

Dreyer, Iana; Hindley, Brian

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Russian Commercial Policies and the European Union – Can Russia be Anchored in a Legal International Economic Order?

Iana Dreyer and Brian Hindley¹

Iana Dreyer (iana.dreyer@ecipe.org) is a Trade Policy Analyst at ECIPE and Brian Hindley (brian.hindley@ecipe.org) is a Senior Fellow of ECIPE and Emeritus Reader in Trade Policy Economics at the London School of Economics

ABSTRACT

THIS PAPER EXPLORES whether Russia can be made to abide by international commercial rules. It discusses the role the EU, Russia's main trading partner, can and should play in fostering better Russian compliance with international commercial rules.

Russia's economic revival, built on oil and gas, has been accompanied by increasing assertiveness in foreign policies, in which arbitrary trade measures and unlawful treatment of foreign investors have played an important role. Russia being outside many international treaties that shape the rules of international commerce, such as the GATT/WTO, Russia's partners in Europe have seemed to have no recourse. The Energy Charter Treaty has not been used to bring Russia into the fold of market-based rules in the energy sector. The European Union's PCA with Russia has been ineffective. The fragmentation of the EU's market in energy weakens its position in negotiations with Russia.

This paper argues that governments and businesses should better leverage the existing legal arrangements, such as the Energy Charter Treaty and the existing bilateral investment treaties: these have not been used to their full potential. For the EU, Russia's WTO accession should continue to be regarded as a pre-requisite for the negotiation for a Common Economic Space. But WTO accession will not solve the EU's problem of power asymmetry in the energy sector. During the coming negotiations, the EU should consider dropping its usual method of regulatory embrace. It should rather focus on core market access issues, strong dispute settlement and adoption of international standards for regulation in business and industry.

www.ecipe.org

info@ecipe.org Rue Belliard 4-6, 1040 Brussels, Belgium Phone +32 (0)2 289 1350

INTRODUCTION

CAN RUSSIA BE brought to abide by international commercial rules? Russia's economic revival, built on oil and gas, has been accompanied by increasing authoritarianism at home and assertiveness in foreign policies, in which arbitrary trade measures and unlawful treatment of investors have played a strong role. Russia being outside many international treaties that shape the rules of international commerce, such as the GATT/WTO, Russia's partners in Europe sometimes have seemed to be reduced to watching helplessly. But is Russia as isolated from international legal regimes as its actions suggest? Why is the legal framework for EU-Russian commercial relations, with their deep mutual interdependence, so weak? What can be done to establish rule-of-law based commercial relations between Russia and its trading and investment partners?

Newly capitalist Russia entered the global economy in an almost festive manner. Vladimir Putin's presidency (2000-2008) saw economic growth rates of 6-8% per annum on the back of a major oil boom. Foreign direct investment into Russia soared. But as an emerging middle class discovered the joys of Western-style consumerism, many turned a blind eye to the changing realities of power in Russia: its slide towards authoritarianism. In the economic sphere, this turn of affairs was translated into re-nationalization and strengthened monopolization of so-called "strategic sectors", in particular hydrocarbons. Corruption has risen. It is now at the same level as countries with whom the Russian leadership would certainly resist comparison². Foreign investors in the hydrocarbons sector have been harshly treated, while the government has mobilized various bureaucratic bodies to seize assets in oil and gas fields, or has supported government-controlled companies in offering compensation for asset transfers at below market prices.

Russia's sudden entry into the world economy after its quick recovery from its 1998 financial crisis gave the Kremlin the means to forcefully voice its claims to power and regional supremacy, both lost in the years immediately following the collapse of the Soviet Union. Trade measures have become an instrument in the new Russian "diplomacy", but, since Russia is not a member of the WTO, its partners have found it difficult to formulate effective responses.

Russia applied to the GATT/WTO in 1993. But a short revival of interest in the early years of Putin's presidency was followed by an obvious lack of interest in the substance of WTO accession. WTO membership is perceived as a token in international respectability, and, as tensions rose with the West during the war in Georgia in August 2008, a sullen leadership claimed it was no longer interested. But, in the midst of a global financial crisis, the war triggered an unprecedented flight of capital, plunging Russia's economy into recession, and its leadership showed signs of a renewed interest in joining.

Jan Tumlir, a leading figure in the history of the GATT, saw constitutional significance in what would become the WTO. The purpose of such a multilateral economic institution, he said, was to protect the market from arbitrary government intervention with the ultimate goal of protecting states from one another. The GATT/WTO provides a predictable economic order, which is in the interests of both states and private individuals. Tumlir stated that "*the international economic order can be seen as the second line of national constitutional entrenchment.*"³

Russia is a textbook case of an absence of constitutional entrenchment of its polity, and this is

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reflected in its external economic relations. Trade and investment are a tool in the projection and exercise of its national power, as the political background to bans on imports of poultry, meat or wine, hitting Poland, the United States, Moldova, or the shutting of gas pipeline taps to former Soviet bloc countries have demonstrated. Foreign investors have been grossly mistreated, and not only in the hydrocarbons sector. Russia's partners are eager to see it join the WTO, in the hope that this will trigger reforms, achieve better predictability in the trading and investment environment, and give them greater access to Russia's market. The European Union (EU) is eager to create a Common Economic Space with Russia.

But without a willingness in Russia to let power be subjected to rules, attempts from outside to engineer the rule of law in the commercial sphere are unlikely to succeed. The success of China's integration into the WTO, might seem to give grounds for optimism. However the factor endowments of both countries tilt interests into different directions. China's interests favour the multilateral system, since it is rewarded by the possibility of flooding the world with manufactured products assembled by its abundant unskilled labour force. Russia's reliance on hydrocarbons, a commodity that rarely meets import barriers, causes it to shy away from domestic reforms that are politically painful even though they are necessary to secure WTO membership and valuable to the economy.

If one adds to WTO accession a strong commercial agreement with the EU that would tackle regulations, the likelihood of success wanes further. The EU is by far Russia's first trading partner. More than half of Russian exports go to Europe, and the bulk of these are hydrocarbons. Russia, for its part, has become the EU's third largest export market and is a major destination for foreign investment.

When one talks about Russia's integration into the world economy, integration with the European economy is inseparable from that goal. The EU's preferred method in dealing with post-Soviet economies has been through regulatory and procedural embrace. Its partnership and pre-accession agreements, in the 1990s, were guided by its wish to stabilize its eastern borders by the partners' acceptance of EU rules, laws, and standards. The content of the Partnership and Cooperation Agreement (PCA) that is in force between Russia in the EU and its insistence on Russia's adoption of European regulations and standards, echoes times in which it was believed that Russia's path would be towards Europe. But the times have changed. The EU will need to reinvent its approach as it meets a partner that is powerful and may wish to respond to incentives other than the lure of EU foreign investment or closer association with Europe.

These considerations are the backdrop for this report, which will evaluate EU-Russia commercial relations and assess whether and how Russia can be integrated into the European and world economy.

The first part of the report undertakes an analysis of the increasing trade and investment frictions between Russia and its partners. The second section provides an overview of the international legal commitments Russia has signed up to, but which have generally failed to contain or resolve problems. Many hope that accession to the WTO will tie down Russia to respecting basic international rules of commerce, but the precedents are not good. The third section assesses in more detail which problems WTO accession could solve in practice, and which not. The fourth and final section of this report proposes basic guiding principles for the EU's coming discussions with Russia on energy relations, WTO accession and the coming negotiations for a new Partnership agreement.

CHAPTER I - THE NEW RUSSIAN COMMERCIAL ASSERTIVENESS

RUSSIAN COMMERCIAL ASSERTIVENESS in the last few years has fuelled the tense relationships that Russia has developed with its neighbours. Its trade and investment relations with the external world have become extremely politicized, with each move taking a dramatic turn and increasingly souring relations with the West. This chapter provides an overview of the main issues in EU-Russian relations over the last years.

1 - TRADE

THE FIRST TYPE of friction is over trade. Russia's partners have been unable to prevent unilateral and arbitrary measures by the Russian government, to which there is a clear pattern, outlined in Table 1 (see next page). These have fuelled tensions with neighbours and with the EU. These trade measures have generally been taken in the context of bilateral political disagreements. These have included: total or product-specific trade bans (Moldova, Poland – in the meantime resolved, and Georgia); temporary gas delivery stoppages (Ukraine, Belarus), unilateral revisions of bilateral trade agreements (Ukraine and United States). Furthermore, protectionist pressures have led to the introduction of restrictions of Russian exports, namely export tariffs on timber, which have hit the Finnish and Swedish industries. Export tariffs on foodstuffs in the spring 2008 have also been a politically expedient to address the issue of rising food prices.

Most of these actions have targeted close neighbours, most of them former Soviet Union republics. Poland is a former COMECON member. All cases have tested the EU's ability to defend its interests towards Russia in a united manner. The blanket ban on Polish meat followed a few cases of illegal Polish exports to Russia, and must be seen in the context of Poland's opposition to the so-called North Stream project that would build a gas pipeline in the North Sea, thereby avoiding transit through Ukraine and Poland. It has been a test in the EU's ability to present a common front towards Russia and central to the decision not to move forward on EU-Russian partnership negotiations at the bilateral summit in Samara in May 2007. Late in 2007, the ban on Polish meat was lifted.

The blanket embargo on trade with Georgia in 2006 coincided with rising diplomatic tensions following its Rose Revolution, and also appears to be linked with its closer ties with NATO, and its moves to reassert sovereignty over the separatist enclaves of Abkhazia and South Ossetia. Rows over gas price increases between Russia and Ukraine, that led in early 2006 to a cessation of delivery, escalated each time Ukraine made a move that was interpreted as hostile to Russia: the Orange Revolution, the 2007 elections that kept the West-leaning government in place, or more recently, joining the WTO.

TABLE 1

EXAMPLES OF UNILATERAL TRADE SANCTIONS IMPOSED BY RUSSIA ON ITS NEIGHBOURS				
Russian Federation (RF) trade actions	Country targeted	Description.	RF Domestic rationale	International rationale
Import bans / Trade bans	Moldova	Ban on imports of wine. March 2006-June 2007	Officially a sanitary measure	RF support of separatist enclave of Transdnistria; ban follows introduction of pro-Western foreign policy in Moldova
	Poland	Nov 2005- December 2007	Officially a sanitary measure	Deteriorating bilateral political relations, Polish opposition to North Stream pipeline project
	Georgia	Ban on imports of wine and mineral water – March 2006 - ongoing	Officially a sanitary measure	Frozen conflicts in Abkhazia and South Ossetia. Deteriorating bilateral political relations; war August 2008
	Turkey	Blockage of Turkish trucks and Russian border. August-September 2008	No explanation given	Conflict in Georgia August 2008. Turkey a NATO member with interests, including pipelines, in the Caucasus
Gas delivery stoppages	Ukraine	January 2006, Russia cut off gas supplies to Ukraine. Further threats have been made in the following years.	Policy of letting domestic gas prices rise to world market level	RF will to end delivering gas at below market prices to CIS members Ukraine Orange Revolution; geo-political orientation of Ukraine towards EU and West
	Belarus	January 2007. Russian government accused Belarus of siphoning off oil from a pipeline. Belarus wanted to introduce an import duty for Russian gas.	Policy of letting domestic gas prices rise to world market level	RF will to end delivering gas at below market prices to CIS members Downturn in bilateral Russian-Belarusian relations, increasing criticism of RF government by Belarusian authoritarian president Lukaschenka
Export restrictions	Export tariffs on timber	Finland, Sweden	Promotion of domestic timber industry/infant-industry rationale	n/a
	Export tariffs on food (removed)	Spring 2008	Ease inflation pressures	-
Unilateral revision of trade agreements	USA	August 2008. Ban of certain US poultry exports, contrary to US-Russian agreement on trade in poultry	-	Georgian conflict
	Ukraine	Announcement early September 2008 that the preferential trade agreement with Ukraine would be revised following its WTO membership, for fear that cheap imports from outside union would reach Russia duty-free.	-	Ukraine accession to WTO; announcement made after the war in Georgia, where Ukraine had supported Georgia's position.

Trade blockages also accompanied Russia's invasion of Georgia in the summer of 2008. Turkish trucks were held up at the Russian border for no obvious reason. And imports of US poultry were banned. Ukraine, supportive of Georgia in the war, was told that since it had acceded to the WTO, the preferential agreement it has with Russia would be revised.

A further category of arbitrary trade measure is quite unprecedented and can be qualified as "forced trade": in 2007, the German air transport company Lufthansa was forced to re-route cargo operations from a base in Astana, Kazakhstan to a base in Krasnoyarsk, Siberia. The government pressurized Lufthansa into doing this by rescinding Lufthansa Cargo's license to use Russian airspace.

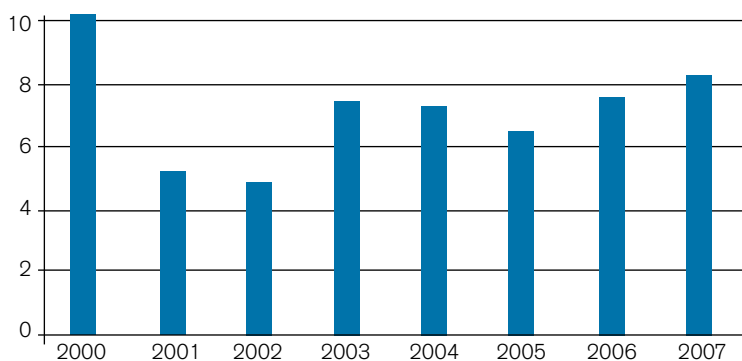
2- INVESTMENT

IN THE LAST years, foreign capital flows into Russia boomed (see figures 2 and 3). Relations with foreign investors, however, have considerably deteriorated.

Policy context

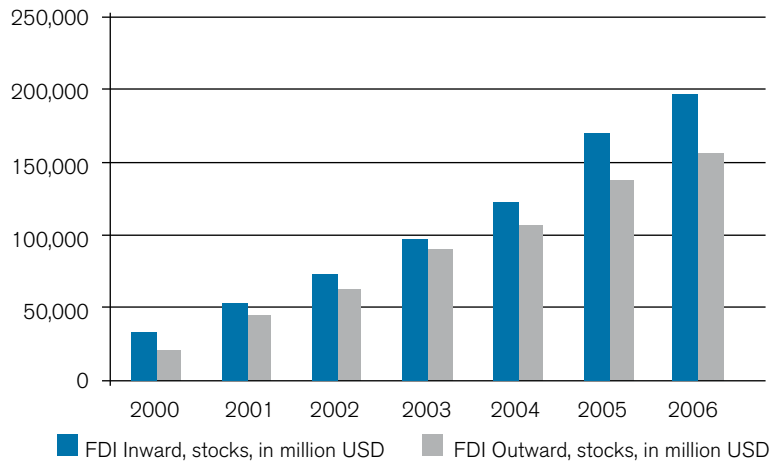
THROUGHOUT THE 1990s, Russia was shunned by foreign investors, due to the collapse of the economy, and the appalling state of its business environment. Yet the 1990s were a period of discovery of the market, massive privatizations, state bankruptcy, and the emergence of a new class of ruthless and gangster-like businessmen, the so-called "oligarchs". The 90s are generally perceived as a period of weakness, misery, violence and humiliation. This situation was reversed, however, after the country's swift recovery from financial crisis in 1998. A new president, Vladimir Putin, introduced further market reforms and solid macroeconomic management. Oil prices soared to reach unprecedented levels close to \$150 in the summer 2008. Economic growth was back, and reached a peak of 8% in 2007 (see Figure 1). Putin and his team have had in mind one major objective: to restore the potency of the Russian state, and to give Russia back its place as global power. In the meantime, FDI to Russia soared, and started moving beyond hydrocarbons, into sectors such as banking, real estate, automobiles, or retailing.

FIGURE 1
RUSSIA: ANNUAL GDP GROWTH RATE IN %



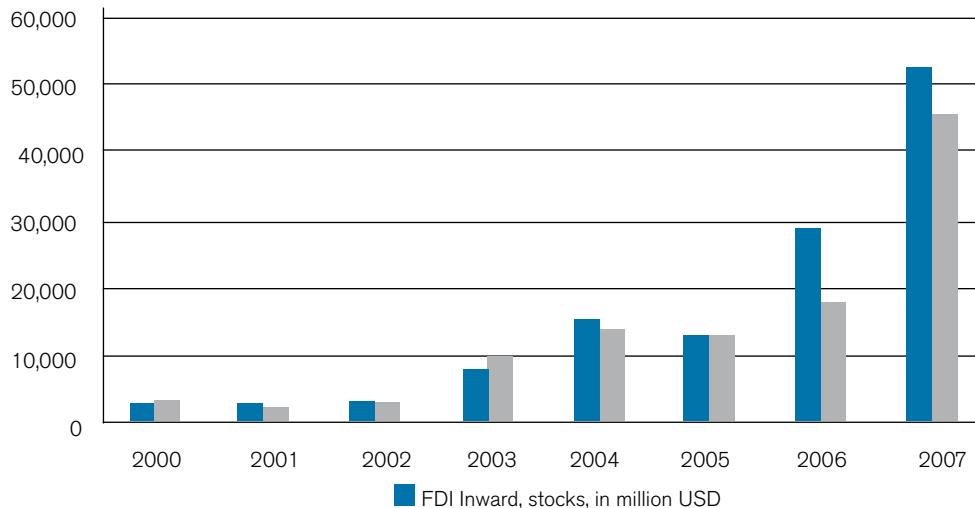
Source: IMF, World Economic Outlook database, 2008

FIGURE 2
FOREIGN DIRECT INVESTMENT STOCKS 2000-2006, MN USD



Source: UNCTAD interactive investment database

FIGURE 3
FDI FLOWS TO RUSSIA 2000-2007, MN USD



Source: UNCTAD interactive investment database; OECD Investment Policy Reviews

Matters started turning sour in late 2003, with the arrest of the CEO of Yukos, Russia’s biggest private oil company, Mikhail Khodorkovskiy. Indicted for tax evasion, Khodorkovskiy was sentenced to nine years in jail. The arrest and sentencing of Khodorkovskiy was the result of the Kremlin’s strategy of reasserting power over the “oligarchs”, in a generalized move towards centralization. The move received strong public support. But with the help of the state bureaucracy, Yukos was systematically subjected to arbitrary legal investigations and to retroactive laws and regulations. Yukos’ assets were seized, the majority of them sold to a shell company that passed on the assets to the state-owned oil company Rosneft. Foreign stockholders of Yukos lost their shares as well, without compensation.

The Yukos affair was the beginning of a trend to renationalization of key sectors of the Russian economy. In 2004, a new policy was formulated, making the development of “strategic industries” a government priority. A law was passed stating that companies from a broadly defined list of sectors would require a minimum level of state ownership and control, and setting limits on foreign

direct investment. In 2008, the law was further clarified, listing 42 sectors in which special approval and caps on foreign ownership were set. These sectors included energy, defence, aircraft, shipbuilding, banking, telecommunications, automobiles, and nanotechnology.

The laws have had two effects. On the one hand, investors have expressed satisfaction at the clarification of the legal framework in which they operate in Russia. On the other, the long list of sectors on which restrictions were ultimately decided upon, revealed the extent of the state's intervention in Russia's productive sector. State assets grew to roughly 40% of the RTS⁴, Russia's biggest stock exchange. The EBRD noted a 5% increase of state ownership on the overall economy after 2004⁵. Renationalization is accompanied by restrictions on competition, from within or abroad: tariffs in the automotive industry were raised; foreign ownership in the oil and gas sector was limited in 2008 to 10% in the oil and gas sector (5% when foreign ownership is in state hands); in 2006, a Gas Export Law strengthened the monopoly of Gazprom's pipelines over exports of hydrocarbons.

Treatment of foreign investors

RENATIONALIZATION AND MONOPOLIZATION occurred in particular in the oil and gas sector. Gazprom, the world's biggest gas company, has seen the state's stake in its ownership increase from 39% to 50.01% in late 2005. It is striking to relate these policy and legal changes to the treatment of foreign investors in recent years.

Sakhalin-2, in 2006, has been a high profile case. It started with questionable methods in an environmental investigation of the Russian government into the international consortium in charge of developing the field. Shell was forced to reduce its share of Sakhalin-2 from 55 percent to 27.5 percent. Mitsui's share declined to 12.5 percent from 25 percent and Mitsubishi's fell to 10 percent from 20 percent. The compensation offered was below market prices⁶.

In 2007, BP was forced to hand over its stake in the Siberian Kovykta gas field to Gazprom at unattractive prices. The last episode, in 2008, involved the BP-TNK, where a sharp dispute between BP and the shareholders of the consortium owning TNK has led to harassment by the bureaucracy on issues like work visas. A deal was reached among the shareholders of BP-TNK – but the methods employed in the dispute, including the mobilization of the state administration to increase pressure, have further contributed to shaking investor confidence.

The cases mentioned in the previous paragraph are high-profile, and concentrated in the oil and gas sector. However, foreign investors in other sectors have also been subjected to arbitrary treatment by the authorities. These included: retailing, catering, automobiles, ICT, business services, financial services or mining. Frequent cases involve, beyond claiming bribes: arbitrary claims on back taxes; introduction of retroactive import tariffs; raids of company offices during investigations; unlawful office raids targeting businesses that have been clients of companies prosecuted in by the authorities such as Yukos or the activist fund Hermitage Capital Management⁷; banning of businessmen; arbitrary product seizures at customs leading to theft; arbitrary investigations for violations of regulations (safety, environment, social); IPR violations and patent theft; forced selling of shares in joint ventures.

To operate in Russia as foreign investor has been adventurous at best, as far back as the 1990s, when law and order collapsed. But the presidency of Vladimir Putin, and in particular his second term, have rendered assaults on the rule of law an integral part of the ruling system. They are more often orchestrated from the top, with powerful business interests, generally well connected

to the Kremlin, influencing the actions of Russia's bloated bureaucracy and its courts.

3- GAS DISPUTES WITH RUSSIA

RUSSIAN GAS HAS become a contentious and divisive issue in the EU, and has significantly fuelled the recent souring of bilateral relations. Contentious issues between the EU and Russia include security of gas supplies, access to Russian hydrocarbon markets for European investments, and Gazprom's operations in Europe.

Security of gas supplies

ENERGY SECURITY HAS become a watchword in recent years, as hydrocarbon has proved to be an increasingly scarce resource, often in the hands of unstable and/or authoritarian regimes. When Russia shut the taps of gas pipelines to Ukraine and Belarus, Western Europe suddenly vividly realized how vulnerable it is to the potential escalation of conflicts with Russia and to gas as one of the weapons to pressurize its neighbours into obedience. Europe imports more than 40% of its gas and 30% of its oil from Russia. For technological, infrastructural and above all political reasons, much of the Middle East, and namely Iran, are non-starters for EU gas imports. Thus, dependence on Russia is here to stay and will probably increase as Europe's energy demand rises.⁸ Security of gas supplies and leveraging of the gas weapon in the context of political disagreements not only concerns Europe indirectly when tensions escalate between Moscow and Kiev or Minsk. These are an old and well-known feature in the Baltic states, which are now full members of the EU. In the early Yeltsin years in particular, the Baltic states were subjected to supply disruptions in the midst of disputes over ownership of gas plants, political allegiances and the place of Russian minorities in these new countries' societies. With the Yukos affair and its consequences on ownership of a Lithuanian gas plant previously owned by Yukos, tensions have escalated again, leading to a new disruption of gas supplies. The methods Gazprom employs in countries of the former Soviet Union have a pattern. They include partial or total supply interruptions, or threats of such, strategic price policies, pressurizing governments under the pretext of existing energy debts and/or *creation* of new energy debts, and hostile takeovers of companies or infrastructure⁹.

This use of energy for geopolitical reasons is not a new Russian feature. However, in recent years it has become, in a more systematic fashion, a tool for the country's new assertiveness in its neighbourhood. Such arbitrary policies raise alarm over the reliability of Russia as an energy supplier to its Western neighbours and the EU. Eastern European countries are more exposed to risks than the big Western markets. Indeed, they have higher dependency rates on Russian gas (ranging from 80% to 100% in Bulgaria, Estonia, Finland, Latvia, Lithuania and Slovakia), but have a lower commercial interest for Russia, given the small size of their market. For transit reasons, however, the big Western markets are exposed to supply disruption risks as well.

Market access in the oil and gas sector

ANOTHER CONTENTIOUS AREA in EU-Russian commercial relations is mutual access to the others' gas market.

The EU has, since the early nineties, demanded from Russia that it open its energy sector to European investors according to the principles of the Energy Charter. The Energy Charter Treaty (ECT) is a European initiative following the fall of the Berlin Wall to create conditions for market-based international trade and investment. It came into force in 1998. The Treaty protects foreign

investors from arbitrary expropriation and sets rules for trade and transit¹⁰ of hydrocarbons. The Treaty's energy-specific provisions on trade and transit are based on those of the WTO, and they also apply to the ECT's non-WTO members. Among other rules, supplying countries are under the obligation not to interrupt or reduce existing transit flows, even if they have disputes with another country concerning transit. The treaty also has investment provisions in infrastructure (pipelines) with the aim of fostering sufficient capacity for transit. Russia signed the ECT, but has not ratified it, although it has agreed to apply it provisionally. Russia has not respected the ECT in these matters: it is not even applying it *provisionally*. Russia has even reinforced Gazprom's monopoly on pipelines. By excluding competitors – be they international or Russian – from investment into the pipeline grid, it fosters underinvestment and threatens energy security. By shutting down energy supplies to neighbours, it has been in violation of the principles of the ECT.

The EU gas market for its part has been open to Gazprom's investments. Table 2 provides a list of Gazprom's participation in EU companies. However, the current EU reform proposals to liberalize the gas market pose a problem, both for the EU and for Russia. The new EU "unbundling" provisions that would force companies to separate energy generation and transmission could affect certain existing Russian investments, namely in the Baltic states, to the displeasure of Gazprom. The EU's liberalization will provide further opportunities for Gazprom to access European consumers directly, which in itself is not a problem. But Russia is concerned that the proposal put on the table by the EU Commission to allow foreign investment only from countries that abide by the Energy Charter – a clause dubbed the "Gazprom clause" - would drive it out of the market.

TABLE 2

GAZPROM'S MOST IMPORTANT INVESTMENTS IN GAS SECTORS IN EU MEMBER STATES			
COMPANY	STATE	% OF SHARES	SECTOR
GHW	Austria	50	Gas trade
Topenergy	Bulgaria	100	Distributor and gas trade intermediary
Overgas Inc. AD	Bulgaria	50	Private gas sale and distribution company
DEXIA Bulgaria EOOD	Bulgaria	25.5	Gas trade intermediary
Vemex	Czech Republic	min. 33	Gas sale
Eesti Gaas	Estonia	37.02	Gas trade and transport
Gasum Oy	Finland	25	Gas transport and distribution
North Transgas Oy	Finland	50	Construction of gas pipelines on the Baltic Sea bottom
FRAgaz	France	50	Gas trade
Ditgaz	Germany	49	Gas trade
Gerogas	Germany	51	Gas trade, stock exchange operations, partner - Ruhrgas
Verbundnetz Gas	Germany	5.3	Gas transport and marketing
Wingas	Germany	35	Transport and storage of gas
Wintershall Erdgas Handelshaus	Germany	50	Distributing gas supplied by Gazexport to 2012
Zarubezgas Erdgashandel	Germany	100	Gas trade
Prometheus Gaz	Greece	50	Marketing and technical services for gas undertakings
Panrusgas	Hungary	40	Gas trade and transport
Promgaz	Italy	50	Gas trade and marketing
Volta	Italy	49	Gas trade and transport

Latvijas Gaze	Latvia	34	Gas trade and transport
Stella-Vitae	Lithuania	30	Gas trade
Lietuvos dujos	Lithuania	34	Gas distribution (monopoly)
Kaunas Power Plant	Lithuania	99	Electricity production
Peter-Gaz	Netherlands	51	Gas trade
Europol Gaz	Poland	48	Gas transport
Gas Trading	Poland	35	Gas trade
WIEE Romania	Romania	50	Gas trade
WIROM	Romania	25.5	Gas trade and distribution
Slovruغاز	Slovakia	50	Gas trade and transport
Tagdem	Slovakia	7.6	Gas trade
Interconnector	UK	10	Operator of the Bacton (UK) - Zeebrugge (Belgium) gas pipeline

Source: Centre for Eastern Studies

CHAPTER II – A WEAK LEGAL FRAMEWORK FOR RUSSIA’S EXTERNAL COMMERCIAL RELATIONS

IN THE WEST and in the world of WTO members, commercial relations very rarely become an instrument of high-politics, although one cannot ignore trade sanctions and investment bans imposed by big powers, notably the United States, on “rogue” states or on Cuba. Trade is an element of a country’s statecraft, but bodies such as the WTO tend to tame the use of economic sanctions as a tool of foreign policy. The politicization of trade instruments in Russia’s commercial policy reveals what can happen when a state is not constrained by binding international rules.

1 - RUSSIA’S WEAK INTEGRATION IN THE INTERNATIONAL TRADING SYSTEM

RUSSIA’S INTEGRATION IN the global economy remains thin, despite its recent growth. Its main exports are hydrocarbons and metals. Both represented 64.7% and 16.1% of Russia’s exports respectively in 2007. Its imports originate mainly from the EU, which provides Russia with the machinery and equipment needed in Russia’s recent economic boom (Table 3). Its hydrocarbon-based economy gives it an important weight in the global economy (Russia is the world’s 10th largest economy), but its reliance on raw commodities only underlines the country’s structural weaknesses. In its last *Global Competitiveness Report 2008-2009*, the World Economic Forum highlights, that:

“Russia’s main strengths are its large market size and improving macroeconomic stability partly thanks to windfall oil revenues. However, to improve its competitiveness further, the country must tackle a number of structural weaknesses. (...) Private institutions (...) get poor marks, with corporate ethics in the country placing Russia 112th overall on this indicator. In addition, goods and financial markets are inefficient by international standards (ranked 99th and 112th respectively).”¹¹

TABLE 3

EU 27 TRADE IN GOODS WITH RUSSIA BY PRODUCT (MILLION EURO)						
EXPORTS			IMPORTS		BALANCE	
	2000	2007	2000	2007	2000	2007
Total	22 738	89 125	63 777	143 587	-41 039	-54 462
Primary products:	3 652	8 626	40 172	100 196	-36 519	-91 570
Food & drink	2 823	6 761	727	893	2 096	5 868
Crude materials	708	1 322	3 652	4 973	-2 944	-3 652
Energy	121	544	35 793	94 330	-35 671	-93 787
Manufactured goods:	18 483	78 715	13 487	22 054	4 996	56 661
Chemicals	3 280	12 369	2 519	4 478	761	7 891
Machinery & vehicles ¹	8 381	43 302	1 074	1 457	7 308	41 845
Other manuf'd articles ¹	6 822	23 043	9 895	16 119	-3 072	6 924
Other	602	1 784	10 118	21 337	-9 516	-19 553

Source: European Commission, DG Trade

Its weak economic integration is matched by a weak institutional and legal integration in the current international economic order.

First and foremost, Russia is not a member of the WTO. It applied to the GATT, which subsequently became the WTO, in 1993. Yet it still has not joined. In the early years of the Putin presidency, the government made serious moves to undertake reforms and negotiate market access with its main trading partners. Russia reached a bilateral accession protocol with the European Union in 2004, and its protocol with the United States in late 2006. Yet the remaining multilateral negotiations and the likelihood of a Georgian veto to Russia's accession point to a relatively long road ahead for accession. Kremlin support for WTO accession waned after 2003-2004, as the domestic policy climate tilted towards greater intervention in the economy. The massive capital flight that followed the Georgian war this summer and Russia's ensuing emersion in the global credit crisis have, however, led to more conciliatory tones from the Kremlin and statements that it wants to join the WTO. However, high uncertainty remains on the willingness of the Russian government to go further in WTO accession¹².

Russia's absence in the WTO renders it difficult to assess its trade regime, since the transparency provided by WTO-exercises such as the Trade Policy Reviews is absent. However, a few indicators give a rough idea of Russia's situation. The World Bank's *Doing Business 2009* report ranks Russia 161st out of 181 countries in its "Ease of Trading Across Borders" index, which measures in priority customs procedures and trading costs. The new *Global Enabling Trade Report* by the World Economic Forum gives Russia an overall rank as 103rd out of 118 countries. In the criterion "market access", Russia ranks 99th, in "border administration", it ranks 92nd, in "transport and communication infrastructure" it ranks 60th, and in "business environment" it ranks 114th.

Russia's absence in the WTO further deprives its trading partners of fundamental predictability in the government's trade policies. Signalling an absence of commitment to international rules of commerce, and giving free reign to arbitrary protectionist measures, this outsider status is bound to deter investment into Russia, which, it must be recalled, took off only recently, and during an unprecedented oil boom. With no recourse to the WTO's dispute settlement body, there is no possibility of trading partners and investors having access to an authoritative and independent ruling and receiving a guarantee that it will be respected afterwards.

Russia is not member of any bilateral or regional free trade agreement beyond the *Eurasian Economic Community* and the *Single Economic Space* set up under its leadership with former CIS members. These agreements have not been fully implemented and contain serious carve-outs.

2 - EU-RUSSIAN FRAMEWORK FOR COMMERCIAL RELATIONS

THE EU WISHES to reach some form of free trade agreement (FTA) with Russia. However, it will not consider an FTA with Russia before it becomes a full member of the WTO. In the meantime a PCA is in place. Signed in 1994, it came into force in 1997. It expired in 2007, but is for the time being renewed on an annual basis. In 2003, the EU and Russia agreed to embark on a Strategic Partnership, and to launch Common Spaces¹³, among which a Common Economic Space. So far talks to renew the PCA or to reach a Strategic agreement have failed, however. In 2007 they were blocked by the EU itself, as it provided a rare common front towards Russia concerning the prolonged ban on Polish meat imports. The war in Georgia in August 2008 failed to trigger a European consensus on a common position towards Russia, yet the decision was taken to suspend the negotiations that had been kick-started in July. In November 2008, however, the EU decided to let the talks resume, despite Lithuanian and Polish reservations.

The current framework for commercial relations offered by PCA is very weak. The agreement sets a basic framework for the operation of trading, financial and other economic transactions. Its fundamental aim is to align Russia's domestic economic legislation with the EU's. There are recurrent references to "regulatory harmonization". It needs to be borne in mind however, that the PCA is *not* a trade or investment liberalizing agreement. Article 1 stipulates the PCA's objective:

"to create the necessary conditions for the future establishment of a free trade area between the Community and Russia covering substantially all trade in goods between them, as well as conditions for bringing about freedom of establishment of companies, of cross-border trade in services and of capital movements"

The list of economic areas covered by the PCA is long. It is provided in Box 1 (see next page). However, many clauses are best endeavour clauses, and the settlement of potential disputes is not binding upon the parties. The PCA has a high symbolic value, but in practice it is largely ineffective.

A certain number of regulatory and political Dialogues at intermediate ministerial level have been set up over the years. The St Petersburg Summit in 2005, which launched the *Roadmap to the Common Economic Space* set up Dialogues in the following areas: investment; intellectual property right protection, public procurement; regulatory dialogue on industrial products; industrial and enterprise policy; energy; competition; macroeconomic and financial services; trade facilitation and customs. These topics reflect the EU's most pressing wish list in its commercial dealings with Russia.

BOX 1**COMMERCIAL PROVISIONS OF THE EU-RUSSIAN PARTNERSHIP AND COOPERATION AGREEMENT**

- mutual MFN treatment
- rules on business establishment and investment;
- rules on transfer of payment and capital transactions

- economic cooperation in the following areas:
 - » industrial cooperation
 - » investment promotion and protection
 - » public procurement
 - » standards
 - » mining and raw materials
 - » science and technology
 - » education and training
 - » agriculture/agro
 - » nuclear energy
 - » space
 - » construction
 - » environment
 - » transport
 - » postal services/telecommunications
 - » financial services
 - » regional development
 - » social cooperation
 - » tourism
 - » SMEs
 - » communication/informatics
 - » customs
 - » statistical cooperation
 - » economics
 - » money laundering
 - » drugs
 - » capital movements and payments

- **Energy cooperation - Art 65** on cooperation in the energy sector, the PCA stipulates: "Cooperation shall take place within the principles of the market economy and the European Energy Charter, against a background of the progressive integration of the energy markets in Europe".

- **Standards - Art 77** of the PCA sets down as principle promotion of European technical standards, systems of certification and regulatory approaches

- **Dispute settlement - Article 101** " (...) The conciliator's recommendations (...) shall not be binding upon the parties"

The effectiveness of the regulatory harmonization approach taken by the EU in the PCA and in the Dialogues is open to question.

3 - RUSSIAN BITs

THE RIGHT TO protect European investors can in principle be created in Bilateral Investment Treaties (BITs). Russia has signed and ratified a number of these and a list of BITs and the date of their signature and entry into force appears in Annex 1. As of today, the Russian government has signed 55 BITs and ratified 36. All existing BITs were signed after February 1989, and most of them came into force before year 2000. Russian BIT partners in Europe include France, Germany, Italy, UK,

the Netherlands, Belgium and Luxembourg, Austria, Finland, Greece, Sweden, Norway, and Switzerland. However, Russia has not ratified the BIT it signed with the United States in 1992. Interestingly a BIT with Cyprus, an important offshore financial centre for Russian companies, has not come into force either. Russian BITs cover about 40% of Russia's inward and roughly 15% of its outward foreign direct investment stock.

Bilateral investment treaties are designed to guarantee foreign investors treatment in accordance with the established standard in international law. They aim to protect investors and investments from discriminatory measures, uncompensated expropriations of property, denial of due process and guarantee fair and equitable treatment. Some BITs go further by providing for 'umbrella clauses' which create the obligation to respect all commitments arising under contracts between a foreign investor and the host state. A core element of BITs is to allow investors to enforce their rights under a respective BIT vis-à-vis the host state through international arbitration, so-called 'investor-state arbitration'. Venues for such proceedings are typically the International Centre for the Settlement of Investment Disputes (ICSID), the Stockholm Chamber of Commerce (SCC), or ad-hoc tribunals on the basis of the widely used arbitration procedural rules codified by the United Nations Commission on International Trade Law (UNCITRAL). However, Russia is not party to the ICSID. Seven arbitration cases involving the Russian Federation are known.

4 - ENERGY CHARTER

A FURTHER AVENUE for legal handling of commercial disputes for European investors is the Energy Charter Treaty (ECT). The ECT has strong dispute settlement provisions, which opens avenues for the settlement of disputes on the treatment of foreign investors and expropriation, a conciliation mechanism on transit matters. As noted earlier, Russia has not ratified the Treaty. It has, however, agreed to apply it provisionally, and is therefore bound by it¹⁴. Nevertheless, Russia has largely ignored many key provisions of the ECT. Yet but for four cases related to the Yukos affair, which are currently ongoing, Russia has not been seriously challenged. There is scope for exploring this legal avenue and attempting to ensure that Russia is made accountable for its international commitments.

Concluding remarks

RUSSIA'S LEGAL INTEGRATION into the world economic system is very weak. It remains outside the WTO. The legal structure of its relations with the EU, Russia's top trading partner, is framed by a weak and outdated agreement. International investors protected by a BIT do have a chance of getting a hearing and receive potential compensation should damage be established by an international arbitration tribunal -- yet only 40% of foreign investment into Russia is covered by BITs.

CHAPTER III – ACCESSION OF THE RUSSIAN FEDERATION TO THE WTO: THE STATE OF PLAY

WTO ACCESSION is a key step for Russia's integration into the international economic order and its rules. Accession of Russia to the WTO accession is a stated priority for the EU, and a precondition for deepening ties further. This section examines the current state of play in Russia's WTO accession and examines what can be expected from Russian WTO accession.

1 - BACKGROUND

APPLICANTS FOR MEMBERSHIP in the WTO must clear three hurdles. The highest two of these centrally involve the working party that the WTO sets up for each application for membership. Any member of the WTO can join any working party, and the decisions of working parties are taken by consensus.

The first step in the accession process proper is a draft memorandum, sent by the applicant to the working party, describing the applicant's trade-policy regime. Members of the working party may question the memorandum and ask for elaboration of its contents and/or omissions.¹⁵ The hurdle lies in the requirement that the applicant amends its policy regime – if necessary -- so that its policies are in conformity with the WTO obligations it will assume.

The working party for Russian accession was set up in June 1993. Russia submitted its memorandum on 1 March 1994, and has since submitted at least two revisions (in October 1995 and April 1997). The working party has met on at least thirty occasions.

The applicant must also negotiate with each member of its working party a bilateral treaty that certifies that the member accepts the accession package offered by the applicant. If the working party has X members, the applicant must take part in X bilateral negotiations; and for accession to occur, each negotiation must end with a bilateral agreement. This is the second hurdle.

In the case of Russia, there are 60 members of the working party (counting the EC and its member states as one) – a record high number. Fifty-seven of them have signed a bilateral agreement. The three who have not include two new members, Vietnam and Cambodia, who probably have not yet had time to negotiate their bilaterals, but seem unlikely to raise major problems; and Georgia, which may.¹⁶

The final step of the working party is taken only when:

- a. all members of the working party have concluded a bilateral agreement with the applicant, and
- b. the working party is satisfied that the applicant's memorandum, revised if necessary, accurately describes its policies, and
- c. the policies described meet WTO standards.

Once these conditions are satisfied in the view of its members, the working party adopts a protocol of accession for submission to the Ministerial Conference. The third hurdle – probably the lowest of the three – is adoption by the Ministerial Conference of the protocol. When that is done, the accession process is complete and the applicant will be invited to become a member of the WTO.

That 57 of 60 bilaterals have been signed might seem to suggest that Russia's accession process is close to completion. In the working party, however, although much had been done, difficult issues remain. We therefore concentrate on the working party as such.

2 - RUSSIAN ECONOMIC POLICY: ISSUES FOR THE WTO¹⁷*Tariffs*

MANY RUSSIAN TARIFFS – about 1700 of 11000 tariff lines – contain a specific element: they are stated, for example, as “X per cent, but not less than Y euros per tonne”. Thus, if €Y is more than X per cent of the import price, the tariff is more than X per cent – and may be *much* more than X per cent.

The specific element means that calculation of an average tariff for Russia demands much more information (in particular, import prices) than for most countries, and it is only recently that Shepotylo and Tarr, 2008, have amassed the necessary data. Tarr, 2007, p.5 reports that “Russia’s MFN tariffs were about 12.1 per cent on a simple average basis or 14 per cent on a trade weighted basis in 2005 . . . (w)e find that ignoring the specific tariff results in a reduction in the calculated average tariff to about 11 per cent”.

Tarr, 2007, p.5 also reports that: “The food sector and light industry are the aggregate sectors with the highest tariff rates – their tariff rates in 2005 were 23.1 per cent and 19.5 per cent on a trade-weighted basis. At the two digit level, motor vehicles, footwear, leather products and sugar are among the most highly protected”.

The negotiations on tariffs created tensions in some specific areas. One of these was civil aircraft, where Russia has eventually agreed that tariffs on wide-bodied aircraft will be reduced from 20 to 7.5 per cent in the four years following accession. Russia has also agreed to substantial tariff reductions on imports of construction equipment; agricultural and scientific equipment; and medical devices. Average tariffs in these areas will be 5 per cent.

Russia has agreed with the working party that its tariffs will fall to 8 per cent on average. It is unlikely to be able to retain the specific element in the existing tariff.

Non-tariff distortions (NTDs)

- *Agricultural subsidies*

SEVERAL NTDs HAVE become prominent in the negotiations, many of them in agriculture. One important outstanding issue is the level of agricultural subsidies that Russia may pay to its farmers. For “green-box” subsidies – subsidies that are deemed to be non-distorting – the WTO imposes no limit. It is the permitted level of *distorting* subsidies, therefore, that the accession negotiation is dealing with.

Acceding countries have in the past taken the three years prior to accession as the base period for permitted trade-distorting subsidies to agriculture and the permitted level has typically been negotiated down from that base level. Russia, however, would prefer a higher level of permitted subsidies than application of that rule allows. Instead, Russia wants to have the right to match US subsidy levels. This demand will be one of the most contentious in the remaining negotiations; especially so as other applicants with a similar negotiating position (for example, Kazakhstan) will expect to be allowed to follow any precedent set in the negotiation with Russia.

- *Meat and poultry*

MEAT IMPORTS AND related documentation and inspection and approval of facilities involved in the

export of meat to Russia seem to raise continuous problems. In its bilateral negotiations with the US, however, Russia reached agreements on inspections by US authorities in Russia and Russian inspections in the US.

But the EU, which currently provides almost 80% of Russian beef imports and 50% of its pork imports, also has problems in this area. Russia lifted a contentious ban on imports of meat from Poland in early 2008, but, in April 2008, issued a new ban on chicken and pork imports from seventy European companies on the ground that meat sourced from them contained traces of antibiotics.

Furthermore, in the first week of September 2008, according to the *Financial Times*¹⁸, Russia suspended agreements to import pork and chicken and banned nineteen US companies from exporting poultry to Russia. It also blocked Turkish trucks at customs posts.

It is apparent that this is an area of sensitivity for the Russians. It is not yet clear whether, or how, those sensitivities can be accommodated.

- *Export taxes*

RUSSIAN EXPORT TAXES, especially on timber, are another outstanding issue. Russia imposes export taxes on raw timber, apparently to promote its own wood processing industries. It doubled the tax to \$15 a cubic metre on 1 April 2008, and has said that it will raise it to \$50 in 2009¹⁹.

The issue is complicated by the fact that the US and the EU are apparently contemplating making a general issue of export taxes. The Commission says that there are 450 instances worldwide of export taxes on commodities. The US is reported²⁰ to be preparing a challenge to Chinese export taxes in the WTO, and the same report says that the EU is considering joining any US complaint. To accept Russian export taxes while attacking Chinese export taxes, however, may be difficult.²¹

Russia also levies a 50 per cent tax on exports of aluminium scrap.

Whether or not the EU takes this issue to the WTO, there can be no doubt that the EU takes it seriously. The EU blocked Ukraine's entry into the WTO until January 2008, when Ukraine agreed to cap its export duties on a range of goods including metals and agricultural products.

Services

- *Financial Services*

THE RUSSIAN BANKING and insurance sectors apparently doubt their ability to survive international competition. They therefore bitterly opposed liberalization in these sectors. In the light of this, the outcome of the negotiations on services is remarkable.

In banking, Russia has agreed to bind existing market-access commitments and has offered new commitments. These include allowing 100 per cent ownership of banks and other non-insurance financial institutions; allowing cross border provision of a variety of services, including asset management and credit cards; allowing foreign investment companies to own and trade all securities available in Russia, and to participate in financing the privatization of state-owned enterprises. Moreover, the share of the sector that foreign banks will be allowed to capture will rise from 15 per cent to 50 per cent.

The US Treasury has been trying to ensure that countries admitted to the WTO should permit branch banking. The issue of branch banking, however, proved to be highly contentious within Russia, with President Putin maintaining that US insistence on a right for US banks to open branches in Russia could cause Russia to withdraw its application to the WTO. In the event, the US did not insist and Russia agreed to allow subsidiaries but not branches. Except for LDCs Russia is the only applicant to the WTO whose conditions of accession include no commitment to permit branches.

In insurance, Russia will allow 100 per cent foreign ownership of non-life insurance companies on accession. Prohibitions on foreign sales of insurance lines mandated by Russian law will be phased out in the five years after accession, as will restrictions on the number of licenses granted to foreign firms. The amount of foreign investment in the sector will be increased to one half of total investment in the sector (from 15 per cent at present).

- *Telecommunications*

THE LONG-DISTANCE LANDLINE monopoly of Rostelekom will end. Telecoms providers that are completely foreign-owned telecoms will be permitted to operate in any telecoms sector. Russia agreed to implement the WTO Basic Telecommunications Reference Paper, which provides for transparency and interconnection obligations and requires the setting up of an independent regulator.

- *Distribution services*

UPON ACCESSION, RUSSIA will allow foreign-owned companies to engage in wholesale, retail and franchise sectors. This commitment expressly applies to express delivery services.

- *Professional and business services*

RUSSIA WILL PROVIDE market access and national treatment for numerous professions, including accountants; advertising professionals; architects; engineers; health-care professionals; and marketing and management experts. There will be no restriction on the nationality of the owners of companies providing business services.

Intellectual property

THE WORKING PARTY appears to accept that Russian laws on intellectual property are consistent with what would become its WTO obligations. The outstanding issue, however, is enforcement: US private industry sources, in particular, claim that Russia is not applying its laws to pirated software, music, films and pharmaceuticals: “culprits are either not caught, or, if caught, they are not punished”.

As part of its bilateral treaty with the US, Russia agreed to strengthen its enforcement of its intellectual property laws, signing a side letter to that effect. According to US sources, however, this has not yet had discernible effects.

Final comment on Russian commitments

ON PAPER, WHAT has been agreed is impressive. Difficult issues remain, however. Of these, the permitted level of distorting agricultural subsidies is likely to be the hardest to solve; but export duties and straightening out Russia's zig-zag course on imports of meat and poultry may also raise serious problems.

Yet the problem at the core of Russian accession may have little to do with these outstanding issues. The central issue may rather be widespread doubt about the status of Russian commitments and promises.

There is little point in rehearsing in this paper the string of cases in which investors in Russia have been maltreated. More important in this context are the common characteristics of many of these cases. The first is the use of soothing words. A report in the *Financial Times*²² provides an example:

EU officials said they had raised the shareholder dispute at TNK-BP, the Anglo-Russian joint venture, with Mr Medvedev. "Mr Medvedev told us that the situation should not be dramatized, the position of the partners should be resolved, and the state should remain neutral." "I welcome this," said Peter Mandelson, the EU trade Commissioner. "He emphasised that the state's job is to provide a legal framework and enforcement but otherwise keep away."

The words are indeed to be welcomed. But they do not correlate with actions. The Russian state did intervene in the dispute – for example by removing the Russian entry visas of key players on the BP side of TNK-BP. Why the gulf between words and action?

It is difficult to believe that Mr Medvedev was simply telling untruths. But, if not, one is driven to the conclusion that the government of Russia is not fully in control of its various ministries. And in that case, how reliable are its commitments in the WTO?

Nor is it only ministries that the government seems unable to control. In other cases of investor mistreatment, regional and local governments, and regional and local courts are involved, perhaps acting independently of the government in Moscow; which might in one sense be laudable, but again raises the question of the reliability of commitments made by the central government.

WTO working parties in the past have been sensitive to the issue of whether central governments making commitments to the WTO are in fact in a position to ensure that the commitments are carried out. To abandon that concern in the case of Russia would be odd. To pursue the issue, however, is to put Russian accession at risk.

Russian membership of the WTO is a major step, both for Russia and the world trading system. Perhaps for that reason, the event is attended by both overstatement and understatement of what WTO accession can achieve. In this section, I address some of these issues.

3 - PROBLEMS THAT WTO ACCESSION CAN PLAY A ROLE IN SOLVING

WTO ACCESSION PROVIDES a clear and sensible framework for the formulation of Russian trade policy. What Russia cannot legally do under the WTO, it by-and-large should not want to do in its own interest.

WTO accession offers other advantages also.

Policy facilitation

Politically, the process of accession can provide a means for a government to overcome retrograde domestic interests. If the objective of accession can be promoted as a worthy national objective, the position of groups opposing accession – whether their opposition is explicit or implicit – is weakened; and the way is opened to worthwhile economic reforms. This happened during Mr Putin’s first term as president: WTO accession was given a high priority, and this facilitated reform.

Rutherford and Tarr have made a number of estimates of the economic gains that might accrue to Russia as a result of accession. Their results suggest that the potential gains are substantial: 7.8 per cent of consumption, for example, in Rutherford and Tarr, 2006. Moreover, the bulk of these gains derive from the facilitation of internal reform: Tarr, 2007, comments that, “... less than 10 per cent of the gains come from improved market access for Russian exporters”.

This potential effect of WTO accession is not automatic, however – some enthusiasm from the applicant is necessary. Hindley, 2008, Ch 8, provides evidence for this proposition from four recent accessions.

Dispute settlement

THE TRADING PARTNERS of Russia, however, might regard the greatest advantage of accession as bringing Russia within the scope of a functioning dispute settlement system. Of course, WTO dispute settlement only applies to alleged breaches of WTO obligations, and actions by Russia to which a trading partner objects may or may not run counter to Russia’s WTO obligations. The commitments that Russia has undertaken as part of its accession process, however, add substantially to the probability that objectionable Russian actions will breach Russian WTO obligations.

The system, however, is not fast: from setting up a panel to finishing an appeal takes a year. Nor are its penalties draconian. They are designed only to compensate for the nullification and impairment suffered by the complainant, not to punish the breach.

Parties in dispute with Russia cannot be worse off by possessing the power to challenge Russian actions in the WTO. It may be, however, that they are not very much better off.

4 - PROBLEMS THAT WTO ACCESSION CANNOT SOLVE

PROBLEMS THAT ARE relevant under this heading are problems in relations with Russia, for which:

- a. WTO accession has been proposed as a solution; but
- b. the efficacy of the prescription is open to question.

For example, here is Nicolas Sarkozy enunciating a view that appears to be widespread in France and Germany:

Nicolas Sarkozy, president of France, which holds the EU’s rotating presidency, told the European Parliament last night that he did not view Russia as a rival to the EU. European policymakers should try to bring Moscow closer to “European values” by laying

the basis of a “common economic space between Russia and the EU”, he said.²³

Mr Sarkozy was in fact talking about resuming talks with Russia on a Partnership and Cooperation Agreement (PCA) between Russia and the EU, but his argument presumably also applies to WTO membership, which EU policy makers appear to regard as a necessary complement for a new PCA.

Mr Sarkozy does not say which playing field he has in mind when he says that Russia is not a rival to the EU, and it is therefore difficult to know what he means. Much the greater problem, however, is the implicit claim that if Russia is accorded a PCA with the EU; or membership in the WTO; or a “common economic space between Russia and the EU” it will be encouraged to adopt “European values”. But will it be? The proposition seems open to doubt.

Why, though, should conversion of the Russians to western values be a western objective? To live peaceably with Russia does not *ipso facto* require that Russians adopt European values (or Europeans Russian ones).

Yet living peaceably with Russia does indeed seem more likely to happen the more contacts there are between the west and Russia. Conversion may be a foolish objective, but mutual respect and accommodation are not; and that seems to imply that the Russians should be met as equals at as many venues as possible.

But should the WTO be one of these venues? The WTO has its own valuable role in the world. It is therefore necessary to ask whether Russian accession would have a negative effect on the WTO. And unfortunately, a case can be made that it will.

There is a widespread belief that Russia is more interested in WTO membership for its perceived political benefits than for its economic ones. The *Financial Times*, for example, reports²⁴ the views of a “diplomat in Geneva”:

“Russia appears to be motivated not by the prospect of economic reform or lowering tariffs for its goods but by the attraction of joining a club that most of the other countries of the world belong to” said one diplomat. “They saw it as more of a political process.”

The WTO, though, operates by consensus. A large and powerful new member who is more interested in demonstrating its power to disrupt than in the processes and objectives of the WTO could totally disrupt it.

Russian accession to the WTO is not a straightforward matter. It demands careful thought.

CHAPTER IV – SHAPING A NEW FRAMEWORK FOR COMMERCIAL RELATIONS - PRIORITIES FOR THE EU

THE EU is about to launch negotiations for a new Partnership agreement with Russia, and hopes that these negotiations will solve its commercial concerns. This final section explores methods for the EU to approach its coming talks with Russia, in the context of its WTO accession, to resolve disputes, and gain better, predictable, and rule-of-law based conditions for trade and investment. The EU’s approach focuses on signing a broad agreement in the hope of thus solving disputes and inducing Russia to operate more predictably. But this approach may prove to be no more than wishful thinking. Should the EU expect to achieve results, several considerations will need to be taken into account, and these are discussed as follows.

1 - PROMOTE COMMERCIAL RELATIONS BASED ON THE RULE OF LAW

As a general approach, the EU should speak out on its principles and objectives, and make them an integral part of its strategy. Brussels' official discourse has considerably evolved. There is no longer mention of cooperating on the basis of "common values", as stated in the existing PCA, but of "shared interests", and the defence of Europe's values²⁵. This is a shift towards greater realism in the EU's approach to Russia.

Yet "realism" risks entailing deals that are in the long run damaging to Europe's interest. Bilaterally struck energy deals, such as the one concluded in October 2008 between Eon and Gazprom, with the support of the German government²⁶, are such an example. The Russian government permits investment into its strategic sectors under certain conditions and as part of a strategy to raise the competitiveness of its firms. But such arrangements and generally offered as a reward for political cooperation and provide no guarantee on the long-term security of the investment.

An approach based on the guiding principle of the rule of law in commercial relations would be better suited. It favours economic integration, but subjects it to guiding principles. This might sound excessively idealistic, but such an approach accommodates the need to further economic integration with Russia without the EU becoming a ball in the game of Kremlin politics.

Fitting neatly in an overall approach based on the rule of law, it is advisable to develop a strategy aiming at defending EU investor interests with the legal tools that are available. There is untapped potential in the existing BITs and the Energy Charter for investors to litigate for their rights²⁷. Litigation is a tool that investors shun in assertive petro-states, and especially Russia. Reasons for avoiding litigation have to do with costs and length of the process. But above all, especially in the field of energy, the reason is fear of retaliation and of putting at risk the assets that remain invested in Russia. But this approach is counter-productive in the long run: failing to defend legal rights does not protect these rights in the future, and reinforces the government's impunity. Furthermore, the legal methods proposed by BITs and the Energy Charter can help depoliticize conflicts and better insulate commercial cases from overall political and geopolitical disagreements. Finally, they subject the Russian government to the accountability it has itself signed up to and to the basic principles of the rule of law the EU wishes to promote.

Rule of law should also be applied domestically. The first area of focus should be scrutinizing EU-Russian business and political relations. Gazprom, other state-controlled companies, or Kremlin-connected Russian "oligarchs" woo European politicians, to offer lucrative jobs on company boards, or to tilt bilateral relations in Russia's favour. Brussels and European governments should foster transparency in disclosing financial relations between high-level Russian businessmen and EU politicians. Any compromising relationship should be widely publicized²⁸, and if necessary, corruption cases brought to court. The other area of particular vigilance is watching Gazprom's competitive practices, and any breach in competition legislation dealt with all the legal tools that are available in the EU.

Finally, a rule-of-law approach in EU-Russian commercial relations means a focus on ensuring Russia's successful integration into the WTO, which provides basic international standards. The current strategy to launch projects for a free trade agreement only after Russia joins the WTO should be maintained. Even if Russia joins the WTO, it could be useful to take enough time to assess its behaviour in practice before rushing into new deals.

2 - CONSISTENT POLITICS

EUROPE'S ENERGY DEPENDENCY, as well as the appeal of Russia's booming domestic market, has led the EU to adopt embarrassingly weak and inconsistent positions towards Russia. After the Georgian war, the EU managed to reach a common decision to postpone negotiations on the planned Partnership agreement. However, as soon as tensions went down and Russia had started pulling out of Georgian territory – but not going back to pre-war positions – both France and Germany held bilateral summits with the Kremlin that led to conciliatory statements²⁹, and various business deals³⁰. Such moves reinforce the idea that no matter what Russia does, business as usual is guaranteed. This message will be reinforced by the decision to start negotiations on the Partnership agreement, although the international status of Abkhazia and South Ossetia is not clear and talks in Geneva in October have not brought convincing results.

Notwithstanding this, partnership talks are likely to go ahead. But the European Union can still enhance its chances of reaching an agreement and reinforcing the legal framework for economic cooperation. That requires, however, the fulfilment of a number of conditions, which are discussed below.

3 - GUIDING PRINCIPLES FOR THE COMING PARTNERSHIP NEGOTIATIONS

THE 1994 PCA between the EU and Russia reflects a time where it was widely believed that Russia would follow a “European” path; but Russia has not followed such a path and the PCA has proved to be an inadequate tool to deal with the problems raised by Russia. Its emphasis on harmonization of legislation and insistence on Russia's adoption of EU standards and norms missed the point. Hardly any important endeavour written down in the PCA has come to fruition. 1990s PCAs were designed for an asymmetrical relationship with neighbours that had an aspiration to join the European Union, or to be closely associated with the EU.

With Russia, the bargaining position is not the same, and the motivation different. The size of the Russian state and of its bureaucracy, and Russia's insistence on its sovereignty, all make ineffective the attempt of the EU to export its regulations. The vision of an EU-style Common Economic Space with Russia with fully open borders and harmonized legislation might well be a long-term objective, yet for the moment it is a very futuristic, if not utopian, given the governance challenges Russia faces. How, then, can the EU work towards a Common Economic Space with Russia?

The EU's approach will need to be incremental, and build on priorities. At the moment, the priorities are resolving investment disputes and finding a way of limiting arbitrary trade and SPS measures (i.e. damage limitation); ensuring better market access via the reduction or elimination of tariffs in key industrial sectors; encouraging Russia to adopt international (not necessarily EU) technical standards in key industries; avoiding the introduction of new trade restrictive measures (import as well as export tariffs); ensuring better market access in services, and protecting the interests of European investors (IPRs, tax and legal discrimination, expropriation, etc.). It is not likely that Europe will be able to achieve any significant advance on investment conditions in the energy sector while Gazprom's monopoly over transit, the current legislation on strategic sectors, and the current Kremlin administration remain in place. This is even truer if Europe's energy market remains unreformed. The EU has a long wish list for Russia laid down in the *Road Map Towards the Common Economic Space* which spans IPR, public procurement, industrial products, industrial and enterprise policy, energy, competition, financial services, trade facilitation and customs. But the EU will need to prioritize.

The EU will also need to be ready to offer Russia a deal as well. In its *Middle Term strategy*

towards the European Union (2000-2010)³¹, Russia sets itself the following goals: “further opening of the EU’s markets to Russian exports”; and “elimination of the remaining discrimination in trade”. Although a certain number of obstacles have been reduced thanks to the EU’s granting of Market Economy Status to Russia, the EU might see it in its long term interest to facilitate the diversification of the Russian economy by offering to eliminate the current quota regime for Russian steel imports, for example, or reduce its agricultural protection. Russian investment should also be facilitated as long as basic requirements on corporate governance and transparency are fulfilled. A functioning EU-wide sovereign wealth fund approach would be useful.

CONCLUSION

THE CURRENT INTERNATIONAL framework to channel Russia’s external commercial relations into rules-based behaviour is weak. The Energy Charter has failed in this regard, but its potential in dispute settlement has not been fully explored. Existing bilateral investment treaties could also be better used. The EU’s PCA with Russia has proved largely ineffective, due to its weak legal foundation and a regulatory approach that does not meet Russia’s institutional and political realities.

High growth rates in the Russian economy and its rapid climb to becoming the EU’s third export destination have made European business leaders and policy makers eager to negotiate agreements with Russia that would reduce uncertainty in the trading and investment environment, solve commercial frictions, and open the Russian market further. This paper shows, however, that these aspirations might well be thwarted by the reality of the power relations at play in the energy sector. The EU’s fragmented energy market renders member states vulnerable to the pressure of dependency on Russian gas. As long as Gazprom’s grip is not loosened within Russia and to its West, the problem will persist.

Expectations of what the EU can achieve in its coming dealings with Russia pre-WTO accession and during the coming Partnership negotiations should not be high, and should be measured against the backdrop of Russia’s lack of respect for its commitments in international instruments that have been considered strong, such as the ECT. The approach in the coming phase of discussions with Russia should be based on realistic assumptions. It should be incremental, and the EU should prioritize its actions. Three main channels have been identified to progressively persuade Russia that it is in its interests to adopt a rules-based approach in its external commercial relations:

Firstly, litigation in areas where the Russian government has committed itself such as the Energy Charter Treaty and bilateral investment treaties should be used more systematically. Fear of retaliation by national governments should be measured against the fact that not making a government accountable for its commitments will not save any investment in the future nor will it improve the situation.

Secondly, domestic reform and clean-up of its relationships with Russia should be a key priority during the talks. As long as the EU’s energy market is not unified, EU member states will remain a ball in the game of Russian economic diplomacy and any EU common position towards Russia will be weakened. Member states should increase transparency of financial relations between Russian state-connected businesses and European politicians, policy-makers and business figures.

Thirdly, Russia’s WTO accession should continue to be regarded as a prerequisite for a future Common Economic Space or free trade area between Russia and the EU. But WTO accession will not solve the problem of power asymmetry in the energy sector, and Russia’s track record of

respect of international engagements does not bode well for its compliance with WTO rules.

Russia should be put to the test first. During the coming PCA negotiations, the EU should consider dropping the approach it has deployed during its eastward expansion, reflected in the existing PCA, namely regulatory embrace. The EU should rather focus on key market access issues, strong dispute settlement provisions and adoption of international – not necessarily European -- standards for regulation in business and industry.

ANNEX 1

BILATERAL INVESTMENT TREATIES SIGNED BY RUSSIA

Partner	Date of Signature	Date of entry in to force
Albania	11-Apr-95	29-May-96
Argentina	25-Jun-98	20-Nov-00
Armenia	15-Sep-01	...
Austria	08-Feb-90	01-Sep-91
Belgium and Luxembourg	09-Feb-89	13-Oct-91
Bulgaria	08-Jun-93	...
Canada	20-Nov-89	27-Jun-91
China	21-Jul-90	26-Jul-91
Croatia	20-May-96	...
Cuba	07-Jul-93	08-Jul-96
Czech Republic	05-Apr-94	06-Jun-96
Denmark	04-Nov-93	26-Aug-96
Ecuador	25-Apr-96	...
Egypt	23-Sep-97	...
Ethiopia	10-Feb-00	06-Jun-00
Finland	08-Feb-89	15-Aug-91
France	04-Jul-89	18-Jul-91
Germany	13-Jun-89	05-Aug-91
Greece	30-Jun-93	23-Feb-97
Hungary	06-Mar-95	29-May-96
India	23-Dec-94	05-Aug-96
Italy	17-Dec-02	17-Dec-02
Japan	13-Nov-98	27-May-00
Korea, Democratic People's Republic of	28-Nov-96	...
Korea, Republic of	14-Dec-90	10-Jul-91
Kuwait	21-Nov-94	30-May-96
Lao People's Democratic Republic	06-Dec-96	...
Lebanon	08-Apr-97	...
Lithuania	29-Jun-99	29-May-04
Macedonia, TFYR	21-Oct-97	09-Jul-98
Moldova, Republic of	17-Mar-98	18-Jul-01
Mongolia	29-Nov-95	...

Netherlands	05-Oct-89	20-Jul-91
Norway	4-Oct-95	21-May-98
Philippines	12-Sep-97	...
Poland	02-Oct-92	...
Portugal	21-Jul-94	...
Romania	29-Sep-93	19-Jul-96
Serbia and Montenegro	11-Oct-95	19-Jul-96
Slovakia	30-Nov-93	02-Aug-96
Slovenia	08-Apr-00	...
Spain	26-Oct-90	28-Nov-91
Sweden	19-Apr-95	07-Jun-96
Switzerland	01-Dec-90	26-Aug-91
Syrian Arab Republic	26-Jan-05	...
Thailand	17-Oct-02	...
Turkey	15-Dec-97	17-May-00
Ukraine	17-Nov-98	...
United Kingdom	06-Apr-89	03-Jul-91
United States	17-Jun-92	...
Uzbekistan	22-Dec-97	...
VietNam	16-Jun-94	03-Jul-96
Yemen	01-Dec-02	...

Source: UNCTAD

LIST OF ABBREVIATIONS

BIT – Bilateral Investment Treaty

ECT – Energy Charter Treaty

EU – European Union

GATT – General Agreement on Tariffs and Trade
PCA – Partnership and Cooperation Agreement

RF - Russian Federation

WTO – World Trade Organization

UNCTAD – United Nations Conference for Trade and Development

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FOOTNOTES

1. Excellent research assistance was provided by David Kleimann. Comments by Fredrik Erixon have helped structure the paper.
2. Transparency International's Corruption Perceptions Index in 2008 ranks Russia 147th (a slide from 143 in 2007), along with Kenya, Bangladesh and Syria. The other so-called BRIC countries rank as follows: Brazil and China 80th, India 85th.
3. Discussion of Jan Tumlir's ideas and quotation taken from Wolf, M. (2008).
4. Aris, B. (2007), "ZAO Kremlin", *Business New Europe*, 16 August 2007

5. EBRD, Structural and Institutional Change Indicators, available on www.ebrd.com
6. International Herald Tribune, *Shell cedes control of Sakhalin-2 to Gazprom*, 21 December 2006.
7. The Hermitage fund was one of the largest portfolio investors in Russia. Bill Browder, the founder of Hermitage, was an activist investor who vocally alleged fraud at state-controlled companies Gazprom, Sberbank or Surgutneftegaz. Browder was denied entry to Russia in 2005 and has not been able to return.
8. See Erixon (2008).
9. Larsson (2006), p.177
10. Transit is regulated by Article VII of the ECT. However, a transit protocol has been under negotiation since 1999, in which Russia and EU have had significant divergences. The transit issue plays a key role in Russia's non ratification of the ECT.
11. The rankings assessed 130 economies. The Report is available on <http://www.weforum.org/pdf/GCR08/highlights.pdf>
12. Financial Times, "Russia seeks to mend ties with the West", 6 October 2008, and "Russia still interested in joining WTO - Prime Minister Vladimir Putin," ITAR-TASS, 27 October 2008.
13. The four Common Spaces the EU and Russia agreed to build at their Summit in St Petersburg of May 2003 are: Common Space of Freedom, Security and Justice; Common Space of External Security; Common Space of Research and Education; and Common Economic Space.
14. See Erixon (2008).
15. A working party's examination of an applicant's policies can go well beyond trade policy, strictly interpreted. Applicants must be prepared to discuss such issues as their laws on joint stock companies; the activities of the central bank and credit institutions; licensing of economic activity; domestic taxation; regulations on food and alcoholic beverages; veterinary medicine and quarantine regulations; and consumer protection.
Transition economies are likely in addition to face questions on the extent of privatization; and a working party is likely also to seek reassurance that government agencies involved in regulation of economic activity act on the basis of transparent rules, not administrative discretion. Concern with these issues derives from a wish to be sure that the role of the state has been appropriately reduced from the dominant position it held when the economy was centrally planned.
16. Georgia signed a bilateral treaty with Russia in 2004, but then withdrew from it. Georgia has also objected to the agenda of the Working Party, thereby blocking meetings. Russia cannot resolve problems between it and the Working Party without such meetings. The recent military action may not ease this situation.
Ukraine, which joined the WTO in 2008, has also declared its intention of joining the Working Party (*Financial Times*, 15 April 2008). The FT comments that: "Moscow has imposed numerous trade restrictions on Ukrainian goods, notably metals and dairy products ...". Ukraine also may raise problems for Russia.
17. A useful source for the details of Russian trade policy as they stood at 19 November 2006 – the date the Russia-US bilateral was signed -- is the website of the United States Trade Representative. The document "United States, Russia sign bilateral WTO market access agreement" links to six "Trade facts" (information sheets) that deal with different aspects of Russian accession from a US perspective.
18. *Financial Times*, "Finland hits back on wood tariffs", 27 June 2008
19. *Ibid.*
20. *The Times*, "Mandelson prepares to stand alongside America to fight Chinese export taxes", 29 September 2008.
21. The note of doubt implied by "may be difficult" derives from uncertainty about the legal grounds on which the US plans to act. Export taxes do not appear to be *per se* illegal under the WTO. *Discriminatory* export taxes, however, clearly are illegal. If the case against China is based on discriminatory application of export taxes and the Russian tax is not discriminatory then, for example, there is no inconsistency in pursuing the Chinese tax while tolerating the Russian.
Of course, toleration may not be *politically* feasible: the Russian taxes on exports of lumber have raised hostility in, for example, Finland, whose paper-producing industry has been badly affected.

22. *Financial Times*, "Medvedev changes summit tone", 25 June 08
23. *Financial Times*, "Europe split on how to restore ties with Moscow", 27 October 2008
24. *Financial Times*, "Russia's WTO bid on ice, say diplomats", 27 August 2008
25. See, e.g. European Council (2008)
26. *Financial Times*, "Gas deal seals Moscow-Berlin entente", 2 October 2008
27. See Erixon (2008)
28. See Aslund (2008)
29. Angela Merkel said on the October 2nd Russia-Germany summit that Georgia was not ready to join NATO's Membership Action Plan, although just at start of the war she had emphasized the Georgia's place was within NATO. See: Business New Europe, *Russia Daily*, 3 October 2008. And Spiegel Online International (2008).
30. See Euractiv (2008), "France-Russia business booming despite Georgia crisis", 22 September 2008 and *Financial Times*, "Gas deal seals Moscow-Berlin entente", 2 October 2008
31. http://www.delrus.ec.europa.eu/en/p_245.htm