The EU-Russia WTO Deal: Balancing Mid-term and Longer-term Growth Prospects?

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In any discussion of EU external relations, Russia looms large as the EU's largest neighbour and the world's largest gas producer. With Russia now virtually certain to ratify the Kyoto protocol, two big issues remain prominent: its accession to the WTO and the economic growth targets of the Russian government.

From the international perspective, the long-running negotiations on Russia's accession to the WTO have helped maintain credibility in a reform process recently described as faltering by Andrei Illarionov, an economic advisor to President Putin. At the same time, expectations of Russia's economic performance have been raised by the President's announcement of a long-run growth target. The question examined here is whether reforms unleashed by Russia's WTO accession can have a positive impact on its economic performance.

The government's growth targets for Russia are certainly ambitious. The headline goal is to double the level of GDP within ten years (between 2003 and 2012). Of course the simplicity of this formula makes it publicly attractive. However, as with all such 'plans', it also invites uncomplimentary comparisons with 'dirigiste' regimes and of course the possibility of general embarrassment if the goals are not achieved.

Hitting the growth target will require the consistent achievement of 7% per annum growth in GDP or better. With around 7% GDP growth achieved in 2003, the goal appears achievable at present (forecasts for 2004 are between 6½% and 7%), but meeting such targets consistently will require more fundamental structural reform, in line with Russia's declared ambition to reduce the country's dependence on oil and gas (Yukos alone makes 4% of GDP). Here, the policy imperatives attached to joining the WTO might be expected to play an important role.

Russia needs to maintain high growth levels for the remainder of the decade and underpin the sustainability of its growth prospects in the longer-term. However, achieving these twin ambitions will not be easy. Structural economic reforms imply costs. Does the growth agenda make reforms more or less likely?

In May the EU signed a bilateral deal with Russia as part of its accession to the WTO. Of course the EU bilateral is only the first of several major hurdles around which Russia must manoeuvre to gain full WTO membership. Comparable negotiations with the U.S., Japan, and China remain ongoing and are likely to prove tough. While some have suggested that the EU deal has been soft on Russia, especially in the services area (and details remain confidential), it provides a starting point upon which other bilateral negotiations can build. For example it seems probable that the US will get a better deal in the telecommunications and financial services sectors, in terms of protection of intellectual property rights, import duties on aircraft and aircraft parts, as well as the dual pricing of energy. So the EU-Russia agreement can be regarded as a milestone in Russia's multilateral progress.

Turning to the substance, the EU-Russia bilateral agreement covers the commitments that Russia will undertake in goods and services once it accedes to the WTO. First, the average tariff level will be bound at 7½% in industrial goods, 11% in fisheries and 13% for agricultural goods, compared with the current effective rate of just under 10% for industrial goods and 14½% for agricultural goods. While these reductions are not dramatic by the standards of a traditional exporting country, importantly the EU-Russia agreement includes progress in two extremely tricky areas for Russia: services trade and the transfer pricing of energy.
Russia is to make commitments in a wide range of service sectors, including telecommunications, transport, financial services, postal and courier services, construction and environmental services, including cross-border provision of services and commercial establishment. At present for example, compared to 100% in the EU and US, the quota set for foreign capital in Russian insurance companies is 25%, and in banks only 12%. These quotas will certainly increase, but to what level is as yet uncertain.

In the telecommunications sector, Rostelekom currently subsidises telephone networks in remote areas from its (disproportionate) profit margins. Russia has agreed to begin the dismantling of the Rostelekom monopoly and a new system of subsidy will be installed by 2008. Overall, approximately 40 service sectors out of total 150 will be opened completely. While this represents only a beginning, we should recall that Russia starts with a much larger service sector than China, and this should perhaps temper any initial disappointment that around forty sectors will remain closed (to varying degrees) to foreign investors.

A second delicate area in the bilateral negotiations has been energy policy: in particular the monopoly position of Gazprom and the question of the domestic price for the industrial users of gas. Despite tough bargaining on domestic gas pricing, the EU was not able to dismantle Russia's defense of Gazprom's export monopoly which, according to outgoing Trade Commissioner Pascal Lamy, is likely to remain 'a red line' for President Putin. While Gazprom controls around 70% of Russian gas production, it controls the vital transit pipelines (carrying, say, cheaper gas from Azerbaijan) and accounts for over 95% of Russian gas exports. Somewhat paradoxically, the EU appears to have been more successful in promoting elements of domestic gas-market reform in Russia than it has been in breaking Gazprom's ability to limit competition in (extra-Russian) EU gas imports routed through its pipelines.

In Russia, gas prices for domestic industrial users will gradually rise from the current \$27-28 to \$37-42 by 2006 and \$49-57 per TCM by 2010. Increasing domestic energy prices will encourage a more efficient use of energy, needed to underpin the Kyoto targets. However, prices reached by 2010 will still be well below the prices for Russian gas exports to the EU (averaging at \$100/TCM plus \$27 transport costs in recent years). So the full economic consequences of the deal may turn out to be subtle.

Somewhat perversely, in view of Russia's aim to wean itself off natural-resource dependency, these arrangements will tend to raise margins in the oil and gas sectors. This will do nothing to reduce Russia's dependence on resource-led growth. By contrast, as we have seen, rising gas prices are likely to depress profit margins in energy-intensive sectors, such as metallurgy, chemicals, and machinery. Meanwhile, higher costs for energy and hydrocarbons should support the necessity to restructure the economy, which has been over dependent on cheap oil, gas and other energy sources.

Thus, if there is a link between the WTO accession and President Putin's 'dash for growth', it probably arises from the hope that rising domestic energy prices may boost microeconomic and institutional reform and stimulate the vibrancy of the domestic economy. However, as the Russian economy tends to be strongly capital-constrained, investment spending tends to come out of profits, or from foreign investment.

Here, the elements of service-sector reform mentioned above should assist the formation of a more mature financial market, and thus in turn encourage greater inflows of foreign portfolio and direct investment. However, they are unlikely to do so in the short-term. For the timeframe of WTO membership negotiations means that accession is planned for 2006. In addition, there will be a transition period of three to seven years, depending on the sector. Therefore, the substantive positive effects of the liberalization of services are not unlikely to be felt until after 2010.

To summarise, reforms arising from Russia's WTO accession may not occur in time to assist its domestic growth aspiration. The bulk of any positive impact of the WTO bilateral deals, arising from reforms to the service sector, are likely to accrue only in the longer-term. That is after 2010. Furthermore, commitments to raise domestic gas prices will only increase the short-term costs of restructuring, but are unlikely to contribute to Russia's medium-term growth aspirations. On the contrary, one consequence of the reforms may be to make it more difficult to achieve high levels of growth during a period of restructuring.