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Taming the Bear: The WTO after the Accession of Russia

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In mid-December 2011 it was announced that the accession of the Russian Federation to the WTO had been agreed. The accession negotiations had taken 18 years. Russia is the last major economy whose international trade is not governed by WTO disciplines, and with its accession 97 percent of global trade will be subject to WTO rules. The Russian economy has not yet made the full transition to a modern market economy and, hence, it is not a good fit with the WTO, which emphasises trade liberalization and the rule of law. Three aspects of the Russian economy are particularly antipathetic to WTO disciplines: (1) the use of trade, particularly energy exports, to achieve political objectives; (2) corruption and weak legal institutions; (3) crony capitalism. The interaction of each of these with WTO commitments is explored. It is concluded that Russia has little interest in liberalizing its trade regime. Hence, the role Russia may play in the future direction of the WTO may not be supportive of the WTO's current long-term objectives.

Keywords: accession, crony capitalism, corruption, liberalization, Russia

Introduction

The accession of Russia to the WTO is a win-win deal. It will cement the integration of the Russian Federation into the global economy. It will bring greater certainty and stability to business operators and trading partners. It is a contribution to the rule of trade law.

It strengthens and opens new trade opportunities. It accords the WTO “quality label” to the Russian Federation.

Pascal Lamy
Director-General of the WTO
December 16, 2011

In the midst of the deepening crisis in the Euro-zone in mid-December 2011 it was announced that the accession of the Russian Federation to the World Trade Organization had been agreed. The accession negotiations had taken 18 years. While the announcement was made with all the fanfare the WTO could muster, the event went largely unheralded, overshadowed by the struggles of individual countries and international organizations to deal with sovereign debt problems in the European Union and the wider economic malaise in the global economy. The lack of prominence garnered by the event may also reflect the declining influence of the WTO as a result of it being stuck in the quagmire of the Doha Round for a decade – and with no likelihood of a completion to the round in sight. Further, while the WTO commitments may have prevented the imposition of *beggar-thy-neighbour* trade barriers (à la the 1930s) in response to the recession that commenced in 2008 (Viju and Kerr, 2011), it would never have had a prominent part to play during the dire economic circumstances of the 2007 financial crisis and the subsequent recession in the real economy. Nothing had changed in Russia that could have justified the change of heart of those countries that had been blocking Russia’s accession. Even reluctant Georgia, which has major political difficulties with Russia, was convinced to drop its opposition to Russian membership in the WTO. The change in the position of those countries that had blocked accession may simply reflect the perception that membership in the WTO was no longer of sufficient importance for it to be used to wring political concessions from potential members.

Will the Russian Economy Be a Challenge for the WTO?

Despite the lack of prominence garnered by the announcement of Russia’s accession, it was a major milestone for the WTO and the broader global economy. Russia was the last major economy to remain outside the WTO. Iran, Belarus and North Korea as well a number of smaller economies remain outside the

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WTO, but with the accession of Russia approximately 97 percent of world trade will be governed by WTO rules. Russia is the world's eleventh-largest economy. Its exports remain heavily dependent on petroleum, and to a lesser extent other natural resources. Hence, it suffers from *Dutch disease*, where resource exports drive up the exchange rate of the rouble to the detriment of the international competitiveness of other sectors, particularly manufacturing. The Russian economy is riddled as well with other inefficiencies. These stem from an absence of well-functioning market institutions (MacKay and Kerr, 2007) and well-specified property rights (Hobbs, 2007) as well as from the presence of deeply embedded and endemic corruption. These characteristics are antipathetic to WTO membership with its emphasis on the rule of international law as embodied in WTO commitments.

It is sometimes hoped that the commitments acceding members make will lead to domestic economic reforms that will strengthen market institutions with the dual effect of reducing the riskiness of engaging in international trade with the acceding country and improving its domestic efficiency. For small economies with the potential to heavily integrate into the global economy, this may well be the case. For a large economy such as Russia, this result is much more problematic.

The Russian government has a history of using its economic power to foster its political aims. This has been particularly true in the case of petroleum resources (Considine and Kerr, 2002). In recent years it has both underpriced its sales of natural gas for near neighbours and cut off exports for political rather than economic reasons. It has threatened to disrupt flows of both natural gas and oil on numerous occasions. Given Russia's diminished military capacity and constraints on formal *sabre rattling* to secure its objectives, it will be hard for the government to resist the temptation to exploit the energy dependence of others. It will chafe under WTO rules and likely ignore them when it is convenient.

Russia has also been willing to restrict exports of agricultural products when food prices rise. Given Russia's long-standing policy preoccupation with food price stability as a means to dampen social unrest, the weak WTO provisions on export prohibitions are unlikely to act as a constraint. Of course, the Russian government is far from the only one that is willing to strategically restrict exports (Kerr, 2011). However, it clearly diminishes the authority of the WTO when a large and important member is willing to ignore its commitments.

While the formal imposition of tariffs is likely to be constrained by Russia's accession to the WTO, the use of non-tariff barriers, the arbitrary imposition of domestic regulations and criminal extortion/intimidation may well be used to inhibit import competition. Corruption is based on services under the control of officials

being sold to those who are willing to pay for such services. If a domestic competitor needs a shipment of agricultural imports to be removed from the market, a - phytosanitary refusal can likely be *arranged*. If a load of foreign medical instruments is inconvenient for a local supplier, it can be *arranged* for them to be found to be defective. If a local manufacturer of glassware is faced with ruin by a nearby distributor selling cheaper foreign alternatives, a visit from the local criminal gang that will make it clear that selling such merchandise is not in the firm's interest and/or the owner's health can be *arranged*. As these *arrangements* are likely to be on a shipment-by-shipment basis, they are very difficult to control – but they will negatively impact on trade. One of the unstated assumptions upon which the WTO is based is that a member state's government is able, and willing, to enforce a market-based commercial (and criminal) legal system. Hence, the WTO has no mechanism to deal with trade-inhibiting activities based on corruption or criminal activity.

Russian judicial and policing authorities have little capacity to deal with commercial crime and are generally considered to be corrupt (Kerr and Bessel, 2007). Of course, there are many other members of the WTO whose economies exhibit similar characteristics, but none is as large and influential as Russia. Many are what might be considered *social* members of the WTO *club* – members which enjoy the status of being part of the WTO but have little interest in liberalizing their trade or in the organization's rule-making processes (Kerr, 2002). Russia, on the other hand, is unlikely to be satisfied with being a *social* member of the WTO.

Beyond the direct effects on trade, widely diffused corruption and largely unconstrained criminal extortion/intimidation increase the risk for those that might be willing to invest in ventures whose intent is exporting to Russia. As a result, many investments never take place and those that do require a much higher expected return. In addition, there are strong lessons from the experience with foreign investment in Russia that suggest there is considerable danger of *post contractual opportunistic behaviour* (Kerr, 1996) if an investment is successful. In particular, Russian joint venture partners are willing to allow foreign partners to shoulder the risk of investing in ventures only to find ways of excluding them from the profits should they eventually arise (Kerr and Bessel, 2007). The petroleum industry has been particularly prone to this type of opportunism (Considine and Kerr, 2002), but examples range from hotels to fast food to forestry. There is no reason to expect investments in international trading activity to be exempt from the risks associated with success.

In addition to the direct and indirect effects on trade in goods and services, corruption and lack of legal enforcement will impact on the protection of foreign intellectual property (Kerr and Boyd, 2007). Accession to the WTO means that Russia

has agreed to take on the commitments of the Agreement on Trade Related Aspects of Intellectual Property (TRIPS). While Russia is reforming its domestic intellectual property regime to comply with its TRIPS obligations and has specifically committed to undertake enforcement activities (WTO, 2011), issues with the technical capacity of judicial and policing authorities remain.

Apart from weak property rights, corruption and poor rule of law, the other major characteristic of the Russian economy that will inhibit the trade-liberalizing effect expected from WTO membership is the high degree of crony capitalism. Kimbugwe et al. (2012) suggest that crony capitalism is fundamentally incompatible with trade liberalization. Crony capitalism entails a symbiotic relationship between the government and favoured businessmen – in Russia's case those known as the oligarchs. The oligarchs provide a considerable proportion of the financing for political activities of the government elite. In return, the government provides the means for the oligarchs to extract considerable rents – part of which is funneled back into financing political success. The most common way for politicians to carry out their part of the crony capitalism bargain is to grant domestic monopolies to individual oligarchs (Kimbugwe et al., 2012). The holders of monopoly rights are able to raise prices and extract monopoly rents. The monopoly rights granted by politicians to oligarchs are enforced by the state.

Trade liberalization, however, can threaten domestic monopolies by allowing lower-priced imports into the market. This, in turn, threatens the symbiotic relationship between the political elite and their business cronies. Kimbugwe et al. (2012) suggest that while the political elite may enter into agreements to liberalize trade, the reality is that the cronies with business interests are sufficiently influential that liberalization of imports never actually takes place. This is why many trade agreements involving developing countries never amount to much more than *photo ops* even if the intent of the politicians is trade liberalization at the time of signing. While formal barriers to trade such as tariffs may come down as specified in the trade agreement, cronies are able to secure their monopolies through regulatory non-tariff barriers. In some cases, the domestic monopoly is extended to include the distribution of imports. As monopolies restrict the quantities that can be sold, even in these cases the quantity of trade is restricted. The Russian economy has been heavily monopolized since it was first liberalized (Gaisford, Kerr and Hobbs, 1994; Hobbs, Gaisford and Kerr, 1993). This characteristic persisted and provided, through the corrupt privatization process, the initial basis for the oligarchs' wealth and the foundation for Russian crony capitalism. It has now become deeply entrenched in the institutional arrangement governing the Russian economy and will prove very difficult

to dislodge (MacKay and Kerr, 2007). When Russia was outside the WTO, foreign competition could not threaten monopolies because trade barriers could easily be erected. Membership in the WTO will provide a constraint on the imposition of some forms of trade barriers, but one should not underestimate the resourcefulness of protectionists – particularly when the rents of crony capitalists are at stake.

In short, there are a great number of vested interests in Russia that would suffer if WTO disciplines were actually imposed. Protectionists are difficult to keep in check even in well-functioning modern market economies with strong property rights and low levels of corruption. Russia's oligarchs are used to striking deals with politicians that serve their ends. As in other parts of the world where crony capitalism is prominent in the economy, trade liberalization is unlikely to take place to any significant degree no matter what commitments have been made in trade negotiations.

Russia as a WTO Member

Given that many aspects of the Russian economy are antipathetic to the trade-liberalizing principles and rule-of-law focus of the WTO, why was Russia so keen to join and what kind of member will it likely be? The WTO still carries considerable cachet as a signaling device for a country having arrived and passed muster as an accepted member of the global economic community. Not being allowed to belong to the WTO relegates a country to second class status in the global economy – it is seen as a country that cannot be expected to live by the accepted norms of international commerce. Firms engaging in international transactions with counterparts in non-members understand that the rules that govern their exchanges are changeable and may not be transparent. Non-membership is a signal that this is riskier territory than is the case when similar transactions take place with firms in other member states. Russia chafed under this stigma, particularly when other post-communist rivals such as China had been able to accede. Of course, the accession process is as much political as it is to do with the ability to meet the commitments required for WTO membership, but being denied membership still carries a considerable stigma. Thus, Pascal Lamy was correct when he said that membership “accords the WTO ‘quality label’ to the Russian Federation” (Lamy, 2011). It is a label that Russia has long coveted.

Membership in the WTO also provides members with protection from the arbitrary or politically motivated withholding/withdrawal of trade concessions that can be practised against non-members – over issues such as human rights or aspects of foreign policy. Thus, membership provides increased levels of surety for Russian firms considering investments in international trade activities. Firms outside Russia

considering similar investments also benefit from the reduced levels of risk that Russia's membership will bring.

The major benefit of WTO membership, of course, is secure access to the markets of WTO members at *most favoured nation* (MFN) tariff rates. As individual countries have been levying higher than MFN rates on Russian goods, and may have applied rates that differ from the higher official rates, it is very difficult to assess the value of the benefits associated with having MFN rates applied, but they could be considerable. Given that Russia's exports are heavily concentrated in the energy sector, where most importers do not impose duties, the benefits of garnering MFN rates may, however, be less than might be anticipated. The negative effect of the *Dutch disease* on the competitiveness of manufactured exports will also work to limit the effect of moving to MFN tariff rates being applied on Russian goods.

Besides these obvious benefits, what else might the Russian Federation desire from WTO membership? There is little to suggest that the Russian leadership sees cheaper imported goods for its citizens as a major objective associated with WTO membership. It appears to have a traditional mercantilist approach to trade, with increased exports as the primary objective – so that other strategic political objectives can be financed. Given that crony capitalism is antipathetic to trade liberalization, Russia will want the WTO to have a light touch when it comes to its own liberalization. Thus, once a member, Russia is a natural ally of developing countries in the Doha Round negotiations. Developing countries have been pushing an asymmetric agenda whereby developed economies open their economies while developing countries can retain much of their protection under *special and differential treatment* (S and D) provisions. Russia could pursue a similar asymmetry for transition economies or for newly acceded states. Failing that, Russia could be expected to prefer no conclusion to the Doha Round over one that exhibited considerable ambition. Having another major member state indifferent to the successful conclusion to the Doha Round cannot be good for the long-term health and prestige of the organization.

Over the longer term, Russia is likely to resist any strengthening of WTO disciplines on export restrictions given the recent volatility of international markets for foodstuffs, preferring the flexibility to moderate food price increases that restricting exports provides. Similarly, it is likely to resist any tightening of restrictions on domestic agricultural subsidies, largely on food security grounds.

One of the major problems for the WTO may relate to Russia's approach to energy trade. It is clear that Russian authorities understand the energy dependence of many of their customers. Alternatives are expensive and switching costs are high. In

the short run, there may simply be no alternatives except storage on a very large scale. This dependency can be exploited to achieve a wide range of political or economic objectives. It is one of the few effective international levers that Russia possesses. It will be hard to give up. One of the specific commitments made in the accession agreement was that:

Producers and distributors of natural gas in the Russian Federation would operate on the basis of normal commercial considerations, based on recovery of costs and profit. (WTO, 2011).

In reality this will be very difficult to enforce. If Russia chooses to openly flout its WTO commitments by continuing to manipulate energy trade for political purposes there will be little that the WTO can do – and the credibility of the organization will suffer.

In short, it is hard to argue that Russia will be a positive force in promoting the WTO's long-term trade liberalizing objective, and may well be a major detractor from that objective. In his statement on Russia's accession Pascal Lamy remarked:

To the Russian Federation I say: we count on you to exercise leadership. To become an active player of the WTO. (Lamy, 2011).

Director-General Lamy is well known for his perpetual optimism.

Conclusion

Russia has not made the full transition to a modern market economy (MacKay and Kerr, 2007). As a result, it is not a good fit for the WTO with its emphasis on trade liberalization and the rule of law in international trade. It is sure to chafe under the WTO disciplines it has had to accept to gain the right to accede. In this way it will be similar to China, which is also not yet a modern market economy. Thus, if nothing else, Russia is likely to be involved in a number of disputes with its trading partners in the wake of accession, as was the case with China. Unlike China, however, there is no controlling entity like the Chinese Communist Party to impose discipline when it is required. Russia's interaction with the global economy and the WTO is likely to be more chaotic than has been the case with China.

Russia has a history of being an activist participant in international organizations, while China has been somewhat passive. Given that Russia does not seem to have a natural interest in long-term trade liberalization, it will be interesting to see what its effect on the organization will be. Thus, with the WTO approaching universal coverage of international trade flows, the nature of the organization may itself be set for change.

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