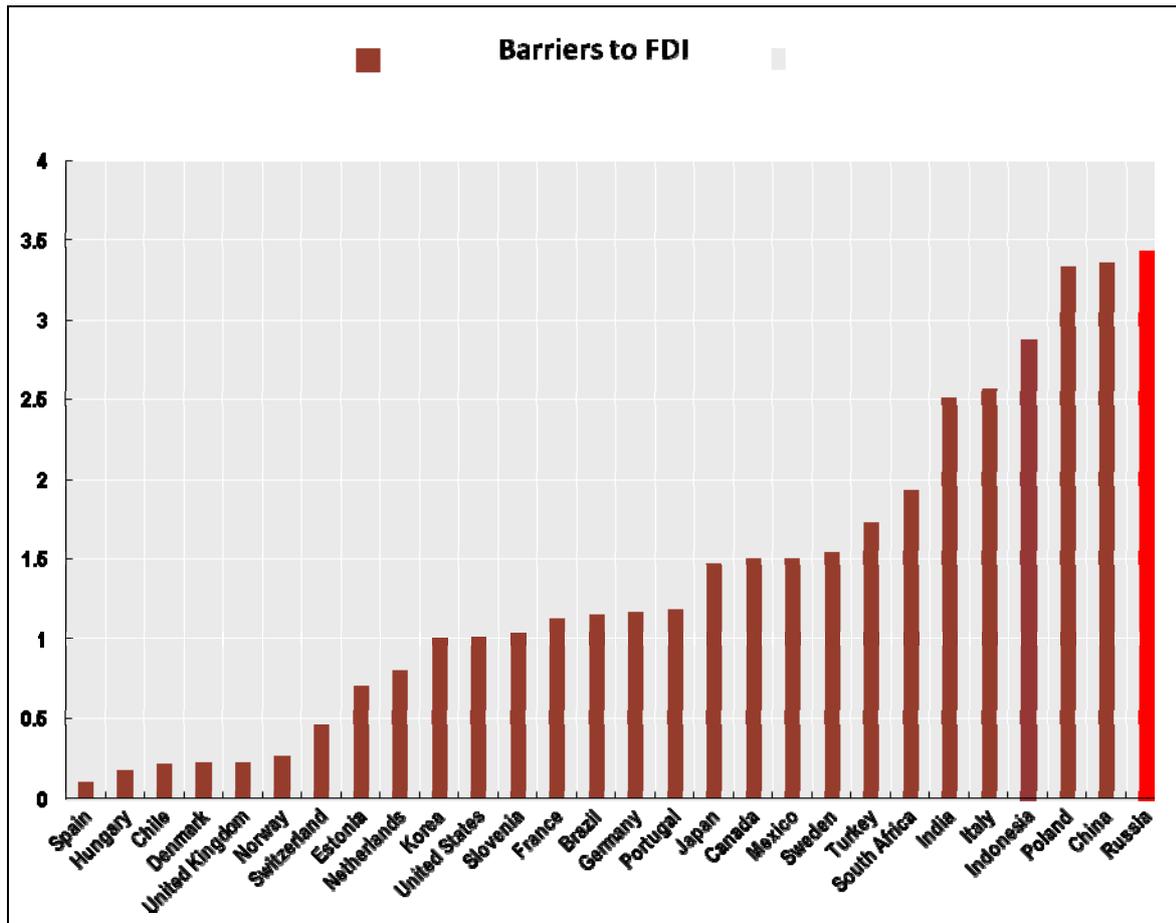
Overall, the chances of Russia benefitting from increased market access abroad will be determined by how successful the country is in effecting structural transformation over the medium- to long-term. But this will in turn entail a substantial and sustained increase in private investment, improvements in the quality of education and infrastructure, increased labour mobility, rapid growth of SMEs, and a plethora of other positive developments across the Russian economy. All of which, of course, requires a positive business environment. Therefore, we come back to the issue of whether or not the Russian elite is willing and able to commit to forging ahead with meaningful and relatively far-reaching economic reform. It is this, along with sensibly designed industrial policies, which will ultimately determine whether Russia will become a successful exporter of higher value-added goods and services in the future.

### 4.3.3 Effects of inward foreign investment

The overwhelming majority of the medium-term welfare gains from WTO accession (around 72 per cent) are expected to come from liberalisation of the barriers to FDI in business services. Rutherford and Tarr (2008) examined household and poverty impacts and found that virtually all households should gain from WTO accession, arguing that skilled labour and urban households would gain relatively more than average due to the increase in foreign direct investment in the skill intensive business services sectors. Rich households should gain less than the average household, due to increased competition from foreign investment resulting in capital gaining less than labour. The poorest households were estimated to gain at about the level of the average household. Similarly, Jensen et al (2006) estimated similar effects in the telecommunications sector, although they found that Russian capital owners who involved in joint ventures with foreign firms would benefit.

Increased FDI in the financial services should also prove beneficial for the wider economy. The role of foreign banks is currently limited, particularly by regional standards. Although it is true that foreign bank penetration has increased in recent years – from 8 per cent of total assets in 2002 to around 20 per cent in 2008 (Fungáčová, and Solanko, 2010) – and that foreign banks tend to be more efficient than Russian banks (Karas, Schoors and Weill, 2010), the regional distribution of their activities tends to reflect the wider trend in the Russian banking system towards a concentration in Moscow and surrounding areas. Foreign banks also tend to service the wealthier sections of the economy (savings, investments, equity trading), and have not made a noticeable difference to the availability of funds to those sections of the economy that are starved of credit, in particular SMEs and firms in more remote regions. In short, foreign banks, which have done much to increase access to finance in other post-socialist economies, are not making a similar contribution in Russia. Increased access in the future thus has the potential to release the constraint on *access* (as distinct from *cost*, which is not especially high) to finance that has hindered the development of the Russian economy in recent years (Connolly, 2011a).

Outside the business services sectors it is unlikely that WTO accession will make a substantial difference to IFDI flows to Russian industry. As outlined in the first section, Russia has a comparatively high stock of IFDI, notwithstanding the fact that a good portion of it is ultimately of Russian derivation. Although some of this IFDI has flowed to retail and manufacturing sectors in recent years, it is true that the bulk of it flows to extractive industries, especially energy production. However, excessive controls on subsoil exploration and exploitation have limited the extent of risk sharing related to subsoil exploration. It is common elsewhere for the substantial risks involved in investments in the energy field to be shared among partners. In Russia, though, foreign shares of investments in Russia's extractive industries are nearly always limited, increasing the risks borne by the Russian economy. Where foreign firms are permitted to invest in extractive industries it is usually because they offer technological advantages that cannot be supplied by Russian firms. The barriers to foreign firm entry in the extractive industries are reflective of similar problems across the Russian economy, with Russia the worst performer on the OECD's measure of barriers to FDI (Figure 7). If Russia is to benefit from increased IFDI in non-business services sectors, the business environment for foreign investors needs to be improved. Again, this can only be achieved by a committed and capacious Russian state.

**Figure 7.** Barriers to FDI, 2008

Source: OECD, *Product market regulation index* (2012)

#### 4.4 Russia as an international trade actor

In addition to the effects that accession will have on the functioning and performance of the domestic Russian economy, Russia's place in global trade discussions will also change. After looking in from the outside, Russia will now be able to influence discussions on the future of the multilateral trading system. Accession to the WTO might also pave the way for membership of several other organisations and agreements.

##### 4.4.1 Potential alliances and positions on international trade

Agricultural issues represent perhaps the most complicated, and apparently intractable, negotiations at the WTO. Indeed, disagreements over agricultural trade continue to block progress in the Doha Round of trade negotiations. Developing countries demand a substantial reduction in, and ultimately elimination of, farm subsidies in developed countries. In comparative terms, Russia does not allocate large subsidies to its agricultural producers, and this is likely to diminish upon implementation of the accession agreement. Consequently, Russia is likely to press for a reduction of farm subsidies in developed economies. On this narrow issue, one might expect Russia to side with the Cairns Group (including Canada, Australia, New Zealand, Brazil, etc.) where there is little or no subsidisation of agricultural production. It should, however, be noted that in some agricultural sub-sectors (e.g., live-stock farming, dairy production) Russia is not competitive. As such, it is unclear just how well aligned are the interests of Russia and the Cairns Group.

It is also plausible that Russia might join the ‘recently acceded members’ group (RAMs) of countries, which currently includes a large number of ex-socialist countries such as China and Ukraine. The RAMs group seeks reduced commitments to liberalisation on the basis that they have already undertaken significant changes as part of the accession process.

Russia might also form a new group to influence trade negotiations within the WTO. An obvious area where Russia might want to assert its newly gained influence would be in diluting the EU’s so-called Third Energy Package. The third energy package envisages the separation (or ‘unbundling’) of companies’ generation and sale operations from their transmission networks, something that Gazprom, the Russian gas company, has vehemently opposed. As a WTO member, Russia might develop arguments to persuade other members to adjust their position and perhaps reduce the effectiveness of the third energy package. In the past, member countries have successfully prevented the implementation of proposed trade measures on the grounds that they violate one of the WTO’s fundamental rules, i.e., that trade conditions should not deteriorate. If Russia can form an alliance that makes a persuasive case for the third energy package to be deemed as threatening trade conditions, it might succeed in making the third energy package more acceptable to Gazprom.

Finally, there has been a considerable increase in regional trade agreements (RTAs) within the WTO in recent years. In light of the recently created Customs Union between Russia, Kazakhstan and Belarus, and given the expressed desire among these countries to deepen wider Eurasian economic integration, it is plausible that Russia might play an important role in formulating mechanisms to harmonize and coordinate RTAs within the wider MTS.

#### 4.4.2 Prospects for joining other international organisations

The *WTO Government Procurement Agreement (GPA)* is a plurilateral pact, i.e., only those members who have signed it are obligated to comply with its provisions. Those signatories agree to open up certain government contracts for purchases of goods and services to firms from other signatories. Signing the GPA is not a prime facie condition of WTO membership. However, as part of the conditions of its accession, Russia has agreed to join the GPA and to notify its intention to the GPA Committee at the time of its accession and to initiate negotiations on the terms of its membership in the GPA within four years of its accession.

Russia has long declared its intention to join the Organization of Economic Cooperation and Development (OECD) and its anti-corruption convention as soon as it has joined the WTO.<sup>18</sup> If the WTO is a rule-based organisation, the OECD is very much a values-based organisation, and as such, membership of the OECD has the potential to improve Russia’s institutional environment by signalling the intent of the leadership to move more vigorously on domestic economic reform. It should be stressed, though, that whilst OECD membership is desirable, it would be neither necessary nor sufficient in successfully promoting domestic economic reform; instead, the intentions of the domestic elite are of far greater importance.

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<sup>18</sup> The OECD has been co-operating with Russia since 1999. In 1996, Russia made an official request for OECD membership. In 1997, OECD countries formally acknowledged that the accession of Russia as a full member of the OECD is a shared ultimate goal of their co-operation. The OECD Council at Ministerial level adopted a resolution on 16 May 2007 to open discussions with Russia for its membership of the Organisation. On 30 November 2007, the OECD Council approved the roadmap to accession for Russia. Accession removes a major barrier to joining, although a number of extra reviews on different sectors of the Russian economy will be required before being accepted to join. OECD If Russia does join the OECD it will be required to sign up to a range of other agreements, including the guidelines on export credits, the transfer pricing guidelines for multinational enterprises, etc. Most recently, Russia signed the Anti-Bribery Convention (February 2012).

## 4.5 Summary

The effects of WTO accession are unlikely to be significant in the short-term. However, in the medium- to long-term accession has the potential to contribute to faster GDP growth and welfare gains across much of the Russian economy. This potential will only be fulfilled, however, if accompanying reform of the domestic economy and business environment is carried out. Thus, for WTO accession to have a transformative effect on the Russian economy it will have to part of a much broader and ambitious reform package.

## 5. WTO ACCESSION AND EU-RUSSIA ECONOMIC RELATIONS

### 5.1 Economic relations between Russia and the EU: some stylized facts

Nearly a decade ago, Katinka Barysch (2004) stated that the Russia-EU economic relationship could be summarised in two words: asymmetry and energy. By this, she was referring to the fact that Russia was, compared to the EU, a relatively minor economic power, with a small and declining share of the world population, a tiny share of global investment flows, and a per capita income that was well below the EU average. The EU was the most important trade partner for Russia and the largest source of foreign investment; on the other hand, Russia accounted for a much smaller proportion of EU trade and was an insignificant source of, and destination for, foreign investment flows.

This asymmetry was further reflected in the composition of trade and investment flows between the two blocs. Russian exports were dominated by energy products, with very few products in higher valued-added areas competitive on the EU market, reflecting a wider tendency in Russia's industrial structure towards the export of raw materials and semi-processed goods. Russian imports from the EU consisted of higher value-added manufactures in precisely those areas in which Russia was uncompetitive. In very simple terms, Russian energy was exchanged for manufactured goods.

In some areas very little has changed since 2004. In 2010, the EU's (all 27 members) share of world exports was, despite experiencing a gradual decline since 1970 when it reached 46.7 per cent, the highest in the world, accounting for 38.2 per cent of global exports of industrial goods.<sup>19</sup> Russia's share of total world exports was only 2.6 per cent, although this was up considerably on its 1.6 per cent share in 1995. Similar asymmetries in size are evident in the respective share of global imports for both blocs. In 2010, the EU accounted for nearly 60 per cent of Russia's exports. EU-27 countries were also responsible for nearly 45 per cent of Russian imports. In both instances, the relative shares have declined over time as China and some other emerging economies (e.g., Turkey) have become larger trade partners for both the EU and Russia.

Russia's population has continued to decline from 144 million in 2004 to an estimated 142 million in 2011, accounting for 2 per cent of the global population (Rosstat, 2011; World Bank, 2011). This decline is not as sharp as has been estimated in previous years, reflecting increased levels of immigration and reduced emigration activity.<sup>20</sup> Unfortunately, the working age population in Russia is forecast to shrink inexorably over the next few decades, after experiencing a rising share between 1995 and 2010.<sup>21</sup> The

<sup>19</sup> All trade data are derived from the UN Comtrade database (2011). Figures for the EU share of world trade includes intra-EU trade.

<sup>20</sup> In recent years the mortality rate in Russia has also started to decline, while births and life expectancy has also risen (Rosstat, 2012). As a result the speed of Russia's net population decline has slowed considerably.

<sup>21</sup> Before 2010 the growing labour force made a positive contribution to economic growth in Russia.

EU has a much larger population, with a population of 502 million, or 7.3 per cent of the global population (World Bank, 2011), although the EU is, like Russia, forecast to experience a reversal in overall population growth and a sharp rise in the dependency ratio as the two blocs enter the 'age of ageing'.

In terms of investment flows between the two blocs, 57 per cent of inward FDI flows into Russia came from the EU between 2004-07 (Eurostat, 2010), making the EU by far the largest source of FDI.<sup>22</sup> However, Russia's importance to the EU as a destination for EU outward FDI is much smaller. In 2007, the Russia accounted for just 1.9 per cent of the total stock of EU FDI assets, although this figure is larger than for China and India (but smaller than Brazil). On the other hand, there have been significant changes in recent years in Russian outward FDI activity, with Russian firms now much more active in the EU than before, with outward flows now almost balancing inward flows.

**Table 5.** Structure of Russian exports to EU member states by technology intensity, 1997 and 2010

	Primary and Resource-Based Materials		Low-Technology		Medium-Technology		High-Technology	
	1997	2010	1997	2010	1997	2010	1997	2010
Austria	95.1%	54.0%	2.6%	21.4%	1.6%	19.3%	0.8%	5.3%
Belgium	n/a	87.1%	n/a	3.0%	n/a	9.6%	n/a	0.2%
Bulgaria	80.9%	88.9%	1.5%	5.6%	8.9%	2.3%	8.6%	3.3%
Cyprus	76.9%	94.5%	3.7%	0.3%	19.4%	5.0%	0.0%	0.2%
Czech Rep.	92.5%	89.0%	4.9%	1.8%	1.7%	7.7%	0.9%	1.5%
Denmark	84.9%	61.6%	4.0%	3.9%	10.5%	34.4%	0.6%	0.1%
Estonia	76.5%	75.5%	7.7%	6.4%	14.5%	16.9%	1.3%	1.2%
Finland	81.7%	92.1%	2.0%	0.9%	14.6%	6.1%	1.8%	0.8%
France	92.3%	93.1%	3.5%	2.5%	3.8%	3.8%	0.4%	0.6%
Germany	90.0%	85.8%	4.2%	6.1%	4.3%	6.5%	1.6%	1.6%
Greece	77.9%	91.8%	5.2%	3.5%	15.2%	4.1%	1.7%	0.6%
Hungary	88.7%	92.7%	0.9%	2.4%	6.5%	3.6%	3.8%	1.3%
Ireland	98.6%	30.4%	0.2%	0.8%	1.2%	62.4%	0.0%	6.5%
Italy	88.1%	84.2%	5.0%	5.0%	6.6%	10.7%	0.3%	0.1%
Latvia	76.3%	90.7%	6.1%	4.8%	16.2%	4.1%	1.4%	0.4%
Lithuania	75.6%	79.7%	5.4%	3.7%	11.5%	12.9%	7.5%	3.7%
Luxembourg	n/a	36.3%	n/a	34.9%	n/a	27.3%	n/a	1.4%
Malta	99.8%	71.8%	0.0%	0.0%	0.2%	27.7%	0.1%	0.5%
Netherlands	94.5%	97.1%	0.6%	0.1%	4.7%	2.6%	0.2%	0.1%
Poland	94.9%	94.6%	1.4%	1.9%	3.2%	3.3%	0.5%	0.2%
Portugal	53.2%	77.9%	36.7%	18.5%	10.0%	3.1%	0.1%	0.5%
Romania	88.9%	86.9%	4.2%	2.0%	6.7%	11.0%	0.2%	0.1%
Slovakia	92.3%	89.0%	0.7%	1.6%	3.3%	8.1%	3.7%	1.3%
Slovenia	87.5%	91.1%	4.2%	3.3%	8.2%	4.5%	0.2%	1.1%
Spain	90.0%	91.3%	4.7%	2.5%	5.1%	5.8%	0.2%	0.5%
Sweden	96.0%	94.4%	1.9%	1.3%	1.8%	4.1%	0.4%	0.2%
United Kingdom	84.4%	94.4%	3.0%	1.2%	12.0%	3.8%	0.6%	0.6%
EU total	89.1%	90.9%	2.9%	2.5%	6.6%	6.0%	1.4%	0.6%

Source: UN Comtrade (2011); author's calculations

<sup>22</sup> This compares to a figure of 74 per cent for the same period using Rosstat data, However, these data are inflated by large inflows from Cyprus, a small country that also serves as a tax haven for many Russian businesses. Thus, the vast majority of FDI inflows from Cyprus are most likely to be recycled or repatriated inflows of ultimately Russian origin.

It is perhaps in the structure of economic relations between the two blocs that Russian sensitivities of backwardness are most obviously justifiable. Russian merchandise exports to the EU are dominated by primary and semi-processed goods, especially energy products (see Table 5). Over the past fifteen years, the proportion of primary and resource-based products in Russia's exports to the EU has remained at a stable level of approximately 90 per cent. Only in a few cases does Russia appear to have enjoyed any success in higher value-added activities. In services, Russia runs a substantial trade deficit (around \$11 bn in 2008), with transportation services.

**Table 6.** Structure of Russian imports from EU member states by technology intensity, 1997 and 2010

	Primary and Resource-Based Materials		Low-Technology		Medium-Technology		High-Technology	
	1997	2010	1997	2010	1997	2010	1997	2010
Austria	25.0%	17.2%	14.7%	18.1%	40.7%	46.6%	19.6%	18.0%
Belgium	n/a	20.5%	n/a	9.5%	n/a	58.8%	n/a	11.2%
Bulgaria	34.2%	22.5%	5.9%	9.5%	36.0%	39.2%	23.9%	28.8%
Cyprus	28.6%	23.0%	11.0%	1.4%	50.3%	30.2%	10.1%	45.4%
Czech Rep.	30.8%	11.5%	14.5%	11.7%	44.4%	59.0%	10.3%	17.8%
Denmark	57.9%	41.2%	7.7%	6.4%	20.7%	31.0%	13.7%	21.3%
Estonia	32.1%	35.4%	3.7%	13.4%	59.8%	46.5%	4.4%	4.7%
Finland	40.3%	31.1%	14.6%	6.8%	34.0%	43.4%	11.1%	18.7%
France	32.0%	23.7%	8.3%	7.4%	38.2%	47.3%	21.6%	21.6%
Germany	23.1%	16.0%	8.8%	8.2%	50.0%	63.5%	18.1%	12.4%
Greece	69.9%	43.3%	9.3%	19.6%	19.0%	20.5%	1.8%	16.6%
Hungary	35.1%	11.2%	6.3%	5.8%	38.3%	19.7%	20.4%	63.3%
Ireland	72.8%	41.6%	3.6%	11.4%	14.8%	14.6%	8.8%	32.3%
Italy	20.0%	16.5%	18.6%	19.3%	52.5%	55.1%	8.8%	9.1%
Latvia	47.0%	31.3%	9.7%	16.3%	31.3%	34.6%	12.0%	17.9%
Lithuania	64.9%	58.7%	7.4%	15.8%	23.8%	22.9%	3.8%	2.5%
Luxembourg	n/a	22.4%	n/a	24.6%	n/a	50.6%	n/a	2.4%
Malta	9.4%	0.1%	4.2%	1.9%	85.6%	96.9%	0.9%	1.1%
Netherlands	59.0%	42.2%	6.3%	4.4%	23.6%	41.8%	11.1%	11.6%
Poland	44.9%	21.3%	16.8%	17.0%	26.7%	50.4%	11.6%	11.2%
Portugal	40.5%	25.6%	23.9%	32.2%	35.5%	33.0%	0.2%	9.2%
Romania	56.6%	7.5%	5.4%	15.3%	31.0%	52.7%	6.9%	24.5%
Slovakia	24.2%	4.3%	32.4%	6.7%	34.8%	73.1%	8.6%	15.9%
Slovenia	12.1%	7.2%	10.9%	8.9%	27.7%	39.2%	49.4%	44.7%
Spain	53.9%	28.0%	9.9%	6.9%	28.1%	55.8%	8.1%	9.3%
Sweden	22.4%	9.7%	17.6%	7.0%	36.1%	57.4%	24.0%	25.9%
United Kingdom	28.0%	11.5%	8.2%	5.4%	41.4%	71.4%	22.4%	11.7%
EU total	33.0%	19.5%	11.2%	9.9%	40.2%	54.4%	15.6%	16.1%

Source: UN Comtrade (2010); author's calculations

Russia's merchandise imports from the EU also reflect Russia's lack of competitiveness in medium- and high-technology goods, with the share of both accounting for around 60 per cent of Russia's imports from the EU in 2008, an increase from 1997 (Table 6). This makes the EU the single largest source of products with higher levels of embodied technology. As a proportion of Russia's imports from each

country, Hungary and Slovenia – both exporters specialising in final stage assembly within international production networks (IPNs) – display the highest proportion of high-technology exports to Russia. In absolute terms, however, Germany is by far the largest EU exporter of both medium- and high-technology goods to Russia, with an increasing proportion of imports from Germany taken up by capital goods, thus contributing towards the technological upgrading of the Russian economy. In terms of services, Russia runs considerable deficits in construction, information technology and software services, financial services, travel and business services.

The asymmetries noted above result in perhaps the biggest asymmetry of them all: in levels of economic output. In 2010, the EU had a gross domestic product (GDP) of over \$16 trillion at current market exchange rates (\$1.58 trillion using World Bank purchasing-power-parity exchange rates), accounting for 25.7 per cent of global GDP (20.9 per cent at PPP). By contrast, Russia, after experiencing nearly a decade of rapid GDP growth between 1999 and 2008, had a GDP of just under \$1.5 trillion (\$2.7 trillion using PPP), a share of 2.3 per cent of global income (3.6 per cent using PPP). In aggregate terms, therefore, the EU is an economic behemoth with a larger share of world GDP than even the United States. Russia, on the other hand, is more comparable in size to Spain, Canada or India.

In terms of per capita income, the most widely used, albeit extremely rough, approximation of living standards, the EU continues to exert a considerable lead over Russia. In 2010, EU per capita income was \$32,365 (\$31,600 using PPP). This is nearly three and a half times larger than the global average of \$9,216 (or 2.85 bigger than the global average using PPP). Russian per capita income is currently \$10,439 (or \$19,190 in PPP), just above the global average (73 per cent larger than the global average using PPP). Using market exchange rates, Russian per capita income is 32 per cent of the EU level, or 60 per cent at PPP. Historically, these relative levels of income compare favourably to most points in the post-Soviet period, but are still below levels observed in 1973, the point at which the gap in relative income was narrowest (Maddison, 2010).

## **5.2 The Partnership for Modernisation**

The Partnership for Modernisation (Pfm) initiative adopted at the Russia-EU summit in Rostov-on-Don in June 2010 is, in principle, aimed at contributing towards the development of the Russian economy and to bring Russia and the EU closer to each other. However, the current version of the initiative is not effective. Its content is amorphous, and the priorities of cooperation are not clear. Russia has also made no firm financial commitments towards the Pfm. As a result, the practical implementation of the initiative will be difficult. The initiative suffers from the influence of the Russian policy elite's 'technology myopia', and focuses too much attention on several high-technology sectors where Russia has expressed a desire in developing further. The Pfm would be likely to achieve more substantial results if, instead of focussing on the development of small high-technology areas, it focussed on creating incentives in the areas where the EU might contribute most constructively towards the modernisation of the Russian economy: technology acquisition and transfer, through both increased trade and FDI in technology intensive sectors; and in promoting small scale but effective institutional reforms at the regional and local levels of Russia to improve the regulation of economic activity. Such a relationship would, however, require both a fundamental reassessment of the Russian modernisation strategy, away from a focus on technological innovation towards one of institutional innovation and technological imitation.

Against this backdrop, the negotiation of a new EU-Russia Agreement is ongoing. Negotiations on a new Agreement were launched at the Khanty-Mansyisk Summit in June 2008. It is hoped that the new Agreement should update and replace the existing Partnership and Cooperation Agreement, providing a comprehensive framework for EU-Russia relations, and include substantive, legally binding

commitments in all areas of the partnership, including political dialogue, economic cooperation, research, education and culture. The new Agreement with Russia will build upon the WTO rules and obligations of the parties, and should strengthen bilateral trade relations by enshrining some basic principles and objectives in the area of trade. The new Agreement is therefore intended to contain substantial trade and investment related provisions. However, the Russian side has made it clear that it believes that it made a number of significant concessions when negotiating the terms of WTO accession; therefore, further significant concessions are less likely. This is likely to limit the scope for future progress in the area of trade and investment.<sup>23</sup>

### **5.3 How will WTO accession affect EU-Russia economic relations?**

It is useful to consider the likely effects of WTO accession on EU-Russia economic relations along three dimensions. First, how will this affect EU imports, i.e., is it likely that Russian producers will present serious competitive pressures on EU producers? Second, what difference will WTO accession make to EU exports, both to Russia and to third countries? Third, will WTO accession increase investment flows between the two blocs?

#### **5.3.1 Implications for EU imports from Russia**

As the preceding sections have illustrated, the profile of EU-Russia trade sees Russia export energy to the EU in return for processed and manufactured goods. Because energy – the EU's largest import from Russia – is beyond the scope of Russia's WTO commitments, the EU is therefore unlikely to experience a sudden change in the composition of imports from Russia. Indeed, due to Russia's chronic lack of competitiveness in most industrial sectors and services it is highly unlikely that EU countries will experience a drastic increase in the volume of imports from Russia, either. Instead, the EU is likely to continue to import energy and other raw materials from Russia, with the volume of imports from Russia likely to be driven by (a) the rate of economic growth in the EU, and (b) the availability of alternative sources of energy, either from abroad (in the form of liquefied natural gas, for example), or domestically (through the discovery and exploitation of new sources, such as shale gas). The only area in which fears existed on significant penetration of EU markets by Russian producers was in steel. However, some sources within Russia consider any expansion of Russian steel exports as highly unlikely due to the probability that EU countries will continue to employ anti-dumping measures to restrict Russian access to EU markets. Finally, some EU countries may experience some increase in imports of Russian ferrous and non-ferrous metals, and some basic chemicals.

#### **5.3.2 Implications for EU exports to Russia**

There is likely to be considerable benefits to EU exporters of goods and services in areas where the accession agreement has brought down tariff and non-tariff barriers. Broadly speaking, Russia will no longer be able to introduce unjustified restrictions (temporary or otherwise) on imports and exports covered under the accession agreement. It should, however, be noted that considerable informal administrative tools remain available to Russian elites, both at the federal and local levels, which may be used to restrict access to some Russian markets. In addition, even where the authorities are not complicit in subverting the enforcement of new legislation, it is not clear that Russia possesses the administrative capacity to implement new rules in a thorough and sustained manner. Several examples serves to illustrate this problem.

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<sup>23</sup> Russia has also indicated that it does not desire the introduction of a new energy chapter in any new Agreement.

First, in the realm of IPR, widespread domestic sales and use of counterfeit trademarks have occurred (e.g., in clothes, luxury products, pharmaceuticals), as well as of illegal software, music and films, both in mainstream retail and in street markets. Uncertainties in the regulation of the use of copyright materials on the Internet have facilitated the establishment of websites selling pirated material worldwide. There has also been evidence of systematic misappropriation of IPRs, e.g. companies or individual obtaining patents for “inventions” that are not new, or registering trademarks that are identical or strikingly similar to the trademarks of foreign companies, and using them to block legitimate producers from entering the market.<sup>24</sup> More generally, there are complaints of insufficient commitment from authorities. Although the police periodically conduct raids, there is often no serious follow-up to apparently successful operations, with seized pirate products often finding their way back onto the market. Courts often fail to apply deterrent and timely sanctions, and the enforcement system is reported to be affected by corruption and under-resourced. Thus, whilst Russian legislation will now be largely compatible with trade-related aspects of intellectual property rights (TRIPS), much progress will need to be made in enhancing administrative capacity if significant progress in IPR protection is to be made.<sup>25</sup> On the positive side, WTO membership – and the fact that Russia has made important formal commitments with regard to IPR – will at least increase the international accountability of the Russian state.

Second, in the past Russia has maintained a number of import restrictions that represent important non-tariff barriers to trade, such as customs charges and fees that exceed the cost of the service provided, and valuation procedures that result in higher total tariff charges than are warranted. Compliance with licensing, registration, and certification regimes is often burdensome and often serves to restrict trade. Under the terms of the agreement, Russia has committed to a reduction in such restrictions. In this area, the prospects for progress are quite good. Because Russia has made progress in improving the effectiveness of its Customs Service, legislative changes may be sufficient to reduce customs related import restrictions.

Notwithstanding some of the important issues outlined above, as a result of Russia’s accession EU strengths in business services (especially financial services, telecommunications, and IT and software services, areas where EU countries possess RCA), light industry, mechanical engineering, machinery, food processing, textiles and clothing, building materials, and agriculture (especially beef and pork production), are all likely to see EU firms in these sectors benefit from improved access to the Russian market.

Any significant increase in EU exports of high value-added products to Russia in the future will be driven less by the terms of the WTO accession agreement and more by developments in the Russian economy. If the Russian economy continues to expand at a respectable rate (so 4-5 per cent annual growth rate or more) then demand for EU products is likely to remain high. Moreover, if the Russian economy experiences structural transformation, it is particularly likely that the demand for medium- and high-technology goods will grow. However, if Russia slips into a period of economic stagnation (by this, anything less than a 3 per cent real annual rate of growth) or worse, then Russia’s role as a major importer of EU is likely to recede. Again, much will depend on the strength of Russia’s domestic reform impulse as it is likely that this will shape the future consumption and investment behaviour.

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<sup>24</sup> It is illuminating that *these* right-holders do not appear to find the enforcement of their rights difficult.

<sup>25</sup> The establishment of the Customs Union between Russia, Kazakhstan and Belarus on 1 January 2010 brought a considerable risk of further weakening the enforcement of protection of trademarks. The risk is linked to the weak IPR regime in Kazakhstan, whose porous borders allow for the entry of counterfeited goods and for illegitimate parallel imports from Asian countries, most notably China.

Finally, attention should also be paid to the dynamics of Russia's current account balance and the effect that this might exert on the value of the rouble relative to the euro. If current trends persist, it is possible that Russia will begin to run a deficit on the current account of its balance of payments by around 2014. If this occurs, it is possible that the rouble will experience a significant devaluation. Moreover, Russia is also at risk of a sudden and possibly disorderly devaluation if any sudden and sustained drop in commodity prices were to occur. In either case, devaluation may very well produce a decline in the volume of Russian imports relative to exports that will be required to bring the current account into balance, with a potentially negative impact on EU exporters.

### 5.3.3 Implications for investment flows between Russia and the EU

As the largest source of FDI in Russia, the EU is likely to benefit the most from the opening of the Russian domestic market to foreign investment. EU firms will now be able to enter Russian business services sectors where they already enjoy substantial trade surpluses, such as construction, information technology and software services, financial services, travel and business services. However, any sustained increase in FDI inflows into Russia will likely require a significant improvement in the Russian business climate.

Absent any concerted effort to improve the domestic business environment, it is unlikely that WTO accession will improve the prospects for any significant increase in access to Russia's natural resources, especially energy resources, unless Russian policy makers and firms identify a particular technological requirement that will be served by EU firm participation. For example, the experiences of Total and Wintershall in Russia's oil and gas markets demonstrate that EU firms are only likely to participate in ventures with Russian oil and gas companies (whether private or state-owned) if they can offer tangible technological advantages. Moreover, if Russia were to open up access to its natural resource sectors beyond those areas where it requires access to technology, it would be an historically unusual step. State-owned companies tend to be the rule and not the exception in most natural resource-rich countries. In this respect, Russia is slightly unusual in that the private sector share of its energy sector is relatively high (Hanson, 2009). To sum up, nothing short of a complete *volte-face* from the Russian policy elite on the involvement of foreign energy companies is required to change the current state of EU access to Russian natural resources, with WTO accession unlikely to make such a turnaround any more or less likely.

## 5.4 Summary

Economic relations between the EU and Russia are currently characterised by asymmetries in size and production profiles, with the role of EU energy imports central to the economic relationship. WTO accession is unlikely to change the basis of the relationship between the two economies. Overall, the gains for the EU from Russia's accession are likely to be relatively modest. Although it is likely that, as Russia's largest trade and investment partner, the EU firms will gain most from greater access to the Russian trade and investment markets. However, any significant shift in the volume and composition of trade and investment between the two countries will be contingent on positive developments in the Russian economy, including a sustained and robust rate of economic expansion and a resumption of vigorous economic reform. The PfM could, in a different form, contribute towards economic modernisation in Russia, but only if the Russian government makes a concerted effort at formulating an alternative economic development strategy.

## 6. CONCLUSION

Over the past two decades, Russia has experienced a fundamental transformation in the way in which economic activity is organised and is now a market economy, albeit one that is flawed in many respects. Whilst Russia now exhibits many characteristics that are common in other countries of a similar level of income, such as imperfect quality of governance, unhealthy close relations between state and business, etc., Russia is far from normal. It is the world's largest energy producer, suffers from a number of negative legacies associated with decades of central planning, and appears to possess a much poorer quality institutional environment than countries with similar levels of income. If policy makers are able to find the formula to unleash Russia's investment potential there is a strong chance that the Russian economy can continue to progress along the path of positive transformation that it began just over twenty years ago, enabling it to deal with the myriad challenges confronting the country. WTO accession has the potential to help Russia along in this process.

However, despite the commitments made by Russia in order to achieve accession to the WTO, the economic effects of WTO accession are unlikely to be significant in the short-term. In the medium- to long-term accession has the potential to contribute to faster GDP growth and welfare gains across much of the Russian economy. This potential will only be fulfilled, however, if accompanying reform of the domestic economy and business environment is carried out. Thus, for WTO accession to have any meaningful level of transformative effect on the Russian economy it will have to part of a much broader and ambitious reform package. Whether a renewed effort at meaningful economic reform takes place will be dependent on the decisions and actions of the President-elect, Vladimir Putin, and the wider ruling elite which Putin is part of.

WTO accession by itself is unlikely to change the basis of the relationship between the EU and Russia. Even assuming full implantation of WTO commitments, the gains for the EU from Russia's accession are likely to be relatively modest. Although it is likely that, as Russia's largest trade and investment partner, EU firms will gain most from greater access to the Russian trade and investment markets, any significant shift in the volume and composition of trade and investment between the two countries will be contingent on positive developments in the Russian economy, including a robust and sustained rate of economic expansion and a resumption of vigorous economic reform.

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