

Working Paper No 41/2014

WTO Accession and Energy Markets: An Overview of Russia

By

Dr.Theocharis Grigoriadis

Coordinator, ELIAMEP Program in Slavic, East European and Eurasian Studies

Dimitrios Moschos and Sofia Saridi, Interns

February 2014

Copyright © 2014

HELLENIC FOUNDATION FOR EUROPEAN AND FOREIGN POLICY (ELIAMEP)

49, Vassilissis Sofias Ave., 106 76 Athens, Greece

tel: (+30) 210 7257110-1, fax: (+30) 210 7257114, e-mail: eliamep@eliamep.gr,

url: www.eliamep.gr

All rights reserved

Working Paper Nr 41/2014

WTO Accession and Energy Markets: An Overview of Russia

by

Dr. Theocharis Grigoriadis, Dimitrios Moschos and Sofia Saridi¹

ELIAMEP, Program in Slavic, East European and Eurasian Studies

¹ Theocharis Grigoriadis is the coordinator, and Dimitris Moschos and Sofia Saridi are interns in the ELIAMEP Program in Slavic, East European and Eurasian Studies. Sofia Saridi worked on the introduction. Dimitris Moschos worked on Russia's WTO accession, Eurasec and BITs. Theocharis Grigoriadis had the idea and the general supervision of the study.

Author's Information:

Theocharis Grigoriadis is a visiting associate professor of Economics and East European Studies at the Free University of Berlin. His current research interests include political economics, aid effectiveness, comparative economics with focus on the economies of the former Eastern Bloc and the Middle East, bounded rationality and field experiments. He holds a doctorate in Economics from Saint Petersburg State University and a doctorate in Political Science from the University of California, Berkeley. He completed an MA in Russian and East European Studies and a Graduate Certificate in European Studies at Yale University, an LLB and an LLM at the University of Athens. His publications have appeared in *Economics Letters*, *Energy Economics*, *Journal of International Development*, and *Rationality & Society*. His first book will appear with Springer in 2014. He has been a visiting researcher at the Social Science Research Center Berlin, the Humboldt University of Berlin, the Higher School of Economics in Moscow, and the University of Haifa. He was an intern at the World Bank Moscow Office and the Economic Section of the EU Embassy to Moscow. Personal site <http://works.bepress.com/thgrigoriadis/>

Summary

In this paper we provide an overview of Russian energy policy in view of its WTO accession. The transition from the Soviet Union to the Russian Federation reinforced the influence of energy resources on Russia's economic growth. Regional economic integration and WTO accession have been treated as complementary strategies by the Russian government since the early 2000s. The emergence of Eurasian Economic Community (EurasEC) has created challenges for Russia's integration into the world economy given Gazprom's market dominance in the Russian economy. Reforming Gazprom's pricing system requires both domestic political will and external incentives that will compensate for price reductions in international markets.

Keywords:

WTO, Russia, BITs, natural resources, EurasEC, regionalism, multilateralism

WTO Accession and Energy Markets:

An Overview of Russia

By Theodoris Grigoriadis, Dimitrios Moschos and Sofia Saridi

I. Introduction

Russia is one of the biggest world energy exporters, whose overwhelmingly large natural gas reserves have turned it into the most significant energy partner of the European Union.² Since the late 1800s Russia has added energy resources to the list of the vital commodities that it could use, in order to achieve its central strategic goals. In the 19th century, European and U.S. investors constructed the Baku and Volga oil fields. This step improved the relations between Russia and the West and facilitated Russia's transformation to a massive energy producer. By the turn of the century, the Russian Empire was producing 31 percent of global oil exports. In the 1950s and 1960s the Soviet Union became the second largest oil producer and the main supplier both for Eastern and Western Europe. Its collapse brought disarray in the Russian oil and natural gas sectors. After 1992, Boris Yeltsin started to develop Russia's energy strategy; its main directions were approved with a presidential decree on 7th May 1995. This was the first initiative to launch an energy strategy for Russia in the post-Soviet era, based on the recommendations of the Fuel and Energy Ministry for the period up to the 2010.³

In November 2000, the Russian government redefined its energy strategy goals to 2020. The new draft document was elaborated by the Russian Ministry of Energy on 2002. The Russian president approved and confirmed these changes in 2003. The main objectives of Russia's energy strategy are to reach a better quality of fuel and energy mix and to enhance the competitiveness of energy services and production in world markets. Focus has been given on three pillars: efficiency, budgetary discipline and environmental security.⁴ Moreover, under Putin the Russian energy sector was nationalized under three state firms: Gazprom, Rosneft and Transneft.

Russia's WTO accession has posed significant challenges for the market position of Russia's energy champions in the European Union and has been the source of various disturbances in Russia's relations with transition economies in the former Soviet Union such

² Delves Broughton Philip, "Beware Russia: Energy superpower", *The First Post*, 12/04/2013.

³ Michael Fredholm (September 2005). A New Energy Policy of Russia: Implementation Experience. Conflict Studies Research Centre, Defence Academy of the United Kingdom.

⁴ Summary of the Energy Strategy of Russia for the period up to 2020, Ministry of Energy of the Russian Federation, March 2003.

as Ukraine and Belarus. This working paper concentrates in the contradictory set of incentives provided by WTO rules and Russian energy markets for efficient pricing and innovation in the energy industries of Russia and of other post-Soviet economies, whose supplies depend on it.

II. WTO vs. Eurasian Economic Community: Gains and Losses for Russia

Russia's accession to the World Trade Organization has been a long and strenuous procedure. The Russian Federation submitted its application to the Organization as early as June 1993. However the negotiations were successfully concluded only in August 2012. The accession procedure was indeed unjustifiably long, but Russia was not the only state to face such problems concerning its accession to the WTO.

The problematic nature of the Organization's accession mechanism has already been researched by numerous scholars. Langhammer and Lücke (1999) attribute such delays to WTO deficient administrative resources and the distinction between commitments required by applicants nowadays and those made by GATT members in the past. The case of Russia has been even more complex. After examining WTO's bureaucratic structure, Åslund (2007) moves even further in identifying causes of the aforementioned delays, this time within Russia's domestic politics. He demonstrates how limited perceptions of WTO importance by Russian politicians, in tandem with their ignorance over the impact of protectionist trade practices has contributed to Russia's rather unenthusiastic approach towards WTO accession. Åslund takes into account rapid economic growth, namely the increase in exports and per capita GDP after 2004. He considers these factors to have resulted to less willingness for WTO membership in Russia. He observes that there was a slump in accession procedures during Putin's second term in contrast with the zeal observed during his first term.

Therefore, Russia has faced a dilemma between multilateralism - in the form of WTO accession and beyond that - and regionalism. The numerous Regional Trade Agreements signed with BRICS countries, ASEAN, and Mexico (BRICSAM) testify for the latter. The multitude of regional trade organizations under the auspices of Russia, such as the Central Asia Cooperation Organization, the Special Program for the Economies of Central Asia, and the Eurasian Economic Community indicates Russia's turn to a rather regionalist trade policy.

The Eurasian Economic Community (EurasEC) has been the most dynamic institution that Russia has itself a leading role in. EurasEC began in 1994 as a customs union between Belarus, Kazakhstan and Russia in the framework of the Commonwealth of Independent States (CIS). Kyrgyzstan and Tajikistan acceded in 1996 and 1999 respectively.

Nevertheless, the CIS Customs Union was poorly implemented. It was therefore succeeded by the Eurasian Economic Community in October 2000. Russia, preserving veto power in the Community, has been the main force in facilitating post-Soviet trade integration. It became the pioneer for the Customs Union between Russia, Belarus, and Kazakhstan, which was established in 2010 within EurasEC.

In addition to its Central Asian “backyard” and China, Russian trade policy focuses primarily on Europe. Both sides have enjoyed extensive trade ties. Bilateral EU-Russian trade amounted up to 250 billion Euros between 2007 and 2011.⁵ The enormous amount of bilateral transactions had given rise to the potential of an FTA between Russia and the EU. Since such a decision would require Russia’s full compliance to the Union’s trade standards, Hamilton (2005) argues that Russia would not accept to simply incorporate EU law, unless it is given an equal voice in the European law-making procedure. Moreover, the preferential treatment of Russian and EU products that an FTA would imply, would in the long-run damage Russia’s trade partners (particularly in the CIS), and additionally divert trade away from EU and Russia (Brenton *et al.*, 1997). The observed stagnation of the debate on an EU-Russian FTA justified Hamilton’s assessment.

Antkiewicz and Whalley (2006) interpreted Russia’s multilateralism beyond the WTO as an effort to offset its obligations derived from WTO negotiations, especially after the deceleration of negotiations in the mid-2000s. However, non-WTO multilateralism and regionalism should be under no conditions treated as substitutes to WTO. On the contrary, they constituted a conscious policy that enabled Russia to preserve its trade distortive measures and allowed Russian elites to keep their control of the market intact.

Russia’s path to WTO accession was paved with difficulties and disagreements. In addition to external obstacles, such as Georgia’s veto due to the situation in Abkhazia and South Ossetia, Russia was expected to liberalize its energy pricing strategy. That would mean that it would be expected to revise its dual pricing policy, i.e. keeping domestic gas prices at a very low level (\$28,9/toe in Russia compared to \$160.1/toe in Germany in 2003).⁶ That way, Russia used foreign energy markets to subsidize its own economy and this has been an issue of intensive negotiations between Russia and the EU during the WTO accession process.

Russia’s WTO membership is expected to have a multifaceted effect on household welfare, governance, and international trade. Almost every household will benefit due to the eradication of trade barriers. Because of the higher increase in the wage rate for unskilled labour - compared to the increase in rate of return to capital - less wealthy groups are also treated as winners of the Russian accession (Rutherford and Tarr, 2007). Babetskaia-Kukharchuk and Maurel (2004) conclude that Russia’s adjustment to WTO

⁵ European Commission, “Russia. EU bilateral trade and trade with the world”, DG Trade, November 2012.

standards will result to less corruption and more transparency in the country's governance. At the same time, trade with CIS countries will drop, whereas trade with the EU is estimated to rise.

Moreover, Kovatch (1998) asserts that the wider access of Russian products to foreign markets and the safer environment for investments due to the implementation of WTO obligations will largely benefit the Russian economy. Similarly, the increase in trade will be most profitable for Russian border regions such as western Russia and the Russian Far East (Jensen et al., 2007). Nevertheless, WTO accession implies radical structural reforms. Since subsidies and protectionism have no place in the WTO framework, Russia would be expected to pursue an effective liberalization of its economy and partially reverse the status quo in its state-dominated energy markets. For the time being, Russia has adopted further protectionist policies by imposing a "recycle tax" on imported cars and banning livestock imports from the EU.⁷

This indicates Russia's reluctance to perform the necessary reforms. It may also suggest that Russia's accession to the WTO is a tactical rather than a long-term commitment of the Russian government. It is thus questioned whether the WTO system has the capacity to boost liberalization measures in the Russian economy. One would name the Organization's sanctions as a possible way to force Russia to comply. However, WTO sanctions imposed by the dispute settlement panel have been designed on a retaliatory rather than a punitive basis. That way, the complaining party is entitled to use trade restrictions against the non-complying state. Since the focus is on the compensation of the complaining party rather than on the alignment of the breaching part, it is unlikely that WTO sanctions would contribute to the liberalization of Russian economy.

Given that sanctions would not be proven effective against Russia's incompliance to WTO rules, Russia has practically acquired all the benefits of WTO membership (significantly lower tariffs for Russian exports, larger market access, and MFN status), while making apparently no important concessions. The tradeoffs for Russia's accession to WTO therefore seem to be extremely favorable. Combined with its profound interest for EurasEC with, the country seems to be implementing a multidimensional trade strategy.

WTO generally encourages regional trade agreements, as the latter take trade liberalization a step ahead, beyond the measures already agreed on the WTO level. Consequently, WTO accession does not prevent Russia from playing a leading role in EurasEC. Given the difficulties faced by post-Soviet states to implement already signed trade agreements, one could expect the WTO to act as an alternative platform, especially after taking into account that Kyrgyzstan, Tajikistan, and Ukraine are already WTO members. Therefore, it is possible for Russia to follow a two-fold strategy and keep its

⁶ Dudek D., Golub A., Strukova E., "Should Russia increase domestic prices for natural gas?", *Energy Policy* 34: 1659-1670, 2006.

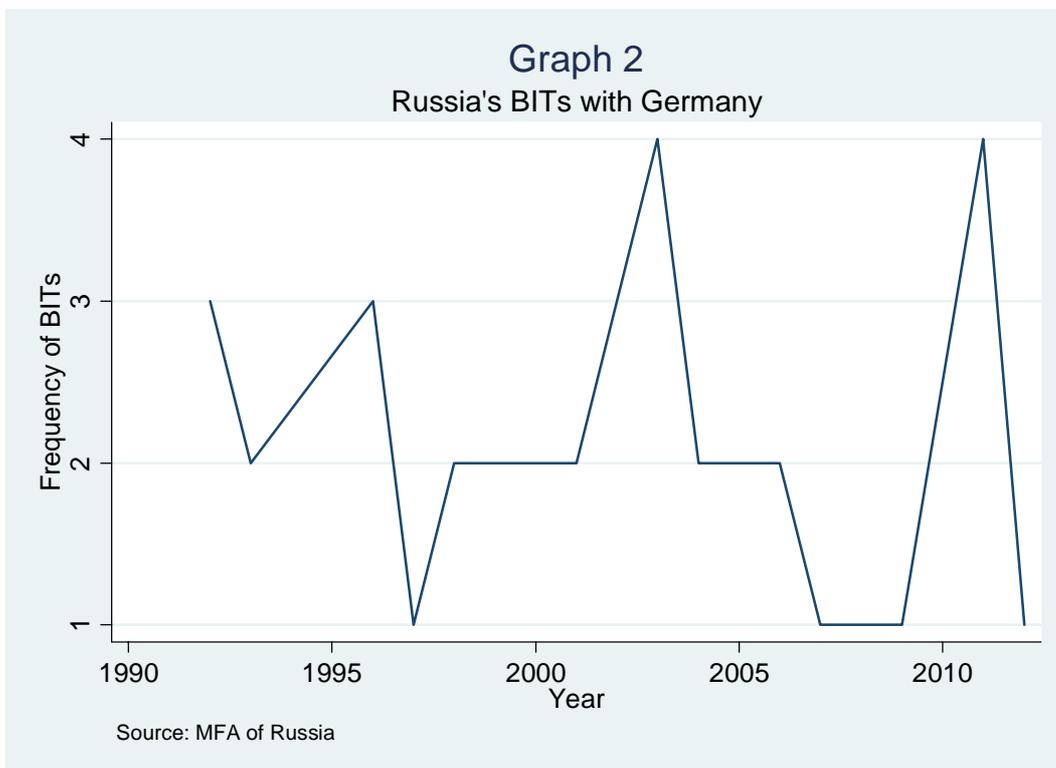
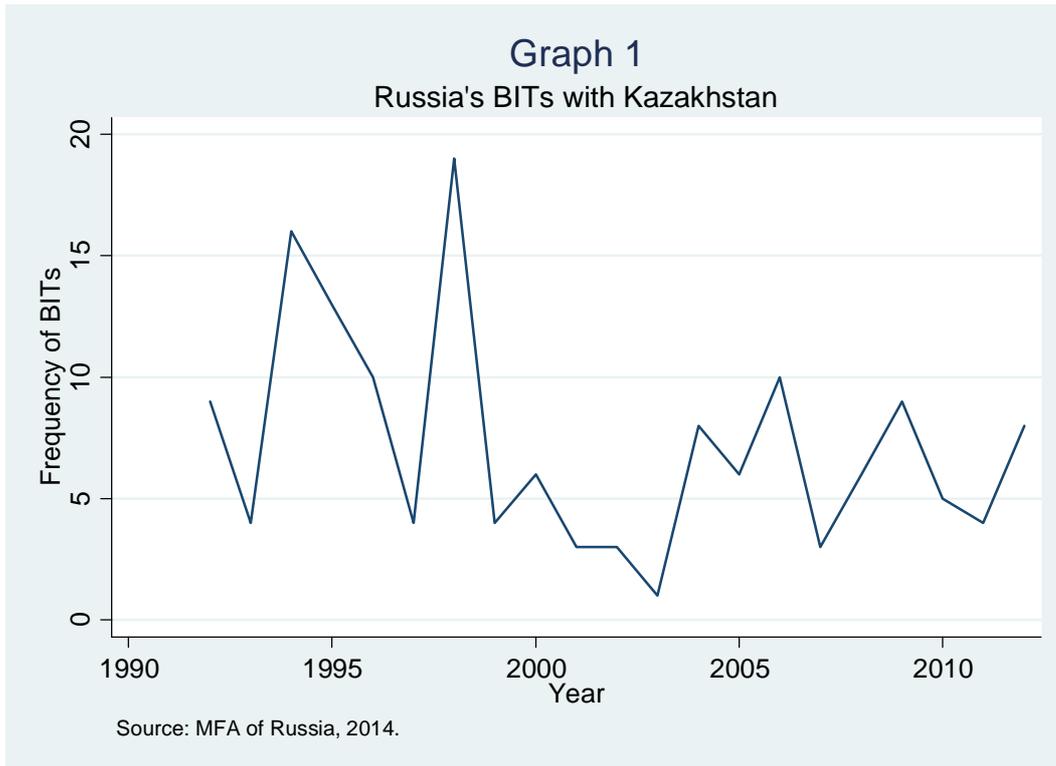
leadership status in EurasEC, while boosting trade with the EU and China within WTO rules.

III. Bilateralism and Regionalism as WTO Complements

Russia established official diplomatic and trade relations with Germany and Kazakhstan upon achieving statehood. Trade between Russia and Germany was regulated by the Bilateral Investment Treaty signed by Germany and the USSR back in 1989. Russia and Kazakhstan signed a BIT on the protection of investments only in 1999. This by no means implies an indifferent stance on behalf of Russia towards Kazakhstan. On the contrary, deep ties were established by the newly independent Russian SFSR and the Kazakh SSR as soon as November 1990. Data shows a profound interest of Yeltsin's government to boost trade in the former Soviet Union space by renewing and deepening the diplomatic and economic ties between CIS states, and first and foremost with Kazakhstan. Russia's resolve to revitalize regional trade is complemented with its EU and most specifically German orientation. The two partners soon developed their cooperation, with Russia becoming EU's greatest supplier of energy, and the EU absorbing a great percentage of Russian exports.

However, BITs with Kazakhstan recede during the interval 2000-2004 (graph 1), while BITs with Germany reach their peak in the same period (graph 2). Given that Russian exports to the EU rose sharply in the very same interval, Russia's turn towards a rather multilateralist strategy between 1998 and 2005 becomes evident.

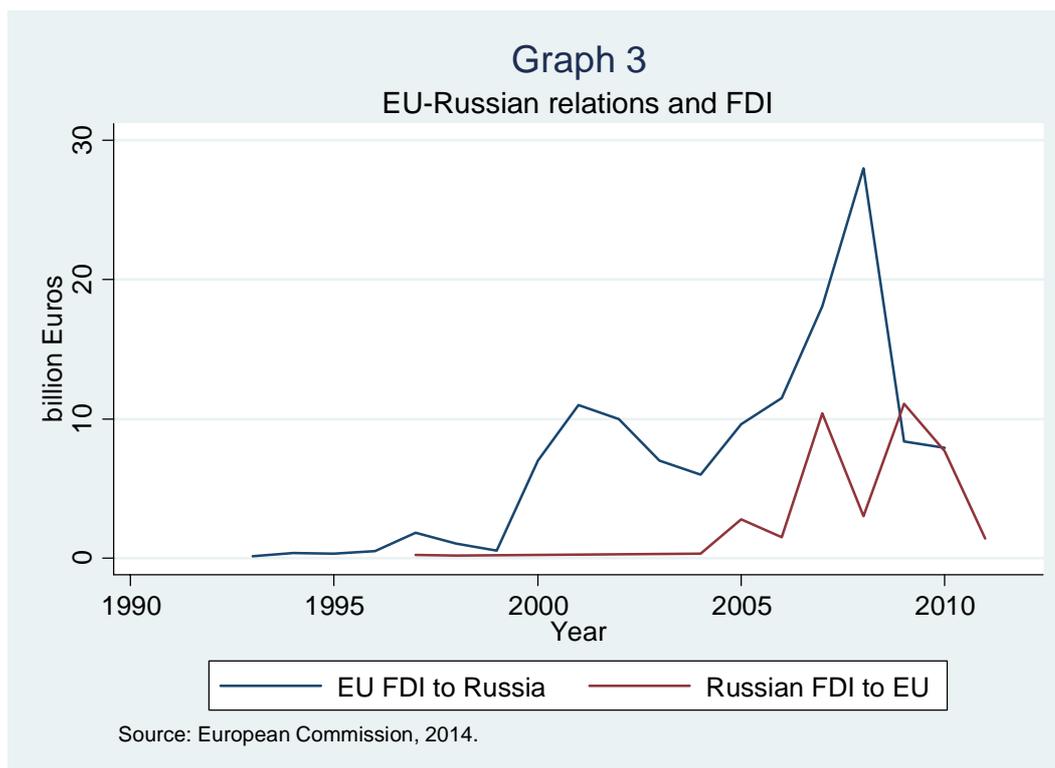
⁷ European Commission, DG Trade, "Ninth Report on Potentially Trade Restrictive Measures", September 11 2011 to May 1 2012



The internal stabilization and the rise of living standards led Russia back to its imperial stance towards near abroad. Putin's second term (2004-2008) has been dominated by regionalism, with a Russian comeback to a more dynamic role in the region. The increasing number of trade sanctions imposed by Russia on its neighbors does not leave much room for doubt. WTO accession procedures were decelerated at this period. Apart from the Jackson-Vanik amendment (dating back to the Cold War, and lifted as an aftermath of Russia's accession to WTO in 2012), there have been almost no trade restrictions against Russia.

Regional cooperation in the former Soviet Union has been continuously linked to trade integration. It was the Commonwealth of Independent States itself that gave birth to trade integration initiatives that began in the form of a Customs Union as early as 1994. These initiatives culminated in 2000 when the Eurasian Economic Community was created. EurasEC has included political bodies such as the Interstate Council and the Interparliamentary Committee and has followed the paradigm of European Economic Community. The Customs Union and the Common Economic Space initiated by Russia, Kazakhstan and Belarus in 2010 lay in the core of EurasEC integration agenda.

Russia has held tariffs on gas to be exported beyond the Customs Union at quite high levels since 2008. Considering gas tariffs after August 2013 (70.8 RUR/1000m³ for 100 km of transportation), WTO membership has not altered Russia's dual pricing policies, given the difference between the aforementioned price and the gas tariff for domestic use (63.93 RUR/1000m³ for 100 km) for the same period. EU FDI flows to Russia had been extremely low during the 1990s due to investor's consideration of political instability in the country (graph 3). However, political developments in the eve of the new millennium created a safer environment for investments. This is why EU FDI to Russia impressively increased after 2000. However, EU FDI flows were severely damaged after Russia's intervention in Georgia in 2008.



IV. Conclusions

While in the 1990s the Russian economy saw the WTO perspective as a further positive signal to consolidate domestic instability and international credibility, in the 2000s regionalism prevailed over multilateralism within and without the WTO. Nevertheless, the Russian side consistently pursued a WTO membership, which would complement its gains from regional economic integration in the post-Soviet space. This strategy has been at odds with WTO rules and the revision of the current dual pricing scheme, which has been a longstanding demand of the EU. Since 2012, WTO has created the institutional conditions for more competitiveness, investment and equity in the Russian economy. Nevertheless, its limited enforcement capacity can only constrain and not alter the bargaining space of the Russian government with respect to its natural gas pricing strategy. Gazprom will continue to be the common denominator of regional economic integration in the former Soviet Union and of EU-Russian relations.

References

- Antkiewicz A, Whalley J, "BRICSAM and the non-WTO", *CESifo Working Paper Series*, No. 1498, October 2005.
- Åslund A, "Russia's Accession to the World Trade Organization", *Eurasian Geography and Economics*, vol. 48, No. 3, pp. 289-305, 2007.
- Babetskaia-Kukharchuk O, Maurel M, "Russia's accession to the WTO: a potential for trade increase", *Journal of Comparative Economics*, vol. 32, pp. 680-699, 2004.
- Brenton P, Tourdyeva N, Whalley J, "The Potential Trade Effects of a Potential FTA between the EU and Russia", *Weltwirtschaftliches Archiv*, vol. 133 (2), 1997.
- Dudek D, Golub A, Strukova E, "Should Russia increase domestic prices for natural gas?", *Energy Policy*, vol. 34, pp. 1659-1670, 2006.
- European Commission, Directorate General for Energy, "EU-Russia Energy Dialogue" 2011.
- Hamilton C, "Russia's European economic integration - Escapism and realities", *Economic Systems*, vol. 29, pp. 294-306, 2005.
- Jensen J, Rutherford T, Tarr D, "The Impact of Liberalizing Barriers to Foreign Direct Investment in Services: The Case of Russian Accession to the World Trade Organization", *Review of Development Economics*, vol. 11 (3), pp. 482-506, 2007.
- Kovatch W, "Joining the club: assessing Russia's application for accession to the World Trade Organization", *Temple Law Review*, vol. 71, pp. 1043, 1998.
- Langhammer R, Lücke M, "WTO accession issues", Blackwater Publishers Ltd., 1999.
- McRae D, "Measuring the effectiveness of the WTO dispute settlement system", *Asian Journal of WTO and International Health Law and Policy*, vol. 3:1, pp. 1-20, March 2008.
- Pomfret R, "Trade policies in Central Asia after EU enlargement and before Russian WTO accession: Regionalism and integration into the world economy", *Economic Systems*, vol. 29, pp. 32-58, 2005.
- Rose A, "Do WTO members have more liberal trade policy?", *Journal of International Economics*, vol. 63, pp. 209-235, 2004.
- Rose A, "Which International Institutions Promote International Trade?", *Review of International Economics*, vol. 13 (4), pp. 682-698, 2005.
- Rutherford T, Tarr D, "Poverty effects of Russia's WTO accession: Modelling "real" households with endogenous productivity effects", *Journal of International Economics*, vol. 75, pp. 131-150, 2008.
- Tarr D, "Russian Accession to the WTO: An Assessment", *Eurasian Geography and Economics*, vol. 48, No. 3, pp. 306-319, 2007.

- Wiśniewska Iwona, “An embargo in Russia’s trade policy-a tactic without a strategy”, *East Week Analytical Newsletter*, Issue 23 (258), pp. 02-05, July 13, 2011.

Databases

- European Commission, “External and intra-EU trade-statistical yearbook” *Eurostat statistical books*, 2010 edition.
- European Commission, “International trade and foreign direct investment” *Eurostat pocketbooks*, 2013 edition.
- European Commission, “Report from the Commission to the European Council-Trade and investment barriers report 2013”, February 28, 2013.
- Federal Tariffs Service of the Russian Federation
- Ministry of Foreign Affairs of the Russian Federation
- Ministry of Industry and New Technologies of the Republic of Kazakhstan
- World Bank

Το ΕΛΛΗΝΙΚΟ ΙΔΡΥΜΑ ΕΥΡΩΠΑΪΚΗΣ ΚΑΙ ΕΞΩΤΕΡΙΚΗΣ ΠΟΛΙΤΙΚΗΣ (ΕΛΙΑΜΕΠ) ιδρύθηκε το 1988 και λειτουργεί ως ένα ανεξάρτητο, μη κερδοσκοπικού χαρακτήρα ερευνητικό και επιμορφωτικό Ίδρυμα. Μέσω του πολυετούς έργου του έχει αναδειχθεί σε σημαντικό φορέα πληροφόρησης, μελέτης και σχεδιασμού θεμάτων εξωτερικής πολιτικής, και θεωρείται ένα από τα πιο έγκριτα σε διεθνές επίπεδο κέντρα μελετών της Ελλάδας στον τομέα των Ευρωπαϊκών υποθέσεων και των διεθνών σχέσεων. Το ΕΛΙΑΜΕΠ δεν εκφράζει, ούτε εκπροσωπεί συγκεκριμένες πολιτικές απόψεις. Επιχειρεί μόνο να λειτουργήσει ως θήμα ελεύθερου διαλόγου και ως κέντρο παραγωγής και ανταλλαγής ιδεών.

The HELLENIC FOUNDATION FOR EUROPEAN AND FOREIGN POLICY (ELIAMEP) was founded in 1988 and operates as an independent, non-profit, policy-oriented research and training institute. It functions as a forum of debate on international issues, as an information centre, as well as a point of contact for experts and policymakers. Over the years, ELIAMEP has developed into an influential think-tank on foreign policy and international relations issues. ELIAMEP neither expresses, nor represents, any specific political party view. It is only devoted to the right of free and well-documented discourse.