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Russia's Relations with the EU after WTO Accession

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Russia's accession to the WTO next year will set the stage for a more active dialogue with the EU on deeper integration and trade liberalisation. In this respect the formation of a FTA with the EU is a necessary, but not a sufficient condition for engaging Russia into an active dialogue on a broad range of political and economic issues. Other modalities of trade liberalisation, including regional cooperation and greater openness to investment would also need to be addressed. The delays in drawing up a new comprehensive framework of EU-Russia cooperation come at a time when the need for a renewed framework is greater than ever, which calls for the speedy launching of talks on the creation of a new comprehensive PCA in the near future.

Keywords: European Union, Russia, trade liberalisation, FTA, PCA, WTO
JEL-Codes: F13, F14, F15

Russia's trade relations with the EU are approaching a crucial stage. With Russia now set to accede to the WTO next year, it is likely to become increasingly active in forging trade alliances across the globe. Even as Russia is looking for partners in potential FTAs and regional projects around the world, its trade relations with the EU need to be revitalised. First and foremost, the Partnership and Cooperation Agreement (PCA) with the EU has expired and the new PCA will need to reflect the new realities of a different Russia and the EU. One of the issues that will need to receive particular attention in the new PCA is the security of energy supplies, which is becoming a crucial theme in EU's relations with Russia, especially after the disruptions in gas supplies that took place in the beginning of 2006.

Accordingly, the paper first looks at some of the crucial changes taking place in Russia's trade policy regime, of which the most important has to do with the significant progress in Russia's WTO accession and the intensification of Russia's attempts to reinvigorate regional integration in the CIS (Commonwealth of Independent States). It then goes on to analyse the current dilemmas in the Russia-EU relationship, including those in the energy dialogue and the new PCA agreement. The paper concludes by looking at the ways of reinvigorating the Russia-EU cooperation via launching talks on the formation of an FTA, boosting inter-regional cooperation, intensifying bilateral cooperation in the investment sphere and joining forces in strengthening the framework of multilateralism within the WTO.

1 Russia's evolving trade policy

The year marked a decisive turnaround in Russia's role in international economic relations. The bilateral agreement with the United States on Russia's accession to the World Trade Organization is an achievement on a par with the repayment of Russia's Paris Club debt in August 2006 and the almost complete elimination of debts to Western countries. Russia has ceased to be a debtor nation, and can now open a new chapter in foreign relations. From now on, the country will compete not for loans, but for increasing trade. This in turn will lead Russia to explore more actively the possibilities of forming trade alliances with Europe in the West and with the "Asian tigers" in the East. It will also strengthen Russia's hand in revitalising the process of regional integration with its CIS neighbours.

1.1 Progress in WTO accession

The WTO accession process has done much to liberalise Russia's foreign economic policy even before actual entry into the organisation. The business climate has already improved noticeably as a result of steps taken to smooth WTO entry: the new Customs Code, the introduction of greater consistency into the Byzantine cobweb of federal and regional legislation, the streamlining of the country's import tariffs, the gradual removal of numerous export restrictions, the education of the business community on rules governing international commercial affairs, the awakening of businesses to the stark reality of needing to compete with foreigners – all these changes in the economic policy regime have made a palpable contribution to ameliorate Russia's business climate.

After the crucial bilateral deal on WTO accession with the EU in May 2004, the most important agreement that still needed to be finalised by Russia was a deal with the US. During the Asia-Pacific Economic Cooperation (APEC) summit in Hanoi on November 20 2006, Russia finally signed a bilateral agreement with the US on WTO entry, which signals the near completion of the bilateral stage of Russia's WTO accession talks and makes the prospect of full-fledged entry into the WTO in the second quarter of this year a real possibility. The agreement with the US involved compromises on both sides – on the one hand Russia agreed to greater liberalisation in the agricultural sector and financial services (particularly insurance). At the same time, the US agreed that Russia would not allow branches of foreign banks to operate in Russia (see table 1).

Table 1: Import and Export duties and quotas before and after WTO accession

| Export duties | Currently | After transition period | Transition period |
|------------------------------|-----------------------------------|---|----------------------|
| Goods | | | |
| Automotive | 25% | 15% | 7 years |
| Civil aviation | 20% | 7.5–12% | 7 years |
| Metal scrap (export duty) | | reduced to 1/3 of current levels | 5 years |
| Copper cathode (export duty) | | Fully eliminated | 4 years |
| Chemicals | | Will be harmonised at 5.5–6.5% | |
| Medicine | 15% | 5–6.5% | |
| Agricultural products | | | |
| Pork, beef and poultry | TRQ and 15% for high quality pork | to be negotiated | Till 2009 |
| Beef | 15% | 12.5 | 2 years |
| Dairy | 15% | 10 | 3 years |
| Fruit | significant reduction of tariffs | 1–5 years for different types of fruits | |
| Soybean | 5% | 0% | 2 years |
| Cereals | 15% | 10% | 4 years |
| Wine | 20% | 15% | 3 years |
| Other alcohol | 20% | 12% | 3 years |
| Services | | | |
| Insurance | 25% quota | Quota introduced at 50%. Branches of foreign insurance companies may be opened in Russia's regions. | 5–9 years |
| Banking | Quotas may be introduced | Quota may be introduced at 50% of the entire banking system. Branches of foreign banks may not operate in Russia. | No transition period |

Source: MEDT (2006)

The positive implications for FDI arising from WTO accession are likely to materialise more quickly than the longer-term 'trade effects'. The ongoing consumer boom will be sustained by people's improved access to imports. Exports are also expected to pick up, as foreign restrictions are contested by Russia in the WTO's dispute settlement body. Investment growth may get a boost from the pick-up in FDI. But the big pay-off of increased trade

and foreign investment will only come Russia's way if companies and the business elite are prepared for greater openness toward the outside world, increased competition both at home and abroad, and more active cooperation with Western companies in the form of joint ventures, and other forms of alliances. Even more important, perhaps, will be the effect of the WTO as an external anchor for Russia that renders its policy framework more rules-based.

At the geo-political level, Russia's WTO membership will allow it to revitalise its regional and bilateral integration across the globe. In other words, Russia will not only have a say in the direction of the WTO-sponsored multilateral trade liberalisation, but it will also get greater leeway in actively managing its own trade alliances.

1.2 Regional ties in East Asia

In the past several years Russia became far more active in promoting its foreign trade ties with Asia. The trade turnover with China is rising at a rapid clip – in 2005 it increased by 37.1% and reached \$29.1 bn. Russia's dialogue with China within the Shanghai Organization for Cooperation (created in 2001 to deal with security issues in the region) is increasingly focussing on economic and trade issues. Russia is also attempting to play a more active role in APEC, which it joined in 1998, including through attempting to raise the profile of discussions related to energy security.

In 2005 for the first time ever, Russia participated in the summit of ASEAN countries, ahead of which Russia and ASEAN signed an agreement on economic cooperation. Russia's contacts with ASEAN are thus becoming increasingly institutionalised, with Russia-ASEAN summits henceforth to be held regularly together with the ASEAN summits. In attempting to elicit greater economic cooperation in the region, Russia is offering to strengthen ties between ASEAN and the Shanghai Organization for Cooperation as well as to intensify trade links with the members of ASEAN in the fuel and energy sector. Finally, in December 2005 Russia participated in the East Asian summit, which brings together members of the ASEAN as well as Japan, China, South Korea, Australia, New Zealand and India. Russia also formally applied for membership in the East Asian Community, which, however, was opposed by Australia and Indonesia.

1.3 Cooperation within the CIS

The process of integration in the CIS continues to be plagued by lack of clear priorities of member countries and the deterioration of bilateral relations between Russia and some of its neighbours. In particular, the stand-off with Georgia has resulted in trade sanctions imposed by Russia on imports of wine and mineral water. Similar restrictions levelled against Moldova are set to be lifted after the agreement reached at the CIS summit held in Minsk in November 2006. Also, Russia's relations with Ukraine have witnessed signs of normalisation recently after the coming to power of VIKTOR YANUKOVICH as Ukraine's new Prime Minister.

In attempting to stimulate greater cooperation Russia is sending a clear signal to the "near abroad" that gas prices charged by Russia are set to increase significantly. In cases of improving political/economic ties (as in the case of Ukraine) the pace gas tariff increases is slowed down, while trade restrictions on agricultural products are lifted. At the same time, Russia is striving to make the framework of integration in the CIS more coherent by focussing increasingly on the formation of a Customs Union among members of the Eurasian Economic Community.

2 Russia-EU relationship at cross-roads

Against the backdrop of Russia's intensifying efforts aimed at integrating into the world economy, its relations with the EU are reaching a crucial juncture. In 2007 the old Partnership and Cooperation Agreement (PCA) expires, which calls for the launching of talks on the creation of a new comprehensive PCA. Unfortunately, discussions on the new accord that were to take place at the Russia-EU summit in Helsinki were postponed. While clearly this was likely only a temporary delay in starting the talks on the new PCA, it does reflect the divisions within the EU on ways of building political and trade relations with Russia.

Table 2: Turnover (\$ bn)

| | 9mo05 | | 9mo06 | |
|--------------------------|---------|------------|---------|------------|
| | Nominal | % of total | Nominal | % of total |
| Total turnover, of which | 315.6 | 100.0 | 241.8 | 100.0 |
| EU | 168.5 | 53.4 | 126.6 | 52.3 |
| APEC | 52.7 | 16.7 | 38.5 | 15.9 |
| CIS | 46.9 | 14.9 | 37.3 | 15.4 |

Source: Rosstat (2006)

The delays in drawing up a new framework of EU-Russia cooperation come at a time when the need for a renewed framework is greater than ever. The EU continues to be Russia's largest trading partner, accounting for well over half of the total trade turnover at the end of September of 2006. This share of the EU in Russia's foreign trade should further expand after Bulgaria and Romania join the European Union in 2007. Furthermore, the urgency of a new PCA comes from the need to increase the role that the fuel sector is playing in Russia-EU trade relations.

Russia's disagreement to acquiesce to the signing of the "energy charter" is a clear sign of the increasing pragmatism of Russia's approach to foreign trade relations. According to President Putin, the era of unilateral concessions on the part of Russia has ended – Russia is seeking commensurate concessions from the EU in return for the EU demands to grant access to Russia's gas pipeline system. Furthermore, Russia's vision of its trade relations with the EU is that they should by no means be confined to fuel and energy and should be broadened as much as possible to areas that include cooperation in high-tech sectors of industry. For Russia one of the key economic priorities is greater economic diversification away from the fuel sector and Russia sees trade relations with the EU as a key gateway to promoting this diversification.

Perhaps these needs can be accommodated to a significant degree by intensifying the ongoing dialogue with Russia on the creation of four common spaces between Russia and the EU (a common economic space, a common space in the field of external security, a common space of freedom, security and justice, and a common space of research, education and culture). Within this framework, talks on the formation of an FTA would be a necessary, but not a sufficient condition for engaging Russia into an active dialogue on a broad range of political and economic issues.

3 Revitalising Russia-EU trade ties

The fundamental question for both Russia and the EU is: What do they want to derive from closer economic ties? It appears that for Russia the key priority is greater integration at the micro-level of individual enterprises with EU companies with the aim of gaining access to advanced technologies in high-tech sectors of the economy. Another key concern for Russia is to expedite the elimination of EU trade restrictions in such sensitive sectors of the economy as steel and chemicals, which in turn are seen as gateways to economic diversification away from the oil sector. The overriding priorities for the EU include the liberalisation of Russia's services sector and its foreign investment regime as well as greater energy security with respect to the supplies from Russia. The most comprehensive way to address and reconcile these priorities is to forge ahead with the formation of a free-trade area between Russia and the EU.

3.1 Regionalism: FTA negotiations

In the course of 2006 high-ranking officials from the EU have on several occasions made declarations on the readiness of the EU to start FTA talks with Russia after its accession to the WTO. Indeed, the launching of FTA negotiations with Russia harbours notable benefits for the EU. Most importantly, the FTA negotiations framework will allow the EU to engage Russia in an active dialogue even as it actively explores the options of building trade alliances across the world economy. Furthermore, Russia is almost a "natural" FTA partner for the EU, in that its trade structure (as measured by RCA indicators) is largely complementary to that of the EU. The relatively high level of import tariffs, which are in the 10–11% range, offer a significant preference margin from Russia for the EU upon the attainment of free trade.

For Russia the attractions of forming an FTA with the EU are likely to be centred on eliminating the remaining restrictions to Russia's manufacturing exports. An FTA accord will also likely be seen by Russia as a springboard to greater integration at the micro-level of sectors and enterprises, through which Russia would seek to attract more FDI and technologies. To some extent, FTA negotiations for Russia would also be yet another way to improve its investment image and show off greater ties with the West. Most importantly, perhaps, Russia's FTA talks with the EU will be an instrument of generating greater competition abroad for trade with Russia.

The strategy that is likely to be pursued by Russia in attempting to generate greater cooperation from the EU or other partners in forming an FTA is likely to be based on a Russian version of "Competitive Liberalisation". Within such a strategy, Russia would offer its partners greater access to its energy resources in exchange for deeper integration/alliances in sectors that are seen as strategic, most notably in the high-tech sector. Thus, Russia could seek to play the West against the East by fuelling competition for greater energy supplies. Declarations that bear close resemblance to such a strategy have already been made this year by Russia's key officials, including President Putin, who talked up the issue of increasing Russia's energy supplies to East Asia.

In fact, Russia has already employed the "fuel weapon" in the East by stoking competition between China and Japan over the direction of its pipelines. The threat of diversifying Russia's energy supplies away from the EU towards Asia, however, is not entirely credible at least in the short-term, due to the lack of pipeline capacity in the East. Still, one should expect Russia to pursue its very own version of "Competitive Liberalisation", in which access to greater participation in the development of Russia's fuel sector or the general direction of energy flows from Russia is used as a tool to boost economic cooperation.

So far, the rhetoric from the Russian government on the prospects of an FTA with the European Union is quite subdued, perhaps in part due to the need to finalise WTO accession. At the same time, there is clearly more discussion within Russia of which partners and allies should Russia bond with in the WTO itself. In this respect, the EU featured in various occasions as a possible partner in the WTO in statements by Russian policy-makers.

3.2 Multilateralism: Cooperation within the WTO

After WTO accession, Russia is unlikely to focus exclusively on building any single alliance. Entry into the Cairns Group, which unites leading agricultural exporters such as Canada and Australia, could prove difficult if it requires wide-scale liberalisation of Russia's agricultural sector. The Cairns Group countries were among the most uncompromising during negotiations on Russia's entry into the WTO. At the same time, Russia may be interested in joining groups that unite countries with transitional economies, as well as new WTO member countries. Alliances with developing countries are also possible within the Group of 20, although it might somewhat

contradict Russia's growing focus on cooperation with the G8. Russia could initiate new regional alliances within the WTO, including members of the Commonwealth of Independent States.

With respect to Russia's cooperation with the EU, one of the possible venues for cooperation could include Russia's attempts to act as a mediator in the disputes between developing and developed countries, including with respect to the issue of agricultural liberalisation. Other areas include the expansion in the coverage of the WTO framework to include issues pertaining to international environmental agreements and greater progress in the liberalisation of investment flows. Most importantly, however, Russia and the EU could use their joint political weight to resuscitate the flagging momentum of multilateral trade liberalisation in the WTO.

3.3 Microregionalism

Apart from launching FTA negotiations and cooperating with the WTO, another possible venue for fostering greater trade integration is micro-regionalism, i.e. greater economic cooperation between sub-national territories and regions. In the case of Russia's cooperation with the EU there is already a wide array of initiatives aimed at intensifying such inter-regional cooperation, particularly between border regions. A key priority for Russia in this area is to attract more investment and trade flows into the Westernmost region of Russia, an enclave largely surrounded by new EU member states, namely Kaliningrad oblast. This territory in spite of its location has a GDP per capita that is nearly 50% lower than the national average. At the same time many in the Russian government are aspiring to transform Kaliningrad oblast into a "Russian Hong Kong" of sorts. The issue of the simplification of the transportation links (including visa formalities in neighbouring countries such as Lithuania) between Kaliningrad and the rest of Russia is a major preoccupation for Russian policy-makers. Apart from the economic ties between Kaliningrad and the surrounding territories of the EU, the accession of Bulgaria and Romania to the EU in 2007 will expand the opportunities for more intensive cooperation between Russia and the EU in the Black Sea region, including within the framework of the Black Sea Economic Cooperation (BSEC).

Overall, the opportunities for expanding the modalities of trade cooperation are set to expand significantly in the coming years and this opportunity needs to be fully exploited by the EU and Russia. This in turn necessitates

the use of wide array of instruments of trade liberalisation. At the same time, all of the above modalities of cooperation may be further complemented by closer ties in the investment sphere, where in exchange for greater access to participation in the development of its energy sector, Russia is given greater leeway in its outward FDI that targets alliances in high-tech sectors of Europe's economy. Russia is likely to seek to complement negotiations with the EU on these issues with a bilateral approach of seeking such alliances with individual members of the EU.

4 Conclusion

Russia's accession to the WTO will set the stage for a more active dialogue with the EU on deeper integration and trade liberalisation. The rules-based framework of the WTO that will become part and parcel of Russia's trade regime after accession to this organisation will greatly facilitate the process of further strengthening of ties between Russia and the European Union. The launching of talks between Russia and the EU on the formation of a free-trade agreement will provide a roadmap for Russia's structural reforms that will supplement the role of the WTO as an "external anchor" for the Russian economy. At the same time, the greater integration of Russia into the world economy as well as the harmonisation of its economic policy framework with that of the EU will redound to greater security and prosperity for all of Europe.

More generally, the need for an active dialogue on closer economic ties will be predicated on the rising number of common concerns/priorities that are shared by Russia and the EU. These include such issues as containing illegal migration, fighting terrorism and money-laundering. The east-ward expansion of the EU also raises the need and the scope for expanding inter-regional cooperation, particularly among border regions. Finally, the issue of energy security is becoming the core issue of Russia-EU cooperation that reflects the inseparability of the security of energy supply for the EU with the security of energy demand for Russia.

The inter-dependencies that are inherent in Russia-EU relations will call for greater trade liberalisation as well as the diversification of the modalities of cooperation in the trade sphere. In the medium-term the key theme of EU-Russia cooperation will be the launching of talks on the formation of an FTA. One of the other reservoirs of boosting economic ties is micro-regionalism and greater cooperation at the regional level. At the bilateral

level of Russia's cooperation with individual countries of the EU, another venue is in the investment sphere related to the formation of strategic alliances at the level of sectors and enterprises. Finally, within the WTO itself Russia and the EU may join forces in breathing new life into the process of global trade liberalisation and working on a common stand in addressing the challenges facing the world's multilateral trading system.

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