Russia's Integration into the World Economy: A European Perspective[1]

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Abstract

The paper discusses the foreign trade, capital movement, migration, and, somewhat more extensively, the institutional dimensions of Russia's integration into the world economy. Possible implications of the sheer size of the Russian nation are outlined. It is argued that the desire to avoid a break-up of the nation may necessitate excessive centralization. Also discussed are some specific aspects of the regional and sector composition of trade, such as the lack of a Russian brand name. It is furthermore suggested that world market prices for natural gas could imply limits to a persistent orientation of Russian foreign trade towards the European Union. Capital flight *cum* out-migration is regarded as a worrisome combination, and the chances of reducing capital flight by way of an amnesty are seen as slim. Within the institutional dimension, WTO accession is considered a *fait accompli*. However, the present state and the future development of Russia's relations with the European Union are found to be more problematical, with the difficulties ranging from dual energy pricing to the practical impossibility of Russia becoming a member of the EU. At the same time, the paper concludes with a basically

1 I am indebted to Evgeny Gavrilenkov for joint work in the context of GLOROS ("Global Economy and Russia: A Russian-German Dialogue"), a former project of DIW Berlin and HSE, State University Higher School of Economics Moscow (supported by the *TRANSFORM* program of the German government). I also acknowledge useful discussions with Leonid Grigoriev. (e-mail: schrettl@wiwiss.fu-berlin.de)

positive assessment of the future prospects for Russia's integration into the world economy.

Let me first of all thank the organizers for inviting me to the highly renowned summer symposium of the SRC. It is a pleasure for me to share with you my thoughts on Russia's integration into the world economy. Although I have some doubts that I shall be able to tell such a distinguished group of scholars anything really new on that topic, it is my hope that I may at least be able to propose some ideas for future research. I will begin with some remarks from a historical perspective and will then address the various aspects of Russia's integration into the world economy. The first topic to be discussed is foreign trade, followed by remarks on cross-border capital movements. I will then briefly touch upon migration of labor, before addressing, somewhat more extensively, the institutional dimension of Russia's economic opening to the world. I will conclude with some speculative thoughts on likely developments from short- and longer-run perspectives.

1. Some Remarks from a Historical Perspective

As the previous speaker, Professor David Lane, pointed out, the Soviet bloc had been characterized by some degree of autarky. Clearly, the "natural" preconditions for autarky are not always and eveywhere given in equal measure. The ability to go alone, i.e. to successfully practice bloc-autarky, varies with physical and other endowments. The former Soviet bloc happens to have been well equipped in that respect. Of course, the flip-side of autarky was isolation, a consequence of which was that the economic potential of the respective economies could by far not be fully utilized. Key elements of the Soviet system were designed, if not to prevent economic contacts with the world economy then at least to exercise full central control over them, the most obvious case in point being the state monopoly on foreign trade which extended not only to contacts with economies outside the Soviet bloc, but also to contacts within the Council of Mutual Economic Aid (CMEA).

When the life-span of the Soviet bloc came to its end, no-one seriously doubted that some degree of opening of Russia was needed. One of the obstacles to the opening may have been that it simply had never really been tried before in Russia – at least not on a scale comparable with prominent historical cases. These days we are being reminded that Japan began to open up following the "visit" of Commander Perry of the US in 1853. More than 100 years later, China opened up beginning in 1978. In a number of respects, this may be seen as a repeat performance of the experience of Japan. For example, one may argue that it takes a shock for a country to open up. In the case of Japan, that may have been the less-than-friendly nature of Commander Perry's entry. In the Chinese case, it may have been the sudden perception of a shocking degree of backwardness. A possibly more important similarity may be seen in what a contemporary observer wrote about Japan's opening in the middle of the 19th century: "When Perry kicked open the door, he didn't go in, they came out" (quoted freely after this week's edition of *The Economist*). In other words, both Japan and China, upon opening, produced export surpluses, did not accumulate foreign debt, and sometimes followed quite protectionist policies. In the case of Russia, it took the shock of the 1998 crisis to make the country follow a similar path. For the time being, that is fine.

However, we should not forget that, before the most recent developments, the final stage of the Soviet bloc was one of disintegration rather than integration. It was disintegration in at least three respects. Not only the "system" – comprising, at the minimum, the single party, inclusive state ownership of the means of production, and the central planning and coordination of economic activities – disintegrated, but so did the CMEA, and also the USSR, the latter resulting, most visibly, in new borders, new countries and separate currencies. Without implying regrets, one lesson was clearly that disintegration can destroy wealth, which may serve to demonstrate the value of integration. In the case of the Soviet bloc, many old ties, including trade ties, were interrupted.

2. Foreign Trade

The western-most members of the CMEA immediately headed "back to Europe," which is almost tantamount to "away from Russia," not only politically, but also economically. As a result, their foreign trade with the West sky-rocketed, while trade with Russia declined deeply. Much of this, although not all, can be ascribed to the forces of gravity (in the sense of gravity models of foreign trade).

The ambition of many new countries on the territory of the former Soviet Union was directed in much the same direction, although their possibilities were clearly fewer. Most importantly, they did not qualify as clear candidates for the European Union in the same way as the central European economies did. Nevertheless, a "hub and spoke" pattern of trade of the FSU developed with the "hub" mostly being the European Union, and trade between the FSU economies being relatively neglected.

The tasks ahead were then clearly defined. One was the development of "natural" trade ties, both with the West and also within the ex-USSR or CIS. This entailed to some extent a resurrection of old trade ties. Efforts into the latter direction were hampered by the overwhelming economic and political weight of the Russian Federation as compared to the other countries in the CIS. This birth defect of an inevitable asymmetry is quite unlikely to disappear.

Furthermore, there is the question of what exactly are "natural" trade ties. Gravity models of foreign trade tend to give ambiguous results. But it is at least reassuring that some of that research suggests that the potential for trade between the Russian Federation and the European Union is not by far exhausted. In the case of the central European countries, the reorientation of trade towards the West may rather easily qualify as a natural trend, all the more so because this conforms with the ambitions of the CEECs, with historical precedents, and with the fact that the

European Union was very receptive vis-à-vis the CEECs, notwithstanding some complaints of the latter.

Russia's ambition was different, although equally clear. President Putin, at the least, leaves no doubt that full participation in the world economy, in all respects, is one of his central goals. Russia is to participate in the process of globalization meaning the economic core aspects of (1) trade in goods, services and intellectual property rights, (2) free movement of people, in particular visa-free travel into the EU, (3) full participation in world capital markets, and (4) institutional integration into the world economy, most importantly into the key governing and regulatory bodies. As a result, Russia should in the end be accepted as a respected and trusted partner with an excellent reputation.

Clearly, in order to achieve this goal it is necessary to overcome quite a number of obstacles. A problem of importance, specifically for Russia, may be that integration into the world economy tends to reduce the need to be part of a larger economic and political unit. With reduced trade barriers, smaller economies have better chances to survive on their own. This may lead to the break-up of nations. Alberto Alesina and his collaborators have shown in theoretical work how the integration of the world economy may contribute to the disintegration of nation states.[2] Given that one of the central concerns of Russian policy makers is to make sure that the disintegration of the CMEA and the USSR will not be followed by the disintegration of the Russian Federation, integration into the world economy may well be a double-edged sword for that nation.

Foreign trade, as a potentially fast-moving variable, did indeed perform a wild roller-coaster ride during the years of reform. Imports especially rose rapidly, then collapsed in the wake of the 1998 crisis and are now rising rapidly again. While there is at present a lot of discussion about tariffs and non-tariff barriers to trade in the WTO context, it needs to be remembered that one of the lessons that had to be learned the hard way in the course of the 1990s concerns the key role of the exchange rate. In particu-

2 See, for example, Alesina and Spolaore (2003).

lar, Russian politicians came to accept, reluctantly, that an overvalued currency could be suicidal for an economy. Of course, one may question what exactly "overvalued" means. The simple answer, i.e. to take PPP (Purchasing Power Parity) as the standard of comparison, clearly does not hold. A better and pragmatic indicator may be the relative growth of exports and imports. Thus, it should be considered a warning sign if imports consistently grow faster than exports, even if that only takes the form of a foreign trade or current account surplus dwindling rapidly, rather than that of an outright trade deficit.

Other facts of key importance for the Russian Federation are the critical role of world market prices for oil and other raw materials, the volatility of those prices, and the dominance of energy, energy products, metals, and raw materials in general in the exports of the Russian Federation.[3] The overwhelming weight of raw materials in Russian exports is mainly, but not exclusively, due to Russia's endowment with natural resources.

What also makes itself felt in a rather negative sense is the almost complete absence of Russian products that would carry a brand name on world markets comparable to those of Sony, Mercedes, Microsoft, Intel, Toyota, Boeing, Airbus, BMW, etc. In other words, with the possible exception of weaponry there is hardly any Russian product that would be known for its reliability and quality so that it could create and sustain a reputation that generates buyers' loyalty. Given that all those companies that are successful on the world market have a strong home base, it seems that the Russian companies need first to be successful on their domestic markets before aspiring to conquer world markets. That task is made harder by the day, as the competition from emerging economies continues to stiffen appreciably.

From a historical perspective, a noteworthy aspect of Russian imports is a change in their composition. The weight of machinery and equipment recently amounted to less than 30 percent of imports – and that figure includes automobiles. This contrasts

3 The frequent claims that Russia is plagued by the Dutch disease are not shared by all observers.

starkly with the Soviet period, when the category of investment goods figured prominently within imports. One is tempted to say that during the Soviet period imports consisted of investment goods and grain, whereas now they consist of consumer goods and automobiles (including used automobiles). Of course, that would be an over-simplified statement and, fortunately, the weight of investment goods seems to be growing at present.

Overall, the Russian Federation's involvement in world trade is still miniscule, despite a decade of trade expansion. Russia's share in world merchandise exports amounted to less than two percent in 2001, the respective share in imports was less than half of that. In the same year, Russia's participation in world services trade was even smaller, with its share in world services exports being less 1 percent and its share in the respective imports being only slightly above 1 percent. Thus, there is still a long way to go despite a tripling of exports during the 1990s.

It is reassuring, however, that the balance of foreign trade, the current account balance, and the foreign exchange reserves all are looking good, the respective figures amounting to somewhat above US$50 billion, US$30 billion and US$60 billion, respectively, in 2002. While the latter figure tends to grow, the former two indices tend to deteriorate, mainly due to rapidly expanding imports. The prospects though are looking good, with the major risk emanating from the heavy reliance, both in quantitative and in price terms, on oil, natural gas and other natural resources. While this may appear as a one-sided form of integration, it is not a form of disintegration either.

Some degree of one-sidedness also prevails in the regional orientation of Russian foreign trade. The European Union clearly dominates, and it will do so even more after EU enlargement. This, however, is mainly due to the forces of gravity, with geographical factors figuring prominently. Relatively little change is to be expected in that regional orientation, at least in the short run.

One factor that may mitigate the influence of geographic proximity in the medium to long run has to do with the world market price for natural gas. At present prices, most natural gas is likely to be transported by pipelines. However, with the gas price now in shouting distance of a level where Liquid Natural Gas (LNG) is beginning to make economic sense, and combined with forecasts of skyrocketing US natural gas imports,[4] large scale Russian exports of LNG to the US and to other customers not linked to the present network of Russian export pipelines become a serious possibility. This would give Russian exporters of natural gas a wider range of potential customers than those in Western Europe to which the existing infrastructure is predominantly linked.

3. Capital Movements

The still most notorious aspect of Russia's involvement in world capital markets is capital flight. According to most estimates, the respective amounts reached up to 10 percent of GDP annually. The cumulative losses may have reached US$200 billion or more. Although the annual volume of capital flight may have gone down recently, from the traditional US$20-30 billion to little more than US$10 billion, the possibility of a dramatic renewed reversal is ever-present. Trust-generating institutional reforms clearly are the most important factor that could work towards a reduction of capital flight.

In the short run, some hopes are occasionally put on an amnesty. However, it has been made clear, not least by President Putin himself, that such an amnesty would apply only to legally acquired wealth, not to ill-gotten wealth. Therefore, reliance on such an amnesty presupposes trust in the ability of the Russian legal system to distinguish between legal and ill-gotten wealth. Given that most Russian wealth tends to be of the semi-legal variety, the wisdom of taking advantage of that amnesty may be too questionable to be attractive to risk-averse holders of flight capital.

The fear factor that lets Russian domestic capital leave the country in the first place, of course, also makes foreign capital hesitant to enter Russia. Thus, foreign direct investment (FDI),

4 Daniel Yergin of Cambridge Energy Associates reckons that within two decades, LNG could account for 20% of the US gas needs, from perhaps 1% now; see *The Economist*, July 26, 2003, p. 60.

although growing somewhat recently, still amounts to a meager one percent of GDP – and even that figure is possibly exaggerated due to an undervalued GDP. By comparison, the central European accession candidates attract FDI amounting to about six percent of their respective GDPs. In absolute terms, the annual inflows have been in the low single-digit billions (US$) during recent years. By contrast, China (PRC) has attracted US$53 billion in 2002 alone.

Of course, one may argue that Russia really does not need any foreign financial capital at all, as domestic aggregate savings exceed domestic capital investment, i.e., Russia is a net exporter of capital. While this is true, Russia at the same time needs new technologies, including management technologies, and a new business culture, which all tend to come together with FDI. Efforts at making the country more attractive for FDI are hampered by the persistence of relational, rather than market-based, corporate governance, by the absence of concrete results on PSA (production sharing agreements), by some less-than-friendly regions, and by the apparent ineffectiveness of newly founded one-stop investment agencies. Little surprise then, that Russian FDI abroad exceeds inward FDI. Among the targets of Russian FDI, it is worth noting that the EU enlargement region, as well as the EU itself, figure prominently. Thus, Russian companies take advantage of a legal environment that is badly missing at home.

As to portfolio investment, the total amount rose, due to a post-1998 rush into Russian stock markets, to well over US$100 billion, not too far away from the entire market capitalization. A worrisome recent development is foreign loans to Russian companies, supposedly for capital investment purposes. It is irritating to observe that the loans are taken specifically by those companies that are operating in the most profitable Russian sectors, i.e., oil and gas. The motive behind the loans seems to be less the need for fresh funds, as those companies have abundant funds themselves. Instead, it seems to have to do with regulations that make it easier to take profits out of the country if they are structured as repayment of a loan, rather than as profits as such or as dividends. This view tends to get support from the fact that, although Russian capital investment is growing, the increase falls far short of the order of magnitude that one would expect had all those loans resulted in *additional* capital investment, rather than constituting only an alternative way of financing investment – out of loans instead of retained earnings.

Still, at the aggregate level, Russia has a current account surplus that is leading to a build-up of foreign exchange reserves, partly in the form of a stabilization fund in the hands of the government, much more however in the form of assets of individuals and companies abroad. So, in total, we still have net capital exports, and they, too, are affected by the volatility implied in the dependence of export earnings on raw materials and energy prices.

4. Migration

Labor mobility was the dominant factor of the great pre-1914 era of globalization, much more so than today.[5] While it was emigration that was the main factor behind the decline of the Irish population in the 19th century, the present "demographic catastrophe" (Putin) in Russia is much more due to highly unequal birth and death rates. Nevertheless, migration is also not negligible.

While much of the discussion is about emigration, it needs to be recognized that, during the 1990s, ethnic Russians immigrated into the Russian Federation from other republics of the former Soviet Union. While this does not seem to have been worrisome for the authorities, they make much more noise about the potential for a massive inflow of ethnic Chinese into the Eastern parts of the country. From Michael Alexeev's contribution to this conference, it seems that the concerns are largely unjustified.

As far as emigration from the Russian Federation is concerned, Russian worries about a brain drain coincide with worries in the target countries about a "crime drain." Both forms of drain appear to be quite real – and, after some tapering off, they may

5 See, for example, Hatton and Williamson (2002) and O'Rourke and Williamson (1999); see also Kotwal (2001).

accelerate again once President Putin's frequently declared objective of completely visa-free travel for Russian nationals is beginning to become reality. Although at present the European Union issues ten times the number of visas as the US to applicants from the Russian Federation, it is the US where a large part of the brain drain appears to have ended up so far.

The effects of emigration depend critically on whether the outflow is of a transitory or of a permanent nature. If the outflow is permanent, then Russia may find itself in a situation quite similar to that of Ireland in the 19th century. During that period, Ireland was a labor-abundant economy and, thus, the outflow may appear to have been to some extent "natural." However, although one might be tempted to expect that a labor-abundant economy would also experience capital inflows, in Ireland it was *both* capital and labor that left. To some extent, the situation in the Russian Federation over the past decade looked eerily reminiscent of the Irish experience of more than a century ago. Of course, if we are dealing here with a short-term, transitory phenomenon, then the negative effects need not materialize. To the extent that highly-skilled labor will return as enhanced human capital, we may see a repeat performance of the Japanese experience after 1853 or of the more recent Chinese experience. This points to the know-how and technology dimension of integration into the world economy which may extend to returning financial capital provided that it comes with "embodied" technical progress.

5. Institutional Integration

As to the institutional integration of the Russian Federation into the world economy, the present Russian administration continues to give this objective a very high priority. The institutional integration is progressing, at varying speeds, in a number of dimensions. Thus, the Russian Federation has graduated into being formally recognized as a market economy, both by the US and the EU – although this recognition is not quite unqualified. Furthermore, Russia, for quite some time already, is a member of the Paris Club of Creditors, notwithstanding the fact that the country itself is, for all practical purposes, more of a debtor than a creditor. Russia has also attained almost-full membership of the G-8.

5-1. WTO

At present, much noise is generated by Russia's ambition to join the World Trade Organization (WTO) – as the last important country not yet a member of that organization, following the recent accession of both Chinas. Membership in the WTO is critical also for Russia's relations with the EU which, as a follow-up to the Partnership and Cooperation Agreement (PACO) of 1994, is now dangling the prospect of negotiations on a Free Trade Area (FTA) with Russia, making it contingent upon successful completion of the country's entry into the WTO. The additional offer of the EU to discuss with Russia the possibility of a Common European Economic Space (CEES), seems much more remote.

WTO membership appeared imminent for a while, but now it is questionable again whether membership will be granted before the conclusion of the Doha Round of trade liberalization. Fortunately for Russia, the Doha Round itself seems to be stalled so that hopes for accession in time still appear justified. Is membership really necessary? From a number of perspectives, the answer is clearly yes. Thus, it is important for Russian self-perception to become a member of the club where the future of world trade arrangements is negotiated. Being locked out from those negotiations, as the last big country of this globe, seems hard to stomach. Membership is also desirable for Russia in order to facilitate countering anti-dumping and other measures against its exports and thus gaining better access to the markets of Western industrialized economies. Not least of all, membership in the WTO may be instrumental for domestic reforms. If the respective measures are required as a result of WTO membership, it may be easier to channel them through the Russian legislative process. Thus, WTO membership is expected also to give a boost to domestic reforms.

At the same time, WTO membership is not all that it has been beefed up to be. Economic success without membership is clearly possible. China's economic success is only the most obvious recent example that countries can go a long way without membership. Conversely, there is no denying that quite unsuccessful countries have long been members in the WTO. At the same time, membership may give even successful economies an extra boost. Although China had cumulative FDI of about US$350 billion before membership, we have already seen that in the year following accession, annual FDI reached a record US$53 billion – despite a drastically shrinking volume of worldwide FDI.

In concrete terms, WTO membership requires the Russian Federation to reduce, over time, both tariff and non-tariff barriers to trade, to open up closed sectors, such as banking, insurance, telecommunications, etc., to foreign investors, to respect intellectual property rights, i.e., to end the pervasive piracy of music, software and movies, and also to eliminate local content requirements.

From the perspective of the EU (which has the mandate to respresent all EU member countries in the negotiations), a major stumbling block for Russia's accession is that country's practice of dual pricing, especially for energy, but also in the area of railway tariffs, which are two-tier for domestic and foreign freights. Export prices of natural gas are about six times the level of domestic prices, for crude oil the export price is about four times the domestic price. The EU argues that these pricing practices amount to hidden subsidies for Russian producers, e.g. for those of mineral fertilizers where over 70 percent of production costs are fuel costs, thus driving Western producers out of business. The official Russian position argues that low energy prices are simply a comparative advantage deriving from the country's endowment with natural resources. While that comparative advantage clearly exists, it does not justify dual pricing; it can only be used to explain a strong position of Russia on world markets for energy products. Another Russian argument is that domestic producers are so inefficient that they simply need three times the energy of Western producers on a per capita and even more so on a per unit of GDP basis. Again, this cannot serve as a justification for dual pricing.

The argument of high transportation costs, for energy, to the West does however carry weight. As a result, there will in the end remain some price differential for energy between domestic and foreign markets; the only open question is the appropriate magnitude. The most recent negotiating position of the EU calls only for decontrol of domestic Russian energy prices (for producers) and for well-head taxes instead of export taxes. It seems that Russia should be able to meet those requirements without undue sacrifices.

The extent to which Russian lobbies (civil aircraft industries, automobile producers, aluminium producers, the banking, insurance, and telecom sectors, and agriculture) and foreign lobbies (reportedly there is some Chinese pressure to open up Russia's labor market) will be able to delay the Russian legislative process and the negotiations in Geneva, respectively, is unlikely to be overwhelming. It is becoming clear even to the most skeptical Russian observers that concerns about cheap imports killing off domestic manufacturers and thus causing high unemployment, are quite unjustified, and that the factor much more important than WTO membership for the amount of imports is the foreign exchange rate of the ruble. Fortunately for this insight, memories of collapsing imports in the wake of the 1998 devaluation are still vivid in Russia. Thus, it is widely known that the importance of tariffs pales in comparison.

It may also be helpful that similar concerns as in Russia had prevailed in China in the run-up to WTO membership, but did not materialize there at all. Ex ante, the prediction in China was that imports would sky-rocket as a result of membership and that pressure on domestic producers would rise. It was further expected that, after a difficult first year, the economy would adjust to the heightened competitive pressure and would quickly recover. In actual fact however, nothing negative at all seems to have happened during the first year of membership. As a result, Chinese experts to this day are unable to give an example of a single negative effect of WTO membership. It very much appears that, for China at least, WTO accession will go down in history as some sort of Y2K event. It would be surprising if the outcome for Russia would turn out very much different.

5-2. European Union: FTA and CEES

The relations of the Russian Federation with the European Union have a mixed history. A period of mutual neglect was followed by heightened interest and then again neglect, especially in the immediate post-September 11 period. This may have to do with the not yet fully-resolved conflict between the European and the Asian identity of Russia. More important, however, seems to be the Russian self-perception in terms of size and weight. At the one extreme, Russia is seeing itself as a world power on a par with the US. At the other extreme, Russia is regarding itself as small enough to contemplate membership in the EU. In actual fact, neither is the country a serious contender for world power status of US dimensions, nor is membership in the EU a realistic possibility.

EU membership seems to be out of question for three reasons. In the first place, it is inconceivable that any EU member will ever get voting rights that would exceed those of the present large members (France, Britain, Germany, Italy). Although shared decision-making is a frequent Russian *desideratum* when it comes to the country's integration into international regulating bodies, shared decision-making within the EU context implies the possibility of being outvoted in matters of key domestic importance. It is hard to imagine that the associated loss of sovereignty would be acceptable to Russia. Secondly, the amount of financial transfers (structural funds etc.) to Russia that would be required according to present EU rules, would by far exceed the EU's willingness to pay. Of course, there is the option of "second class membership" with smaller financial transfers. But it appears equally inconceivable that Russia would accept second class membership in *any* club, least of all when it comes to financial transfers. Of course, such an attitude is not unique to Russia – witness the noises made by Poland when reduced EU payments were contemplated. Thirdly, the bundle of rules and regulations of the EU (the *acquis communautaire*) would be by far too heavy a burden as it would stress to the limit Russia's ability and willingness to implement. It is no secret that Russia has trouble implementing its own laws. The difficulties would be multiplied in the case of laws and regulations that come by mail from Brussels.

A possibly realistic alternative to EU membership would be to develop various degrees of institutional affiliation of Russia to the EU, including adoption of suitable parts of the *acquis*. Among the advantages of such an arrangement would be a partly reduced entrepreneurial risk with the possible result of increased FDI. In other words, gains from trade could be complemented by "gains from trust." This would be in line with the central tenets of newer theories of economic growth which put institutional quality, social capital, etc., at the center.[6]

Of course, it needs to be mentioned that some authors question the wisdom of adopting the *acquis*. Aslund and Warner (2003) argue that the *acquis* is infested with social democratic inflexibility that could be damaging for Russia. The *acquis* is said to go with too much bureaucracy, too high costs and overregulation, thus constituting a barrier to economic growth. As evidence for the inflexibility, these authors point out that the rate of unemployment is about twice as high in Poland as in Russia. While they fail to discuss alternative reasons for this difference, such as Poland being relatively less protected by an undervalued currency or the possibility of still very high hidden unemployment in Russia, their argument, if true, points to a potential tradeoff between two results of the *acquis*, namely on the one hand increased FDI and, on the other hand, an increased inflexibility. A pragmatic conclusion from that difficulty could be to argue for a careful and selective adoption of parts of the *acquis*.[7] That possibility is already under discussion in Russia. In any case, in the short and medium run the power of geography, i.e. the location of the big agglomerations in the Western part in the Russian Federation speaks strongly in favor of a substantial EU-orientation of Russia.

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6 See, for example, Zak and Knack (2001).

7 See Mau and Novikov (2002).

The next concrete step following Russian accession to the WTO would be negotiations on a Free Trade Area. The concerns raised in Russia in that respect are much the same as those that can be heard in the context of WTO accession. Incidentally, they also very much resemble the fears that were voiced in the US in the run-up to NAFTA. Normally, a trade-off can be expected between short-run pain and long-run gain. The short-run losses that come with increased competitive pressure would affect some sectors, whereas others would gain. The long-run gains are expected to result, as usual, from a more efficient division of labor. To the extent that the present round of EU enlargement will create trade diversion, which is, however, hardly to be expected, an FTA could help as it would mitigate some of the trade diversion. However, this is likely to be a pseudo-problem as present EU tariffs are lower than those of the EU candidate countries. Thus, rather than new trade barriers being erected, accession economies will have to reduce tariffs vis-à-vis Russia as a result of enlargement. On the most important, for Russia as well as for the EU, imports of natural gas, the EU at present has zero tariffs. Of course, a problem may emerge for Russia because accession countries will also have to reduce tariffs vis-à-vis the third world so that Russian exporters will face increased competitive pressure from there. On an even more general level, Russian critics of an FTA argue that it would cement the raw material bias of the Russian economy. While this is indeed a theoretical possibility, countries like Norway and Britain have shown that with suitable policies, such as the stabilization fund in Norway, this danger can be minimized.

A more fundamental concern with FTAs keeps being raised by international economists. While some of them argue that an FTA is a harmless transitory stage towards full multilateralism, others, most prominently Jagdish Bhagwati, suggest that bilateralism in actual fact is a dead-end rather than a transitory stage towards multilateralism.[8] The argument is that if countries begin to charge differentiated tariffs, with rates depending on the origin of

8 A *locus classicus* is Bhagwati (1992).

the traded goods, the final result will be a mess. Moreover, bilateralism is prone to undermine the most-favoured-nation principle, i.e., the rule that the lowest tariff applicable to one member must be extended to all members.

The position of political practitioners, such as Robert Zoellick, the present US trade representative, is that the road to multilateralism is simply much too cumbersome and slow.[9] The veto power of the unwilling participants in multilateral negotiations would unduly hamper progress. Rather than wait for the slowest participants, consenting countries should go ahead and not allow themselves to be held back by the laggards. For the sake of completeness, it needs to be added that the main partner in many of the bilateral negotiations, the US, is frequently accused of behaving like a selfish hegemon, exploiting its present power at the expense of poorer countries. In some quarters, this accusation is even extended to the WTO which is said to be in danger of degenerating into an instrument of US lobbying interests. That latter accusation is, however, unlikely to apply to the proposed FTA between the EU and Russia.

Although an FTA is still far from being a realistic prospect, there is already talk about a Common European Economic Space (CEES), also encompassing the EU and the Russian Federation. Perhaps not surprisingly, the ideas discussed by the prospective partners in such a CEES differ considerably. Thus, in the Russian understanding of the CEES the "four freedoms" (free movement of goods, services, capital and people) figure prominently. President Putin called for a European continent without dividing lines which, in his view, will require the freedom of movement, within all of Europe, for Russian citizens.

In the understanding of the EU, the concept of a common space includes not only the economic dimension, but also issues of security, justice, education, and culture. The specific economic dimension includes the harmonization of legislation in the areas of standards, technical regulation, tariff regulation, government procurement, and competition. Harmonization is meant to in-

9 See Zoellick (2002).

clude the adoption by Russia of key provisions of the *acquis communautaire* of the EU. It also includes the recurrent theme of energy corporation, especially in the area of natural gas.

Critics see serious drawbacks of the economic dimension alone. The idea of making Russian laws and regulations compatible with those of the EU implies considerable difficulties, not only because not all rules can be regarded as beneficial to the Russian side.[10] Thus, it is suggested that, beyond the four freedoms, only parts of the EU company law and some regulations on state aid might be suitable for Russia.[11] The rest is regarded as either superfluous or harmful. A potentially more prohibitive obstacle to the harmonization of EU and Russian laws and regulations has to do with the fact that harmonization can by no means be interpreted as convergence. In practice, it rather means the unilateral adoption by Russia of EU laws and regulations. This is difficult *per se*. It is made even more difficult due to the dynamic nature of the *acquis*. Russia would not only have no say in the *acquis*, it would also have to rubberstamp its continuous changes over time. This is already causing serious constitutional problems in countries like Ireland and Norway, which are associated in a comparable way to the EU. Notice however, that the unilateral adoption of the *acquis* and its development over time, while it causes problems of democratic legitimacy, has so far not caused any practical or functional problems. Yet, the political concerns appear to be serious and there may be no easy solution.

One possible way forward could be to include the Russian Federation, in the form of consultations, already at the stage of discussing and legislating new elements of the *acquis*. That, however, may well be both impractical and unacceptable to the EU. Nevertheless, negotiations over those issues may already serve to signal a willingness of both parties to make progress. That in itself may have positive effects on productivity, in that it could be interpreted as a positive sign by investors. Although the respective discussions *per se* cost next to no resources, it needs of

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10 An excellent discussion of the issues is contained in Hamilton (2003).

11 See again Mau and Novikov (2002).

course to be made sure from the outset that no possibility for disappointment, comparable in particular to that of Turkey, would be implied for Russia. In other words, no *ex ante* perspective for membership should be contemplated, irrespective of what may be considered conceivable, or what could possibly develop, over the longer term. In addition to those most obvious fundamental difficulties, it should also be mentioned that Russia's involvement in the customs union with Belarus, Kazakhstan, Kyrgyzstan and Tajikistan, and also the occasionally revived efforts towards a common currency (or even state) of Russia and Belarus can only exacerbate the problems.

Concluding Remarks

All in all, the path towards Russia's integration into the world economy seems to be charted out in a reasonably clear way. Accession to the WTO can be regarded, for all practical purposes, as a foregone conclusion. This in itself may give Russian reforms a palpable boost. In the area of foreign trade, the EU will remain the principle partner. Oil, natural gas and other raw materials will continue to be the key Russian export products. Foreign direct investment in the Russian Federation will continue to rise, less so because of any immediate Russian financial needs, but rather due to a Russian interest in facilitating technological and managerial spill-overs. Multinational companies in ever larger numbers will also make their presence felt, not least visually. Integration within the CIS will continue, at the minimum in the area of trade, but possibly also extending to a common Russian-Belorussian currency, for example. Infrastructural links between Russia and Western Europe will continue to grow, with the respective possibilities being almost unlimited.

The orientation of Russian exports to the EU, while strong, may become less pronounced once LNG exports take off in a serious way. In other words, the US as a customer may overcome the economic forces of gravity. At the same time, once EU enlargement is completed, the Brussels bureaucracy may have more resources, in terms of time and energy, ready to be devoted to the Russian Federation. (Of course, even after enlargement, digestion problems resulting from the present round of EU enlargement may continue to require the attention of Brussels and thus tie up resources.) The integration at the level of the population will also continue, e.g. with ever larger numbers of students moving in both directions. Partly as a result of that, the integration of what could be considered common global knowledge will make further progress. The latter point is of particular importance in the light of the factors said, by modern economic theories, to generate economic growth.

At the same time, it needs to be recognized that integration into the world economy is by no means an automatic process. The political leaders will have to make choices and there exist forces, not least within Russia, that militate against integration, for example due to worries about Russian identity. However, the fact that countries like Italy, France, and Great Britain had no trouble retaining their identity, despite membership in the EU, or that Japan has extremely successfully integrated into the world economy while also keeping its identity, should demonstrate even to reluctant Russian observers that their worries are exaggerated. What may push Russia forward is that, in a competitive world, integration into that world is itself a competitive process. A case in point may be Russia's effort to expedite its accession into the WTO following China's success in that respect. Still, Russia's integration into the world economy is unlikely to happen all too fast. Critical factors, such as people's attitudes, are slow-moving variables. Similarly, reputation is something that takes a long time to acquire (and a long time to get rid of). Also, the Russian capacity to make unnecessary mistakes, destroying some of the progress, should not be underestimated.

There are also dangers and risks associated with Russia's integration into the world economy. The most important one, from Russia's perspective, is that successful integration into the world economy may facilitate the disintegration of nations. Preventing that from happening could require a more centralized regime in Russia than one might wish to see. The ubiquitous Russian problem of inequality is in part also linked to integration into the world economy. Obviously, inequality of income and wealth distribution does affect foreign trade – witness the huge numbers of luxury limousines imported by Russia. This observation can be generalized in that large chunks of Russian imports are characterized by goods of high unit value, thus signalling high-quality goods. If integration into the world economy tends to exacerbate the inequalities, then the latter's productive (incentive) effects may be outweighed by its destabilizing effects on the social fabric. Moreover, the fight against too much inequality may itself deter investment, both domestic and foreign. That danger could be reduced, if the courts could be trusted to sort things out in a fair way. But this most obvious solution does not yet seem to work in a satisfactory way. The respective difficulties will remain with us for quite some time.

A less general, but more immediate, danger is the possibility of a domestic Russian economic slump, for example in the wake of collapsing oil prices on world markets, and a time-wise coincidence of that slump with WTO accession. That could lead to a *post-hoc-propter-hoc* error, i.e. a possible recession would be wrongly ascribed to WTO membership. Therefore, if a slump has to happen, then one would wish it to happen *before* WTO accession. In this way, the slump has to be attributed to other causes than WTO accession. Even better, a subsequent recovery from the slump, after accession, would then be ascribed – possibly again wrongly, but conveniently – to membership, with headlines then reading something like "WTO pulls Russia out of recession." But that is just a pragmatic thought. In general, it is to be hoped that Russia can avoid a slump and that integration into the world economy will continue to progress smoothly.

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