



National Security Project

# A Bull in Bear's Clothing: Russia, WTO and Jackson-Vanik

Task Force Paper | January 2012



BIPARTISAN POLICY CENTER



## National Security Project

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## Co-Chair Letter

The end of the Cold War has not eliminated, or even significantly reduced, the importance of U.S.-Russia relations for either country. That relationship is relevant to U.S. efforts to prevent a nuclear Iran, supply our troops in Afghanistan, address the challenge of a rising China, fight al-Qaeda and other national security challenges. Yet despite the centrality of U.S.-Russia relations, the United States has often lacked a coherent strategy that elucidates U.S. interests vis-à-vis Russia and proposes means for achieving them. The Obama administration's "reset" in relations has brought some benefits but more can be achieved.

In light of this state of affairs, we agreed in late 2010 to co-chair an inter-disciplinary initiative for the Bipartisan Policy Center (BPC) that examines Russian and U.S. political, economic and strategic dynamics and interests in order to propose a new U.S. strategy toward Russia that better advances U.S. security and economic interests. At the heart of our effort is what appears to be a paradox: the United States and Russia appear to share many common core foreign policy interests and yet, over the past decade, they have only partially managed to work well together. Further, it is in the U.S. strategic interest that Russia develop a more diversified economy and free society, and overcome some worrisome health and demographic trends in order to ensure long-term domestic stability.

We will release the full report later in 2012, but decided to release some precursory papers before that time, including this paper, which addresses Russian accession to the World Trade Organization (WTO) and graduation of Russia from the Cold War-era Jackson-Vanik Amendment – two very pressing issues for early 2012.



Secretary Donald L. Evans



Senator Charles S. Robb

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# Executive Summary

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## Overview

Relations with Russia remain central to U.S. strategic interests. Russia plays a pivotal role – positively and negatively – in our policy toward Iran, Afghanistan, North Korea, China, terrorism, energy security and other pressing national security issues. The improvement in bilateral ties in recent years is welcome but, in and of itself, has not fundamentally changed the structure of the relationship or sufficiently advanced U.S. interests. Indeed, Russian leaders recently continued their habit of manipulating elections to hold onto power and blaming America for any internal dissent. With Vladimir Putin expected to return to the presidency in March 2012 and the possibility of his continuing dominance of Russian politics to 2018 or beyond despite his party’s electoral rebuke in December and growing political opposition, U.S.-Russia relations could only become more challenging in the years ahead despite the mutual benefits that could come from deeper collaboration. Cooperation could also be slowed in the near-term during the U.S. presidential election in 2012. The goal of U.S. policy towards Russia should be to find ways that our two nations can work together as closely as possible on common objectives, while also working to resolve the issues that divide us. Our purpose is to advance U.S. economic and security interests, and to promote our values – in the case of Russia, these go hand-in-hand.

One of the common goals should be Russian entry into the World Trade Organization (WTO). Russia membership was approved in December 2011, and formal entry awaits a vote by the Russian parliament, which is widely expected to occur by the spring of 2012. The WTO is a multilateral institution designed to promote and manage international trade. Russia is by far the largest economy outside this 153-member organization, which represents the vast majority of the global population and 97 percent of total global trade. Some in Moscow view WTO membership – and U.S. support for it – as a prerogative of its Great Power status, a prerequisite for further cooperation with the United States and a vehicle for economic growth. Other Russian leaders fear WTO membership will hurt some domestic industries and shine an unwelcome light on, if not undercut, the country’s rampant corruption and those who greatly benefit from it. Outgoing president and the apparent next prime minister, Dmitri Medvedev, is seen as part of the pro-WTO camp, while Putin is considered among those more skeptical of the WTO. We would welcome a more constructive approach from Putin, assuming he returns to the presidency.

We strongly believe WTO membership would benefit the Russian people by requiring the government to adopt rules and policies that might begin to modernize their economy

and society. Such changes are desperately needed as far-reaching graft has hollowed out Russia's economic core, devastated its civil society and undermined respect for human rights. Russia's citizens are increasingly demanding a political system with greater respect for the rule of law and greater transparency. These demands should not be ignored and Russian membership in the WTO would provide an opportunity to address them, both by spurring economic liberalization—which could lead to political reforms—and by giving Congress an opportunity to replace the anachronistic Jackson-Vanik trade restriction with more modern human rights measures.

WTO membership would not only be good for Russians but also for Americans. It could potentially double bilateral trade over five years and create more U.S. jobs. Moreover, the positive economic and political reform that WTO accession might spur in Russia will, in addition to improving the lives of Russians, create better conditions for U.S.-Russia cooperation. It is in the American interest for Russia to be a strong, vibrant and increasingly open country, and that ultimately rests on Russia developing a more modern and vibrant economy and civil society. However, once Russia joins the WTO the United States would need to take action to reap the benefits and avoid damage to trade: Congress has to graduate Russia from the Jackson-Vanik amendment to the Trade Act of 1974. We urge Congress to take action on Jackson-Vanik in a timely manner and enact new legislation that would address modern-day Russian human rights abuses and corruption.

## WTO & Jackson-Vanik

Jackson-Vanik was designed to penalize countries, such as the Soviet Union, that restricted emigration by denying them permanent normal trade relations (PNTR) status, which permanently grants low tariff rates and high import quotas. Most U.S. trading partners enjoy PNTR status. Two decades after the Cold War, Congress continues to apply Jackson-Vanik to Russia even though it has graduated 15 other countries from its provisions entirely, including former Soviet republics Ukraine and Kazakhstan, as well as China and Vietnam. However, since 1994 successive U.S. presidents have certified that Russia is compliant with Jackson-Vanik requirements. This has made Russia eligible only for normal trade relations (NTR), which offers the same trade benefits as PNTR but must be renewed annually.

Once Russia formally accedes to the WTO, this annual NTR certification process will no longer suffice without detriment to American interests. WTO rules require that member states grant each other unconditional free trade, and an annual certification process does not meet that requirement. Thus, even if the United States continues to certify Russian compliance with Jackson-Vanik, WTO rules will permit Russia to deny the United States the benefits of PNTR. In other words, Moscow would have legitimate grounds to discriminate against U.S. businesses. Failing to grant PNTR would also alienate Russia and undercut our bilateral relations. To avoid these significant diplomatic and economic

drawbacks, Congress needs to act in a timely fashion to graduate Russia from Jackson-Vanik.

Political issues are involved. Jackson-Vanik has been used by various Members of Congress as leverage on a myriad of Russian issues: human rights record; policy toward Iran, Georgia and other countries; willingness to embrace market reforms and the rule of law as part of its WTO accession process; and a desire by the Jewish Hasidic group Chabad to repatriate books to the United States. Successive administrations have also found Jackson-Vanik as a useful lever in their dealings with Russia.

These impediments notwithstanding, we believe it is time to move beyond Jackson-Vanik and modernize U.S.-Russia relations for the benefit of both countries.

## Benefits of WTO & Jackson-Vanik Graduation

WTO membership is crucial to ushering Russia's economy into the 21<sup>st</sup> century. Russia is among the world's largest economies. Its wealth, however, is highly dependent on natural resources, while its manufactured goods are largely uncompetitive in global markets. This is not only economically risky but has incentivized Russia's leadership to meddle abroad to ensure high energy prices, and a continued stream of revenue into its coffers.

Meanwhile, corruption, state capitalism and the legacy of Soviet-era planning have inhibited productivity, foreign investment, entrepreneurship and the diversification of exports. Indeed, Transparency International ranked Russia 143<sup>rd</sup> out of 178 countries in its annual Corruption Perceptions Index and the World Bank put Russia 120<sup>th</sup> out of 183 countries for ease of doing business. Large-scale graft drives these negative rankings, yet it not only has a hugely distortive economic impact (inefficiency, capital flight, etc.) but also promotes a culture of lawlessness in which human rights abuses are ignored if not tolerated. We believe this rampant corruption, perhaps as much as or more than any other factor, is seriously eroding the Russian economy and state.

The regulations imposed by WTO membership would open Russian markets to foreign imports and investment while promoting greater transparency and accountability in its financial sector. Enmeshing Russia within these international rules could spur greater external trade and foreign investment that might, in turn, promote economic liberalization and much-needed modernization. A robust monitoring and enforcement regime on the part of the United States and international community might be necessary to keep Russia compliant with its WTO obligations initially. As Russian firms and products begin to increasingly compete with foreign imports and seek a greater share of foreign markets, however, market mechanisms will likely drive them to adopt more efficient and transparent practices, curbing costly corruption. Such modernization will greatly benefit the Russian people's living standards, which, although much improved

over the past decade, are threatened by economic stagnation and demographic decline. This should be welcomed and embraced by the wider Russian leadership out of responsibility to their citizenry and because it will enhance the strength and stability of the Russian state.

Russian accession to WTO would also benefit the United States. Despite the size of Russia's economy, it was only the 23<sup>rd</sup>-largest U.S. trade partner in 2010, behind Belgium and only slightly ahead of Colombia. As a WTO member, however, Russia would be required to lower tariffs on imported goods, leading to a freer flow of trade. According to some analysts, Russian WTO accession could double U.S. exports to Russia over the next five years, from \$9 to \$19 billion, which would spur American job creation and growth.<sup>1</sup> U.S. sectors that could benefit include: agriculture, specifically meat and poultry producers; manufacturers, especially those that produce high-technology products such as pharmaceuticals or aeronautics; information technology; and a range of services from finance to education.

More important, however, is that a Russia from which citizens and capital alike do not flee, a Russia more open to foreign trade and investment, a Russia with greater transparency and respect for human rights would be a better partner for U.S. leaders. Improving the economic, social and, perhaps ultimately, political conditions in Russia will enhance U.S. strategic interests by creating a stronger partner, more confident in its standing in the world, with a solid economic base.

## Human Rights

We understand that any modernization and liberalization, if it plays out, would be gradual and that WTO membership alone will not improve Russian human rights in the near-term. This is not an issue that we can ignore, as we believe American values, including the respect for human rights, is an important element in our relationship with all countries. Further, it is a political reality; many Members of Congress from both parties consider Russian human rights an important element in our bilateral relationship. Similar dynamics were in play in the case of China, a major power with a poor human rights record. Congress only agreed to graduate it from Jackson-Vanik during its WTO accession (2000-2001) by creating two commissions to review and report on U.S.-China bilateral relations, Beijing's adherence to its WTO accession commitments and human rights in China.

To be sure, Russia's human rights situation is significantly better than it was under the Soviet Union. We welcome this progress. However, the human rights situation remains inadequate and has deteriorated in recent years. According to Freedom House, Russia is plagued by great "electoral abuses, declining religious freedom ... growing police corruption and the repeated use of political terror against victims including human rights activists and journalists."<sup>2</sup> The lack of political and civil liberties in Russia has only been

highlighted recently by Putin's intent to return to the presidency and numerous reports of fraud during parliamentary elections held on December 4, 2011. But these events have also demonstrated that Russians are increasingly dissatisfied with the constraints of their current political system.

After the latest elections, the ruling United Russia party officially registered less than half of the vote – down from 64 percent per official results in the 2007 election – though suspicions of electoral abuse suggest the party's actual support was much lower. Russians have, as of mid-December, demonstrated their disapproval beyond the ballot box as well, taking to the streets in the days after the election in one of the largest shows of political opposition to the Kremlin since the 1991 coup attempt. With Russians demanding a freer political process that respects their voice and Russian leaders already quick to blame the United States for any protests, U.S. policymakers should not ignore the human rights abuses, electoral fraud and corruption that have become endemic there. This situation not only has moral implications but also impedes a vibrant economic environment, undermining foreign investment and leading to capital flight.

U.S. policymakers already possess tools to address human rights violations, beyond Jackson-Vanik trade restrictions, which have not been invoked since 1994. In addition to public statements by administration officials and annual State Department reports on human rights in Russia, the Executive Branch maintains the authority to deny visas and freeze U.S. assets of foreign officials implicated in human rights abuses and corruption. The State Department exercised this authority on visas for certain Russian officials (though not their assets) in July 2011, but seemingly only after pressure from Members of Congress. There also have been post-Cold War U.S.-Russia commissions to address a broad range of issues, but these have been generally ineffective on human rights, corruption and similar U.S. concerns. The current Obama-Medvedev commission has a working group dedicated to civil society, but it does not specifically include corruption or human rights under its purview.

The apparent insufficiency of existing mechanisms has motivated some to seek new levers to hold Russians accountable for human rights abuses. A bipartisan group has proposed the Justice for Sergei Magnitsky Act and Sergei Magnitsky Rule of Law and Accountability Act, in the House of Representatives and Senate, respectively, which would authorize specific penalties for individual Russians considered to be involved in the tragic death of the 37-year-old lawyer Sergei Magnitsky, who died in prison after accusing Russian officials of massive embezzlement. The Senate version would also target any Russian official committing "gross" violations against human rights activists or anyone exposing illegal activities by the Russian government.<sup>3</sup>

## Recommendations

It is in the U.S. interest for Russia to be a strong, vibrant and increasingly open country, a goal that ultimately rests on Russia developing a more modern, vibrant economy and civil society. Interest in this outcome – and concern about the obstacles that prevent it – is shared across the U.S. government and multiple outside groups. Russian membership in the WTO, by promoting freer trade with Russia and encouraging its political system and society to have greater respect for the rule of law, including human rights, transparency and civil society could potentially contribute to this end.

When Russia joins the WTO, however, it must then be graduated from Jackson-Vanik or U.S. businesses and jobs will be negatively impacted. Moreover, we recognize that Congress has little appetite to graduate Russia from Jackson-Vanik without some replacement legislation targeting human rights and rule of law. We support efforts to hold Russian officials accountable for human rights abuses for the sake of the Russian people and its society, and because liberal values are the foundation of the United States. While U.S. influence in such domestic matters is limited, valid and important concerns over human rights and rule of law must be part of the U.S. agenda along with strategic and economic issues and the overall U.S.-Russia relationship. We believe, thus, that Russia's WTO accession and graduation from Jackson-Vanik should be part of a comprehensive policy framework – developed by the Executive and Legislative Branches, as well as other concerned parties – for building a constructive bilateral relationship with Russia.

Therefore, we recommend that:

1. The Executive and Legislative Branches should together with outside stakeholders to craft a new comprehensive policy framework that advances U.S. interests, builds a more constructive bilateral relationship with Russia and promotes Russian human rights, rule of law, democracy, transparency, civil society and commercial engagements.
2. Congress should: a) enact legislation that graduates Russia from Jackson-Vanik, thereby ensuring that the United States will not be denied the economic benefits of Russia's WTO accession; and b) enact legislation that promotes more effectively Russian human rights and civil society.

# Russia's Economy and Trade

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Russia's economy ranks among the largest in the world after rebounding from its tumultuous post-Soviet transition. The "shock therapy" of economic and political reforms in the early 1990s, designed to transform the Soviet Union's lumbering centralized economy into a free market through rapid liberalization and privatization, contributed to years of domestic economic upheaval culminating in a financial meltdown in 1998. That year, the country's banking system collapsed and foreign investment dried up as global energy prices fell and major domestic fiscal reforms provoked financial instability. For many ordinary Russians, this engendered an association between free market reforms and economic instability, and reinforced for many of their leaders the need for the Kremlin to maintain a controlling share in Russia's political and economic decision-making.

The country has bounced back economically since that collapse, thanks primarily to a decade of massive natural resources exports, high commodities prices, reconsolidation of state control over major industries and minor reforms at the expense of significant economic and political freedoms. In addition, its populace is highly educated, and the country has a long history of advanced scientific and industrial achievement and production.

Significant systemic problems remain, however, and may have worsened in recent years: Russia's economy and government are heavily dependent on energy export revenues, corruption and bureaucratic red tape are rampant, the rule of law is weak and inflation is high. This undermines productivity, stifles foreign investment and triggers sizable capital outflows. President Dmitri Medvedev and other Russian leaders have articulated a reform agenda to arrest these negative trends and modernize the economy, including accession to the WTO, but many of these changes have yet to be fully implemented, if at all.

Reform – and a healthy Russian economy – is also in the interests of the United States as it seeks a more constructive relationship with Russia. Improved rule of law, greater transparency and reduced corruption could open the door to further political liberalization, spur foreign investment and allow for new, non-extractive Russian industries to blossom. These developments could, in turn, transform Russia into a more democratic, prosperous and secure partner, one less concerned with proving its greatness and less liable to use its natural resources as geopolitical leverage. This also

opens the potential of new business opportunities for American firms and jobs for American workers. Finally, integrating the world's primary producer of hydrocarbons and largest non-WTO economy into the global trade system would benefit U.S. interests in global development and energy security by increasing the free flow of goods and enhancing access to energy resources.

## Russia's Economic Recovery

By most measures, Russia's economic recovery since the 1998 financial crisis has been striking.

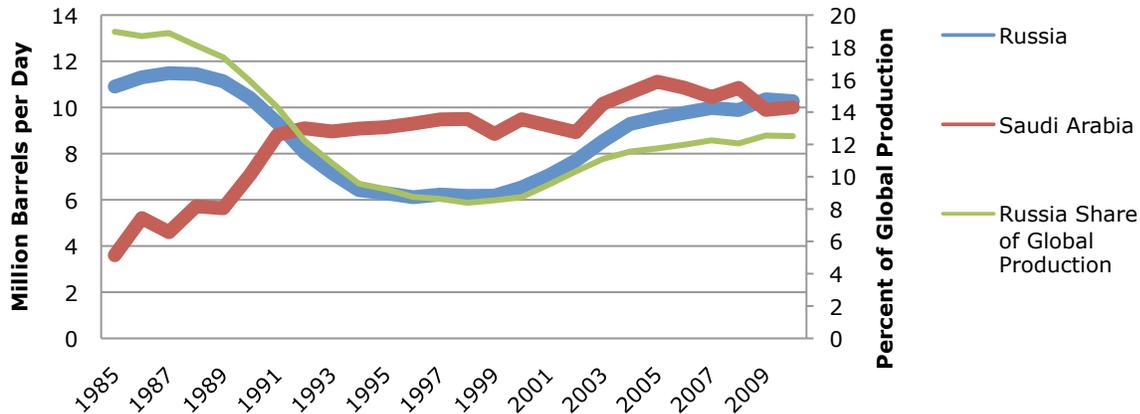
Under President Vladimir Putin (2000-2008), rising energy exports and global prices drove economic growth and turned Russia into a leading emerging market economy. Robust energy export revenues boosted budget surpluses, current account balances and currency reserves, and attracted modest foreign investment into the non-energy sectors of the economy. In an effort to partially protect against a replay of the domestic upheavals of the 1990s, the Putin government used energy export windfalls to intervene extensively in the economy and fortify government bureaucracies. In major economic sectors like natural resources, defense, heavy industry, nuclear power and aerospace, Moscow consolidated existing companies into state-controlled agglomerates. At times, this was achieved through hostile takeovers and intimidation that undermined foreign investors' confidence in the rule of law and property rights in Russia.

The banking system was also brought under state control as the Central Bank of Russia established controlling ownership in the small handful of banks that dominated much of the domestic market. At the same time, Putin began replacing elected government positions with appointed loyalists, strengthening one-party (United Russia) rule and solidifying popular support through extensive social spending. Presuming these moves would stabilize and stimulate Russia's economy, the government encouraged its favored companies and banks – many of whose leaders had personal ties to Putin – and smaller private businesses to borrow \$500 billion abroad from 2004-2008. This generated further economic growth at home, but also provided the capital for companies affiliated with the government to increase their hold over the economy.<sup>4</sup>

These measures helped pull Russia out of its post-Soviet tailspin. Under Putin's presidency, gross domestic product (GDP) quadrupled and the economy averaged seven percent annual growth as real incomes more than doubled, while unemployment and poverty rates halved. In 2008, the global financial crisis and Russia's war with Georgia actually reinforced the consolidation of economic power in the hands of the government. As Western investors pulled more than \$130 billion out of Russia in favor of less risky markets, Moscow was forced to use its oil revenue windfalls to inject liquidity into the country's stock market and state-owned banks and bail out many of the companies it had encouraged to borrow abroad. As a result, the government further increased its

ownership of Russian companies and much of the banking sector, to the extent that the state owned half of all businesses and accounted for 60 percent of GDP at the end of 2009. Not all changes during this period were overtly statist, however. The government took small steps to lower individual income and corporate tax rates, loosen regulations on corporate registration and licensing and cut interest rates.<sup>5</sup>

**Figure 1. Russia Oil Production in Global Context 1985-2010**

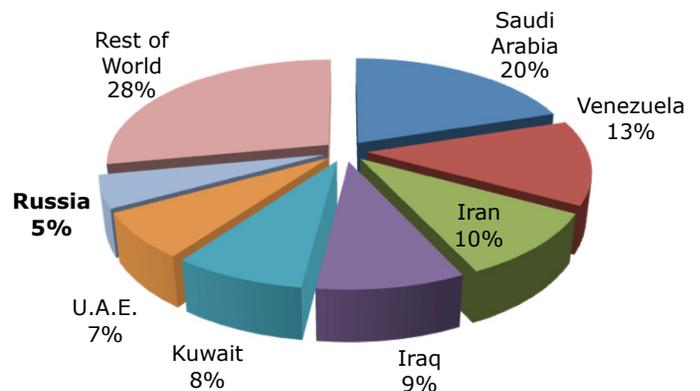


Despite the instability of the global financial crisis and ensuing recession, by 2010 Russia’s economy had become the tenth largest in the world by GDP – by far the largest outside of the WTO.<sup>6</sup>

## Challenges for Future Growth

Despite this notable economic improvement over the past decade, many challenges remain. First, Russia’s economic and political stability has depended largely on the export of natural resources, which makes it both vulnerable to volatility in global prices and resistant to genuine economic reforms. Second, the renationalization of key economic sectors has deterred foreign investment by undermining the rule of law and economic efficiency. Finally, and related to the second point, prevalent corruption further engenders an inhospitable business environment.

**Figure 2. Global Proven Oil Reserves (2010)**



## A. NATURAL RESOURCE DEPENDENCE

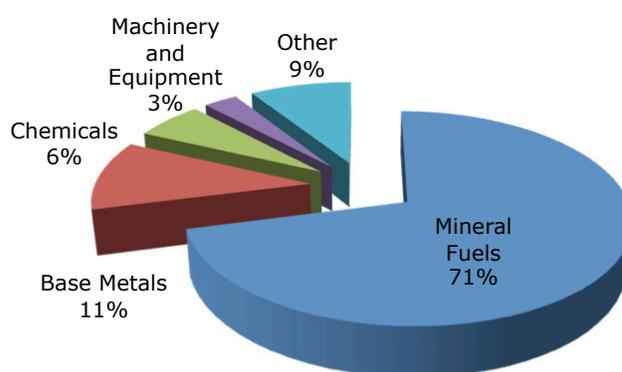
Russia is the world's largest producer of hydrocarbons. The energy sector accounts for one-fifth of GDP, half of federal budget revenues and 60 percent of export earnings. GDP skyrocketed as oil prices climbed from approximately \$20 per barrel to a peak of \$147 per barrel in July 2008, at the same time that Russia's oil production levels rose 53 percent. Natural gas prices and production grew as well, with output levels for other fuels also increasing. To a slightly lesser extent, exports of strategic materials such as coal, metals, timber and water provide additional government revenues.<sup>7</sup>

This dependence has only increased in recent years. From 2000 to 2011, oil and natural gas rose from less than half to more than two-thirds of total exports, but still only accounted for one-fifth of economic activity. Another 15 percent of exports came from other extractive commodities, while high-tech exports accounted for only nine percent of the total. Despite their leading role in exports, the energy and metals sector employ only two percent of Russia's labor force.

Simultaneously, the share of services exports actually fell from the already-low figure of 11 to less than eight percent. This sets Russia apart from other emerging market economies like Brazil, India or China – which together with Russia are widely known as the “BRICs” – as did the fact that its export growth came only from the expansion of *existing* exports in *existing* geographic markets.<sup>8</sup>

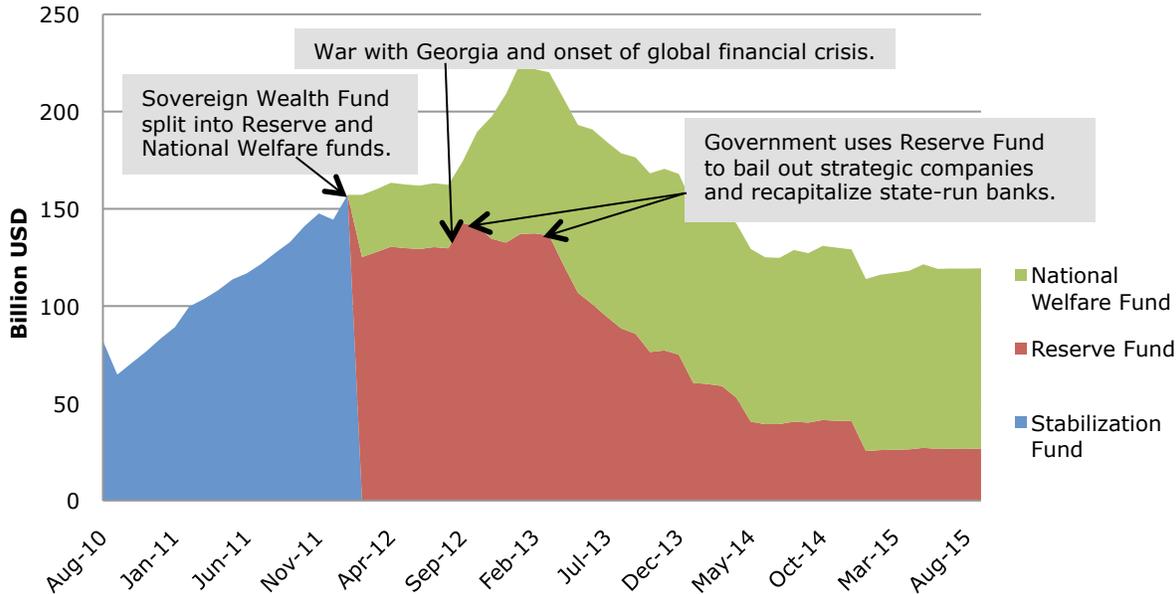
Such singular dependence on energy exports has served Russia well as global energy prices have steadily climbed over the last decade but, nevertheless, leaves it at the mercy of commodities markets while doing little to fuel domestic job growth. Moreover, recent high energy prices have attracted sizable capital inflows to the oil and natural gas sectors, but this disguises the larger, long-term problem of an uninviting investment climate: the country saw \$50 billion in capital outflows in the first three quarters of 2011 as domestic investors sent their money abroad, Russian companies repaid the massive foreign debts accumulated before the global recession and non-energy sector growth continued to slump. Half of the foreign direct investment (FDI) that has flowed into Russia (accumulated FDI stock) has gone toward natural resource extraction, compared with only 20 percent for manufacturing. Even with high oil prices on the eve of the global financial crisis accumulated FDI stock (around 10 percent of GDP) trailed far behind China (26 percent) and Brazil (20 percent).<sup>9</sup>

Figure 3. Russia Exports (2010)



Given this low level of economic diversity, Finance Minister Alexei Kudrin set up a Sovereign Wealth Fund (SWF) to use surplus raw material export revenues to balance the federal budget, reduce market volatility and fund social programs. However, Russia drained many of these reserves in the wake of the global financial crisis (\$200 billion overall). The replenishment of the funds was further slowed by the simultaneous falloff in oil prices, which has only recently begun to be reversed. As a result, in July 2011 the Finance Ministry had to revise upward by 20 percent – to \$97 per barrel – the oil price required through 2014 to keep the federal budget deficit below three percent of GDP.<sup>10</sup> At the same time, Russia still has not attracted sufficient FDI to reduce its dependence on natural resource exports.

**Figure 4. Russia Sovereign Wealth Fund**



The current federal budget deficit is only 1.3 percent of GDP, but the high non-oil budget deficit of 11 percent undermines confidence in the country’s long-term fiscal sustainability. Furthermore, Moscow’s use of the Stabilization Fund to bail out the economy during the global recession, combined with low investment rates, rising commodities prices and high social spending, contribute directly to an inflation rate of 10 percent, the highest of any G20 country.<sup>11</sup> Finally, dependence on energy revenues incentivizes Russia to meddle abroad to ensure high prices, secure deposits and transit routes, and dissuade competitors that might challenge its dominance.

**B. STATE INTERVENTION**

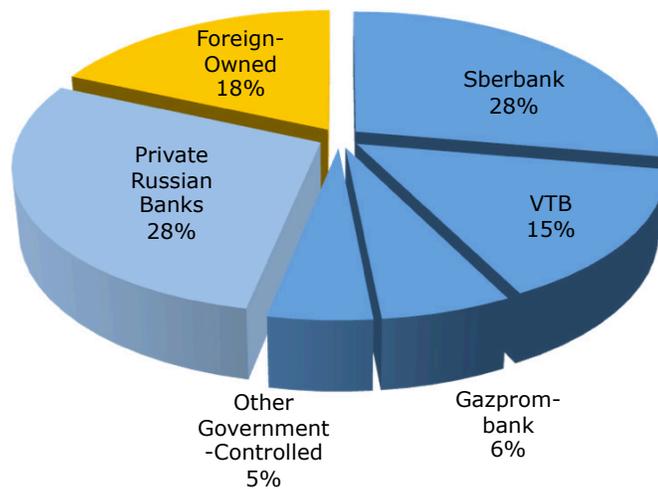
A primary reason Russia has not been able to attract significant foreign investment is

the state’s extensive presence throughout the economy. This creates an unattractive business environment in several ways. First, the economy still bears the scars of Soviet-era mismanagement and central planning. Entire cities were designed around capital-intensive heavy industries, with each designed to fulfill a predetermined supply and production role. The low economic diversity of such “monotowns” rendered them obsolete in the post-Soviet transition period, since they were now making uncompetitive products in market-unfriendly locations. Despite this, they still form a large section of the national economy and account for a significant share of social spending. By the Russian Ministry of Economy’s own assessment (predating the recent recession), monotowns accounted for 40 percent of all cities, 30 percent of total industrial output and one-sixth of the total population.<sup>12</sup>

Second, state-controlled monopolies and politically connected corporations have created a power base for Putin and others, but at the cost of economic efficiency. The idea behind these so-called “national champions” was for loyal *siloviki* and lobby groups to control the upper echelons and day-to-day operations of the country’s largest generators of wealth. Because these appointments were based on political connections instead of expertise, Russia’s largest companies lacked transparency and sound investment and marketing strategies, and used their political backing to dominate the market.<sup>13</sup> This, in turn, deterred foreign investment and limited these companies’ competitiveness and productivity.

Massive subsidies and tax breaks for these companies, direct government intervention in high-tech industries, sweetheart contracts for United Russia supporters, poor anti-monopoly enforcement and high social spending – 70 percent of the federal budget in 2010 – combine to further undermine domestic competition and productivity. Moreover, they discourage infrastructure upgrades, which, given Russia’s sheer size, harsh climate and outdated transportation and communication networks, are crucial to productivity and efficiency.

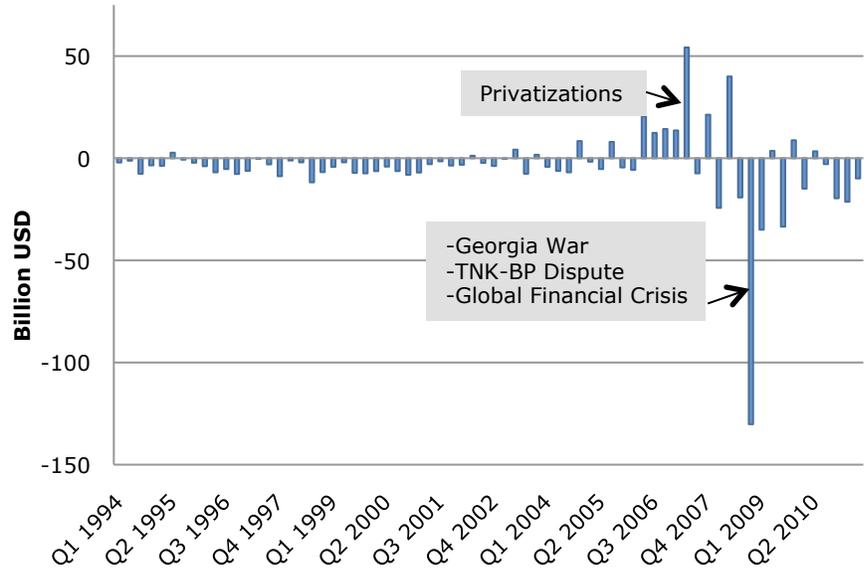
**Figure 5. Banking Sector by Assets (2011)**



Two laws provide good examples of this problem. The 1999 Federal Law on Foreign Investments outlines foreign investors’ rights, but has major exceptions, including “the

protection of the constitution, public morals and health, and the rights and lawful interest of other persons and the defense of the state.” The 2008 Law on Foreign Investment in Strategic Sectors requires government approval before any foreign investors can establish a controlling stake in any Russian company deemed “strategic” by Moscow, primarily lucrative industries like energy, metals, aerospace and defense.<sup>14</sup> There is no rationalized system to determine compliance with these laws, which can lead to drawn-out review processes. Moreover, the Kremlin has used the chief supervisory body – the Federal Antimonopoly Service (FAS) – to pressure private firms. The overall effect of these laws has been to discourage investment by foreign and competitive domestic companies in major high-tech projects in Russia.

**Figure 6. Net Capital Flows 1994-2011**



In addition to all of this, the lack of large private banks reduces Russian consumers’ and small- and medium-sized companies’ access to credit at home. This was not a major problem before the global financial crisis, as private Russian banks were

able to access European capital to lend domestically. In the wake of the crisis, however, Moscow bolstered its control over the banking sector by recapitalizing state-run institutions and letting many of these smaller banks fail. Today, the government pumps capital into large, non-transparent state banks to finance mergers and acquisitions of strategic assets and companies, while genuine economic recovery is hampered by the inability of Russia’s many private lenders to extend credit to new projects and businesses at home.<sup>15</sup>

Third, Moscow’s heavy-handed treatment of private companies operating in Russia undermines investors’ confidence in the government’s commitment to rule of law and private property rights, including intellectual property. Notable examples include the 2003 takeover of Yukos, Gazprom’s assumption of a controlling stake in the Sakhalin-2 energy megaproject from Royal Dutch Shell in 2007, the 2008 TNK-BP corporate dispute

and the ongoing controversy surrounding the death in prison of Hermitage Capital's lawyer Sergei Magnitsky. This sentiment is reinforced by Russia's opaque tax regime, which is plagued by unclear laws, arbitrary auditing and tortuous court cases.<sup>16</sup> Combined with Russia's lack of a politically independent judiciary, private firms have good reason to believe they will not only be subject to arbitrary prosecution – and their assets subject to expropriation – but their claims will not be given fair treatment in court. Accordingly, Russia was rated 186<sup>th</sup> out of 196 countries – qualifying it as an “extreme risk” for investors – in a 2011 survey by the risk assessment firm Maplecroft.<sup>17</sup>

Finally, the Russian government often imposes trade barriers to develop domestic industries it deems “strategic” – including hydrocarbons, metals, automobiles and agricultural products – many of which are already subject to significant state ownership. High export taxes, import tariffs, subsidies and sanitary and phytosanitary (SPS) inspections on imported agricultural goods, as well as the arbitrary and abrupt application of such measures, protect Moscow's support bases by discouraging competitive imports and private domestic production. During the global recession, for example, heavy import tariffs were rapidly placed on automobiles, heavy industrial equipment and agricultural products. When this occurs, Russia's economy becomes simultaneously less efficient – reinforcing its dependence on natural resource extraction – and less attractive to foreign investors. As a result of all these factors, the country came in 66<sup>th</sup> out of 142 in the World Economic Forum's *Global Competitiveness Report 2011-2012*, and ranked near the bottom in burdensome government regulation, respect for property rights, quality of roads, trade barriers and judicial independence.<sup>18</sup>

### **C. CORRUPTION**

In addition to inhibiting productivity and investment directly, low economic freedom and the concentration of revenue-generating activity in a handful of state-owned corporations enables extensive and debilitating extortion by state officials. The costs are not just economic: corruption among contractors, labor unions, safety inspectors and other regulators has contributed to the deaths of hundreds of Russians in several high-profile tragedies since 2008.<sup>19</sup>

Signaling the severity of the problem, in 2010 Transparency International estimated that bribe-taking cost Russia 20 percent of GDP and ranked the country 154<sup>th</sup> out of 178 in its *Corruption Perceptions Index*, behind the rest of the G20 and alongside Kenya, Laos and Papua New Guinea. Combined with the country's difficult regulatory environment, Russia also ranked 120<sup>th</sup> out of 183 in the World Bank's *Doing Business 2012* survey. Specific figures are difficult to obtain, but the tens of billions of dollars lost to graft, bribes and related economic crimes annually led President Medvedev to lament in 2008 that the country's “eternal corruption ... has debilitated Russia as long as one can remember.”<sup>20</sup> There is significant appreciation among Russian business leaders and the population more generally that such rampant graft discourages economic growth and investment.

It can be prohibitively expensive and exceedingly difficult to operate a business in an uncertain environment where 40 percent of companies said corruption is a serious hindrance in doing business, and reported making frequent unofficial payments, often to avoid corporate raiding by state-affiliated competitors or being shut down on trumped-up charges. This hinders competition and innovation by deterring capital inflows, reduces profit margins and returns on investment, depletes the country's tax base and limits the amount of money spent on research and development (R&D). According to a leaked 2009 U.S. State Department cable, "by taking merit of the equation for success, it [is] simply easier to pay for entrance to a university, for a contract, etc."<sup>21</sup>

Additionally, top-to-bottom corruption siphons off a large portion of government funds earmarked for maintaining and improving road, rail, port, pipeline, tanker and telecommunication networks tying together the world's most geographically expansive country (funds which were reduced in the first place by Moscow's bailout of strategic companies beginning in 2008). On a very basic level, this hinders economic growth by reducing efficiency, raising transaction costs, discouraging foreign investment and hindering the development of efficient, modern supply chains. Corruption also permeates the country's social programs, weakening the government's ability to care for its aging population and balance the federal budget. Finally, corruption in the court system and police undermines the rule of law, corporate governance and even-handed regulation that are required for foreign businesses to feel confident their property and other investor rights will be respected.<sup>22</sup>

## Halting Attempts at Reform

A heavy reliance on natural resource exports, increased state interventionism and widespread corruption create a troubling economic and political situation in Russia. The government has steadily consolidated control over the economy since 2000 – banking and revenue-generating high-tech sectors such as energy, in particular – to restore national wealth and power, enrich loyal elites and raise living standards. In this model, growth was predicated on state-run capital-intensive industries backed by state-owned banks, and restricted political and economic freedoms were the tradeoff for security and prosperity for the country and for the average citizen. More labor-intensive sectors like manufacturing and services were neglected, while domestic and foreign private companies – many of whom were more technologically advanced and efficient than Russia's state-owned behemoths – were driven out or sidelined.

The primary engine of economic growth – oil production – has likely reached a plateau for the next decade, but the country's human capital is stagnating: in 2011 only 15 percent of Russia's labor force was employed in highly-skilled jobs.<sup>23</sup> Not surprisingly, investors have little incentive to pump money into new projects that are subject to undue government interference and unlikely to generate products that can compete at home or abroad.

Russia now faces a conundrum: demand for consumer goods since 2000 has risen with the swelling tide of energy production – the very same that washed out foreign investment and the non-energy sectors of the economy. Western companies like Ford, General Motors, Deere & Co. and PepsiCo have opened plants recently in Russia, but the country's outmoded domestic manufacturers can neither meet this growing demand nor help pay for much of it by exporting competitive products. With flattening energy production unlikely to keep pace with imports of consumer goods in coming years, Russia will need foreign investment to finance a trade deficit.

Moreover, in 2011 Finance Minister Kudrin estimated that Russia would require six to seven percent annual economic growth to remain among the largest in the world, and for Moscow to balance its budget. This level of growth was achieved under Putin's presidency before the global recession, but even with the return of high energy prices, Russia's largely unattractive investment climate limited economic growth to 4.1 percent in 2010. Furthermore, the World Bank and International Monetary Fund (IMF) both forecast four percent future growth if Russia maintains its current policies.<sup>24</sup> The accumulation of these problems has led to increasing calls for earnest economic reforms.

The majority of proposed changes put forth by President Medvedev and reformist cabinet officials fall into three general overlapping categories: improving the country's business climate; modernization; and privatizing state assets and large shares of strategic companies. Medvedev often highlights WTO membership in this context, and Russia's accession requirements could help promote these types of reforms. While many observers have applauded these efforts, they simultaneously note that most have yet to be implemented or enforced.

#### **A. IMPROVING THE BUSINESS CLIMATE**

Russia's uninviting business climate is embodied in the country's pervasive corruption, barriers to foreign participation in large-scale projects and poor transparency and rule of law. To combat this, Medvedev, Kudrin and others have advocated several legal and regulatory changes. The first is to loosen the restrictions on foreign ownership of strategic companies contained in the Law on Foreign Investment in Strategic Sectors, which was passed during Putin's second term. Since its enactment, the law has hamstrung or deterred foreign investment in the most lucrative sectors of Russia's economy, including high-tech ventures where Russian companies require outside expertise and capital. It has even affected large-scale investments in lower-end consumer goods. In 2010, PepsiCo's purchase of a controlling stake in Russia's largest food company (Wimm-Bill-Dann) for \$3.8 billion proceeded smoothly. That same year, Coca-Cola's ultimately successful attempt to acquire Wimm-Bill-Dann competitor Nidan Soki was held up for months by Moscow because Nidan Soki's license to conduct microbiological research qualified it as a strategic company, despite the fact Coca-Cola wanted to double its investment in Russia.<sup>25</sup>

Second, reflecting the growing appreciation among Russian officials and businessmen of the damaging effects of corruption and inefficient bureaucracy, the government has drafted or enacted a series of laws designed to protect investors and reduce the costs of conducting business. In 2011, Medvedev signed bills prohibiting bribes for foreign officials and in commercial transactions (raising the penalties for violators) and tripling police salaries, while also combing out corrupt officers. He has also called for a new law reducing red tape for highly-skilled foreign workers, lower corporate tax rates and corporate governance reforms to protect minority shareholders' rights in Russian public companies, increase transparency and enforce international accounting standards.<sup>26</sup>

At the same time, deputy prime ministers have been replaced with independent directors on the boards of several state-run companies, including Rosneft and VTB Bank. The costs of corruption were made apparent by the federal government's July 2011 bailout of Bank of Moscow, which at \$13.7 billion was the largest in Russia's history. After spending \$3.5 billion for a blocking minority stake in February 2011, state-owned VTB Bank discovered billions of dollars in problematic loans by the Moscow city government-owned bank, including loans to the wife of former Moscow mayor Yuri Luzhkov (Medvedev fired the high-profile Luzkhov over corruption accusations in September 2010).<sup>27</sup>

Furthermore, the government has also outlined several steps to streamline the procedures and costs for setting up new businesses or investments in Russia. Medvedev has called for executive authority to repeal laws the government deems "anti-business" and remove inept civil servants, while simultaneously creating investment ombudsmen to help get private investment projects off the ground more quickly and efficiently.<sup>28</sup>

The previous year, the Finance Ministry moved to help auditing firms identify and report corruption and conflicts of interest in companies operating in Russia. These measures may have been prodded by Russia's potential accession to the Organization for Economic Cooperation and Development's (OECD) Anti-Bribery Convention, which requires OECD candidate countries to undergo detailed review of their anti-corruption laws. In addition, Russian state and private-sector firms have begun adopting Western standards for business ethics in the hopes of attracting investors and clientele.<sup>29</sup>

A final initiative, backed by Medvedev and Putin, is the Russia Direct Investment Fund (RDIF). Unlike the SWFs, in which tens of billions of dollars in energy revenues help balance the budget, prop up state companies and cover social spending, this fund will use \$2 billion from the same source annually for five years to set up investment partnerships in Russian growth companies in pharmaceuticals and energy, among other sectors. By making the state an equal – but not controlling – stakeholder with foreign investors, Moscow is hoping the project not only slows capital outflows but also assuages fears of a repeat Yukos or TNK-BP scenario.<sup>30</sup>

While Russia may improve outside perceptions by promising more money and updating rules, the real test in countering graft, improving the rule of law and incentivizing investment has always been enforcement. Currently, the burden of proof remains on Russia's regulatory and judicial authorities, as well as the companies themselves.

## **B. MODERNIZATION**

Improving Russia's business climate will be insufficient for Moscow or investors if the economy remains fundamentally uncompetitive. Massive capital flight undermines the country's tax base and its companies' ability to innovate, which further reinforces its "abject dependence" on raw materials. Indeed, Medvedev's use of this term in a 2009 open letter to the Russian people underscores the feeling among some experts that the post-shock therapy recovery could unravel if energy exports slow and the country continues to produce little else of economic value.<sup>31</sup> Technological advancements could help Russia extract commodities more effectively, compete in major export markets and produce more goods to meet the rise in domestic living standards since 2000, thereby helping contain deficits in trade and the federal budget and address the blight of monotowns. With this in mind, Moscow is pursuing a two-prong approach to modernize the strategic sectors of its economy.

First, Russian leaders are courting technology-sharing and investment agreements with foreign companies in the energy, communications, aerospace, defense, transportation and nanotechnology sectors. Even reformist leaders recognize energy production will form the backbone of the economy for decades to come. Russia's massive oil and natural gas reserves make the energy sector the most attractive investment opportunity for foreign companies, even though the Putin years were trying times for the Western supermajors. Most of Russia's current energy production comes from declining Soviet-era fields controlled almost exclusively by state-owned companies, but the vast remaining reserves are in remote or offshore fields that present significant technological and logistical hurdles. Some of these have been brought online by Western consortia, and Moscow has been busy inking long-term deals to start additional megaprojects. Most notably, in August 2011, state-owned oil company Rosneft agreed to a \$3.2 billion deal with ExxonMobil to set up a joint research center in Saint Petersburg, finance new output and access the U.S.-based supermajor's deepwater drilling technology.<sup>32</sup>

Russia's leaders have continued Soviet Union-era dependence on energy exports for hard currency to balance budgets and finance imports. They are also trying to raise much-needed capital to modernize neglected economic sectors in which the country has historically held a competitive advantage, or where they perceive high future export demand. In 2010-2011, Medvedev led a series of high-level delegations to the United States and Europe in search of investment deals to upgrade its defense industry, expand telecommunications bandwidth, spur R&D in information technology (IT) and improve the country's export infrastructure.<sup>33</sup>

These delegations spurred the second prong of Russia's modernization strategy: creating a version of Silicon Valley outside Moscow called Skolkovo Innovation Center. This is intended to become an R&D hub promoting cooperation with leading global firms, attract foreign investment and increase its competitiveness in the aforementioned high-tech sectors. A key focus has been energy efficiency, in the hopes of not only establishing Russia as a leader in this developing industry but also to reduce the costs associated with having one of the world's most energy-intensive economies. Highly skilled foreign professionals willing to work at Skolkovo will be exempted from many of the country's tax and regulatory burdens, and the government has pledged more than \$3 billion through 2013 to support R&D and initiate a transparent grant-making process for start-up companies in Russia. Major partners thus far include Boeing, Cisco, Dow, EADS, General Electric, IBM, Intel, Microsoft, Massachusetts Institute of Technology, Nokia, Philips and Siemens.<sup>34</sup>

### **C. PRIVATIZATION**

The final reform effort to address Russia's potential economic stagnation was announced in 2010, when the government passed legislation and outlined a massive four-year plan to sell \$49 billion of stakes in state-controlled enterprises. Over one-half (\$29 billion) would come in the form of minority stakes in a dozen strategic companies that dominate sectors Moscow wants to modernize. The rest would come from selling 5,000 of what the government deems "nonstrategic assets," mostly small companies and banks acquired in the aftermath of the global financial crisis.<sup>35</sup>

In August 2011, the government expanded the plan by doubling the number of strategic companies whose minority shares were on the block (which raised the total to \$212 billion over five years), several months after paring the companies covered by the Strategic Sectors Law from 448 to 50. To some extent, Moscow was pulled toward the more ambitious plan by strong international interest, but it was also pushed by the need to improve Russia's business climate, modernize strategic companies and generate much-needed revenue.<sup>36</sup>

First, Moscow intends for privatization to contribute to its other efforts to attract foreign investment through an improved business climate. Facing only four percent GDP growth, in June 2011 Medvedev cautioned that the state's role in strengthening Russia's economy was "exhausted" and "it is not right to rely only on stable, gradual growth. Behind this notorious stability could lie the next stagnation." In tandem with the aforementioned regulatory changes, diversifying these large companies' ownership structures and investment bases could boost capital inflows, improve transparency and allow for more efficient corporate management and investment strategy. This is especially true for the country's two largest banks, Sberbank and VTB. Moscow hopes privatizing parts of Sberbank and VTB will allow them to become more effective lenders, thereby driving domestic growth while making it harder for private banks to compete.<sup>37</sup>

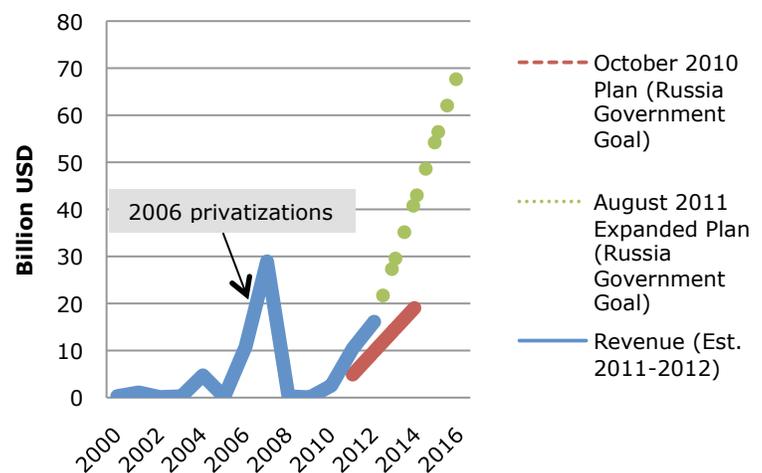
Second, as Medvedev’s speech indicated, there is a feeling within parts of the Kremlin that the state-centric growth model of the past decade has run its course. Many of Russia’s strategic companies dominate the economic sectors targeted for modernization, but over the years their roles as instruments of state power have created opportunity costs in terms of new technology, capital and productivity, especially as their debts rose due to Moscow-directed buyouts of independent businesses. Selling stakes in these companies to private investors could generate an influx of human capital and technical expertise, without forcing the government to relinquish its controlling shares.

Finally, Moscow needs money. In 2006, with the SWF rising on the back of oil exports, the government launched a modest privatization initiative to raise funds for state companies and banks that had accumulated debts consolidating control over Russia’s private sector. It was short-lived and offered only small stakes in a handful of strategic companies and 1,500 minor state-owned assets. Since then, Moscow spent \$200 billion to bail out strategic

companies, recapitalize state-run banks and buy up bankrupt small businesses during the global financial crisis – all while oil prices fluctuated and net capital outflows remained high. Between 2004 and 2009, government ownership of Russia’s publicly traded equity doubled to 52 percent.<sup>38</sup> Under these pressures, privatization is an attractive way to pay down the budget deficit while limiting further borrowing, tax increases or spending cuts (particularly in an election season).

The magnitude of these problems is greater now than five years ago, so the number of strategic companies – and the percentage of their shares – on the block have risen. The government is a motivated seller for its banks: it sank \$44 billion into its three largest banks during the financial crisis, and state-owned VTB bank currently needs \$3.6 billion to recapitalize Bank of Moscow. Sberbank, which accounts for more than a quarter of Russia’s banking sector assets and more than half of all deposits, could have 10 percent privatized for \$10 billion. VTB received \$6.4 billion in bailouts in 2008; a 10 percent stake sold for \$3.3 billion early in 2011 to Texas Pacific Group, and a second tranche is being offered for \$4.5 billion.<sup>39</sup>

**Figure 7. Russia Privatization Revenue**



Beyond the banks, much of the remaining revenue would likely come from companies that dominate economic sectors in need of new technology as much as money. French supermajor Total bought 12 percent of Russia's second-largest natural gas producer, Novatek, in March 2011, and this could rise to 20 percent by 2014. Rosneft, which received a large bailout during the financial crisis, could have up to 24 percent of its shares privatized (less than half that figure was offered in 2006), raising as much as \$25 billion in the process. Another \$50 billion could come from privatizing electricity utilities and agriculture, telecommunications, mining, aerospace and shipping firms, as well as the monopoly Russian Railways (a key bailout beneficiary).<sup>40</sup>

#### **D. THE FUTURE OF REFORMS**

Many of these initiatives have been attempted or at least mooted previously, though they appeared to gain momentum during Medvedev's presidency. Putin's announcement of his intention to return to that office, combined with Kudrin's abrupt exit, immediately shifted the focus from Medvedev's willingness and ability to steer these reforms through significant political and bureaucratic hurdles, to Putin's interest in pursuing them at all.

Medvedev usually contrasts his sense of urgency in these matters with his prime minister's preference for limited and staggered measures, but Putin notes the duo's "shared program." Putin's economic policy statements since declaring his candidacy have largely followed Medvedev's and Kudrin's tone, calling for balanced budgets and increased foreign investment. His emphasis on "gradual" change, however, is counter to Medvedev's aversion to a slower process. Either way, reforms under both leaders have largely been halting, limited and outpaced by promises for serious change.<sup>41</sup>

These political issues compound preexisting uncertainties about the scope and implementation of reforms, many of which have yet to progress beyond the drawing board. In terms of improving the country's business climate, there is a prevailing feeling among Russians and foreigners alike that corruption and poor rule of law may be the country's most intractable afflictions. More than a year after Medvedev's first initiative, the National Anti-Corruption Plan of July 2008, a leaked U.S. State Department cable noted, "corruption in Russia remains pervasive and deep-rooted. While Medvedev's anti-corruption rhetoric is a step in the right direction, we have yet to see significant implementation of new measures." Skepticism attends current efforts, which have been undermined by the Khodorkovsky and Magnitsky cases and Putin's statement that anti-corruption policies under his next presidency would be gradual.<sup>42</sup> Kudrin's unsettled future could complicate matters, as his Finance Ministry encouraged many projects to improve transparency and protect investors' rights.

Putin's return could also cloud the prospects for modernization. Western supermajors have maintained steadfast interest in Russia's energy sector over the past decade, and Medvedev's initiatives attracted significant foreign interest in other high-tech sectors as well. However, doubts about the prospects for *state*-driven innovation projects like

Skolkovo surfaced even before the 2012 presidency decision. The Russian government and foreign companies have shown interest in joint ventures, but this interest exists primarily as memoranda of understanding instead of firm financial commitments from either private investors or Moscow.<sup>43</sup>

With the president and prime minister likely switching places next year, the question arises whether the influence of reformists under Medvedev will be edged out by more conservative policymakers in the Kremlin who fear modernization's potential threat to the country's political and economic status quo. It remains unclear the extent to which Putin views the two options as tradeoffs, and how he will seek to balance competing visions for the country's future. On the one hand, many conservatives rose to power during Putin's first two terms as president; on the other, Medvedev will head the cabinet as prime minister, and the door appears open for Kudrin to return. Furthermore, it is unlikely Medvedev was able to pursue many of his initiatives without Putin's consent.

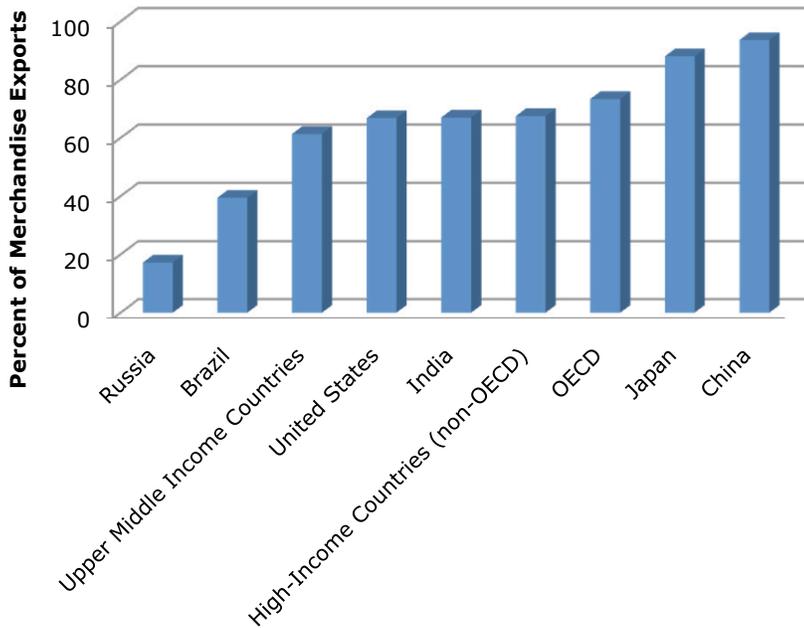
Finally, uncertain timelines and multiple vectors of opposition from within Russia could derail the drive for privatization. Medvedev viewed the October 2010 program as too modest and pushed for the more ambitious August 2011 version, but fears of a double-dip recession have motivated the Kremlin to try and stretch the expanded plan's timeline out to 2017 and delay further IPOs until 2013.<sup>44</sup>

More fundamentally, Putin's return may restrict the number of companies – and the number of their shares – that end up on the block. His first economic policy speech after announcing his 2012 presidential candidacy called for loosening state control over the economy only gradually, and many of his political allies have vested interests in retaining their influence over the country's most lucrative companies, particularly in natural resources sectors. The government has taken an active role in determining who it will, and will not, allow to bid for major stakes in state-owned companies, and how the deals will be structured. Natural gas monopoly Gazprom – which provides about 20 percent of federal revenues – is tellingly not on the list, nor is Gazprombank (Russia's third-largest bank) despite the company's massive debts.<sup>45</sup> Last but not least, for Russians of all stripes, "privatization" raises the specter of repeating the socioeconomic dislocation and lost national prestige following *perestroika* and shock therapy.

## Russia's Trading Partners

Russia's natural resource wealth, geostrategic location and sheer expanse have created significant partnerships with a wide range of neighboring countries, where its hydrocarbons, metals and chemicals exports enjoy a competitive advantage. However, it has relatively little economic interaction with partners afield. Furthermore, in most export markets outside the former Soviet Union (FSU), Russia's manufactured goods are at a decided competitive disadvantage. This helps explain the fact that minerals, metals and chemicals accounted for almost 90 percent of its exports in 2010, while most

**Figure 8. Manufactures Exports (2009)**

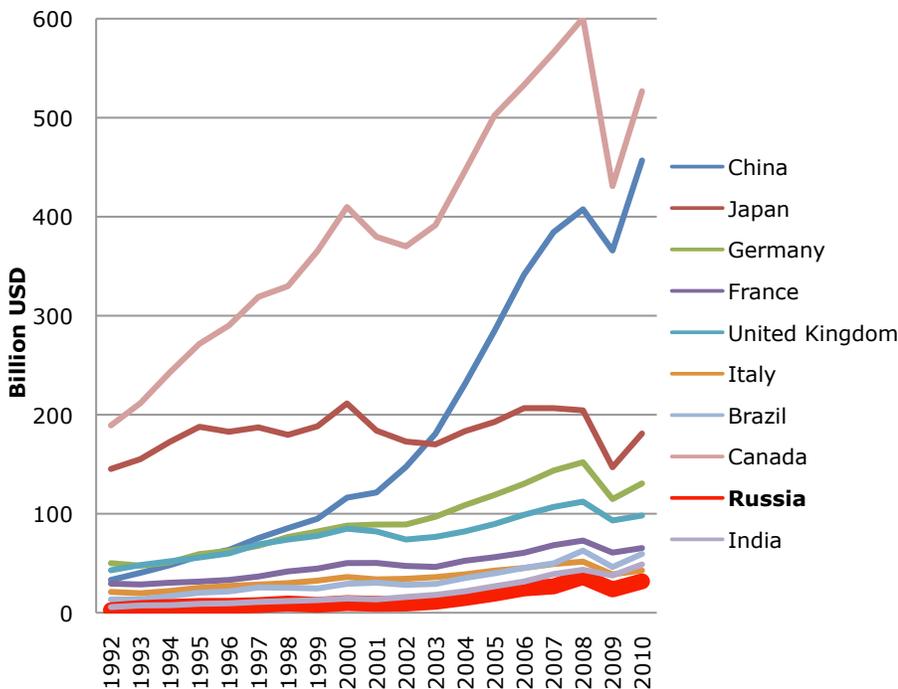


manufactured and consumer goods were imported.

Historically, Europe has been Russia's economic center of gravity, with roughly half of Russian exports and imports accounted for by the European Union. The majority of Moscow's revenue is derived from extensive energy exports to European consumers, while Russians rely primarily on Europe for foreign investment and high-end products and services. Russia has a

trade imbalance with Asia, upon which it depends for one-quarter of imports but less than 10 percent of exports – as with Europe, mainly natural resources.<sup>46</sup>

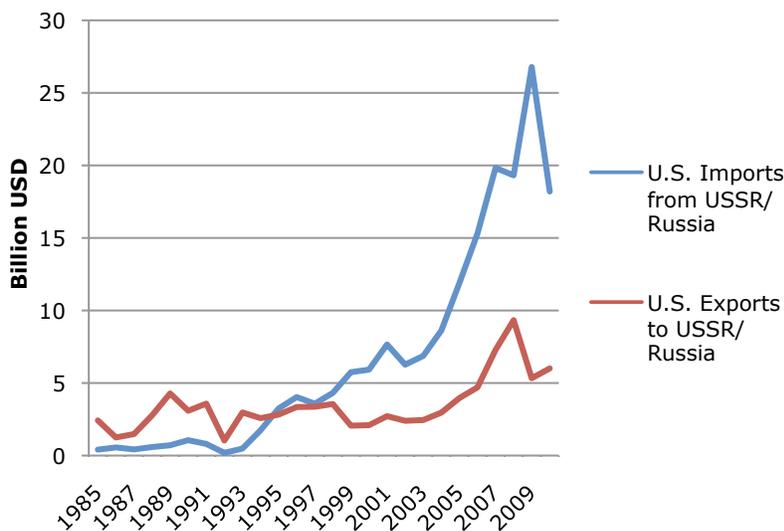
**Figure 9. U.S. Trade Flows 1992-2010**



Russia's trade relationship with Europe is reversed in its captive FSU markets, where weaponry and traditional Soviet-era heavy industrial goods – which would be uncompetitive in developed economies – form the bulk of Russian exports to these countries (14 percent of total exports from Russia). The FSU accounts for roughly 12 percent of Russian imports, primarily energy transshipments from Central Asia. That

region also provides most of the semi- and unskilled immigrant labor Russia needs to compensate for its shrinking indigenous labor pool. Furthermore, Russia is one of the world's largest consumers and traffickers of heroin, all of which comes through Central Asia. Russia formed a customs union with Belarus and Kazakhstan in 2010 with the goal of increasing the former Soviet republics' dependence on Russian imports, and Moscow hopes to extend the arrangement further into the FSU.<sup>47</sup>

**Figure 10. U.S.-Russia Trade Flows 1985-2010**



Trade flows between the United States and Russia are relatively low, considering they were the world's largest and tenth-largest economies, respectively, by GDP in 2010. Although total U.S.-Russia trade flows increased twelve-fold since the Cold War – and doubled

between 2005 and 2010 – this was still a minor fraction of U.S. trade with other top-ten economies, including much smaller countries like France and Italy. Only around five percent of Russia's total exports go to the U.S. market, with the United States accounting for an even smaller fraction of Russian imports.<sup>48</sup>

More than 70 percent of U.S imports from Russia are mineral fuels and metals, reflecting Russia's status as the world's largest hydrocarbon producer, as well as very low U.S. import tariffs on these goods. Unlike other U.S. trading partners like China, Russian exports are predominantly raw materials as opposed to value-added goods. U.S. exports to Russia are dominated by industrial goods like motor vehicles, aircraft, heavy machinery for energy production, and medical and pharmaceutical supplies – primarily merchandise requiring highly-skilled labor and capital that is lacking in Russia's non-energy sectors. Much of the remainder is agricultural products – crops and meat.<sup>49</sup>

The United States' trade deficit with Russia was \$19.7 billion in 2010, and U.S. FDI stock in Russia is less than 10 percent of the latter's accumulated total (the European Union's accumulated FDI stock in Russia is six times that of the United States). Two-thirds of U.S. FDI in Russia goes to oil exploration, although recently U.S. investment diversified

somewhat. In addition to potential future partnerships between U.S. and Russian companies in Skolkovo, PepsiCo's \$3.8 billion purchase of Wimm-Bill-Dann was the largest foreign investment in Russia outside its energy sector.<sup>50</sup>

Additional U.S. investment is hampered by the lack of a Bilateral Investment Treaty (BIT). BITs help promote FDI by establishing conditions and mechanisms for foreign investment in the other member's economy. These agreements usually include: guarantees of fair and equitable treatment for investors; protections against discrimination and expropriation without compensation; and legal recourse to third-party arbitration. Given high levels of corruption and Moscow's attitude toward foreign investors in cases like TNK-BP and Sakhalin-II (not to mention its treatment of Yukos), the lack of a BIT outlining investors' rights hinders U.S. capital investment in Russia. Moreover, it limits U.S. companies' market share in Russia by favoring investment from countries with which Moscow has ratified BITs, primarily E.U. member states.

A BIT between the United States and Russia was signed in 1992, but the treaty never took effect because, while the U.S. Senate ratified it in 1993, the Russian Duma never did. Presidents George W. Bush and Vladimir Putin agreed to negotiate a new BIT at a joint summit in Sochi, Russia, in April 2008. Russia has BITs in force with most of its non-FSU trading partners in Europe and Asia, while the United States has free trade agreements with many of its largest export markets.<sup>51</sup> Increased trade between the United States and Russia would benefit both countries by bringing greater opportunities for economic growth, and draw Russia into global web of economic interdependence, raising the costs of bellicose behavior.

# Russia and the WTO

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It is this potential for economic growth and stability that often frames discussion of the benefits of WTO membership. Russia's accession path has been extensive and has had to clear multiple hurdles. Russian membership was officially approved at the WTO ministerial conference in Geneva, Switzerland, on December 16, 2011.

## Background

The WTO is a multilateral institution designed to promote and manage international trade. It provides its members with a legal framework for interstate commerce, and also serves as a forum for negotiating lower tariffs and other barriers and resolving trade disputes. There are currently 153 members representing the vast majority of the global population and 97 percent of global trade turnover. Russia is by far the largest economy outside the organization; it originally applied to join in 1993.

After China acceded in 2000, Putin made Russian membership a priority in his first term as president (2000-2004). Those years saw Russia create a legal framework for protecting intellectual property rights (IPR) and copyright laws, as well as bring its customs, civil and tax codes into WTO conformity. But WTO accession – along with the SWF, part of the “Gref Program” for liberal economic reforms, named after Minister for Economic Development and Trade German Gref – was put on the backburner for much of Russia's economic growth spurt during Putin's second term (2004-2008).

The process only began gathering momentum within the past five years. Crucially, the 2006 U.S.-Russia WTO Bilateral Market Access Agreement on IPR, meat imports, plant inspections, embedded encryption technology (EET) and aircraft sales gave the United States a legal basis for ensuring that Russia abides by its commitments undertaken as part of the WTO accession process. These commitments include: lower import and export duties; binding tariff rates that Moscow cannot raise abruptly; increased foreign ownership of Russian banks; access for U.S. service companies in Russia; and enforcement of IPR legislation on pharmaceuticals and internet technology. This was a major step in a larger process of preparing Russia's WTO working party report (Russia agreed to similar protocols with the E.U. in 2004). This document essentially sets out the acceding country's terms of entry to the WTO, and it is the result of complicated negotiations and consultation regarding members' concerns and questions about the entrant's trade regime.<sup>52</sup>

Over the years, Russia's report has been written and rewritten with extensive U.S. and E.U. assistance. The process was slowed in 2009-2010 as Russia announced it would

only pursue membership as part of its customs union, and as it hiked import tariffs and said it would not reduce them until accession was assured. However, Obama and Medvedev agreed to fast-track Russia's accession negotiations at a June 24, 2010, Washington, D.C., summit. This was aided by Russia agreeing to pursue its WTO membership separately from its customs union, a decision that averted the need to form an entirely new working party. Russia reached agreement with the U.S. and E.U. on most major bilateral trade issues related to WTO membership in 2010.<sup>53</sup>

A handful of working party report issues needed to be resolved before Russia submitted the report and finalized bilateral trade agreements with current members. Several of those were technical questions about Russia's trade regime. Beyond this was a political roadblock: WTO member Georgia blocked formal working party meetings, one of which was needed to officially approve Russian membership. Tbilisi and Moscow announced an agreement in early November 2011 addressing concerns about customs in the disputed territories of Abkhazia and South Ossetia, which paved the way for Russia's membership to be approved at the December 16 WTO meeting in Geneva, Switzerland. Formal entry awaits a vote by the Russian parliament, which is widely expected to occur by the spring of 2012.

## Benefits to Russia

WTO membership could benefit Russia in two basic ways. First and foremost, it could benefit the Russian people. By lowering trade barriers and helping to create a more hospitable investment climate, accession could contribute to much-needed economic growth and diversification in Russia over the medium to long term. Second, it could benefit the country in a broader perspective. Joining the WTO is an issue of respect and pride: Russia is by far the largest economy outside the organization, and views its inclusion as a prerequisite of its Great Power status.

The living standard of the average Russian citizen improved markedly in the past decade as growing energy prices and exports led to economic stability, increased domestic spending and modest foreign investment. Sustaining economic growth, however, is now being undermined by the strong arm of the state in key economic sectors and by corruption. The country depends heavily on volatile energy prices to balance the federal budget and attract foreign investment. WTO membership could promote some of the policy changes required to avoid sluggish growth or even stagnation, in several ways.

First, by binding Russia's tariff schedule to internationally-agreed levels, reforming the country's customs administration and detailing SPS standards, the accession agreements will likely increase its external trade by both lowering rates and preventing Moscow from imposing prohibitive duties and quotas in an ad hoc fashion, as it did in response to the global recession. For instance, Russia agreed to join the WTO's Information Technology Agreement (ITA) as part of the accession process. This could contribute to

modernization – embodied in projects like Skolkovo – by eliminating the country’s tariffs on high-tech goods and services. It could also increase economic efficiency by removing preferential treatment for domestic industries favored by Moscow.

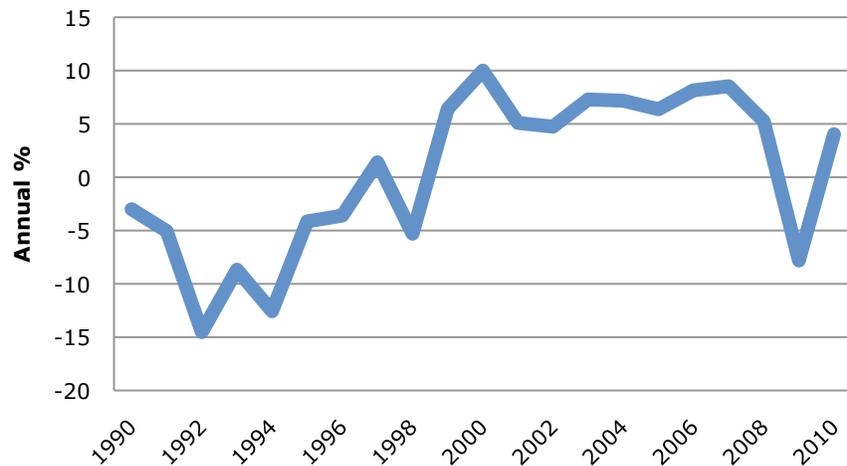
Second, FDI can be expected to increase if and when Russia institutes its accession commitments to protecting foreign investors’ rights – especially in the services sector – and enforces IPR legislation and other new regulations. This is bolstered by the WTO’s legal system for

adjudicating trade disputes. Increased FDI would help reduce the country’s current heavy capital outflows, lower the high non-oil federal budget deficit, which the IMF has singled out as a major concern for long-term growth, and make it easier for Moscow to carry out its modernization and privatization agenda.

Finally, domestic consumption growth and FDI could be boosted further if Moscow allows foreign banks to open branches in Russia. Most small- and medium-sized Russian businesses, not to mention average citizens, do not have sufficient access to credit to fuel consumption and investment at home. This is due to the fact that state-owned institutions designed to support strategic companies currently dominate the banking sector, and because Moscow let many smaller banks fail during the global financial crisis. While the government may privatize minority shares in a handful of large banks, it has remained obstinate on this point, despite the positive effects on its economy and its citizens.

Given the potential benefits of trade liberalization, the World Bank has estimated accession could increase Russia’s annual economic growth by 0.5 – one percent of GDP annually for five years. Over the longer term, welfare gains could reach as high as 24 percent of Russian consumption (11 percent of GDP). These gains are not insignificant for a country whose goal for annual growth is six – seven percent GDP, yet whose current projected growth hovers near four percent.<sup>54</sup>

**Figure 11. Russia GDP Growth 1990-2011**



Beyond the strictly economic calculations, Russia's self-image as a world power is intertwined with its status in relation to the world's major multilateral institutions, among other things. This is especially true given the post-Soviet collapse of Russian power, and is evident both in its troubled relations with NATO and its insistence on the U.N. Security Council as the preferred forum for resolving key international issues. Moscow does not view WTO membership so much as a quid pro quo, but rather a right of any Great Power. This is evident in certain issues of Russia's accession negotiations, and in Medvedev's June 2011 comment that Russia would not join the WTO on disadvantageous terms.<sup>55</sup>

## Benefits to the United States

There are four main benefits of Russian WTO membership for the United States. First, WTO membership would ensure favorable market access for U.S. exporters and investors. Russia cannot produce many of the manufactured and consumer goods its population demands, and freer trade could allow U.S. exports to Russia to double within five years. Needless to say, this would protect domestic producers in many sectors and increase opportunities for investment abroad. Second, it would give the U.S. a stronger bilateral trade toolbox by embedding Russia in the WTO's institutions and laws. This would help stabilize U.S.-Russia trade relations and create a more hospitable investment climate in Russia for U.S. companies – no small consideration in a country seeking to attract foreign investment but where concerns about the rule of law remain. Third, economic liberalization could spur political liberalization, as well as countervailing forces within Russia to the often bellicose policies emanating from Moscow since the Putin era. Finally, U.S. support for Russia's successful accession is a confidence-building measure that could pave the way for expanded bilateral cooperation on a range of issues beyond trade and investment.

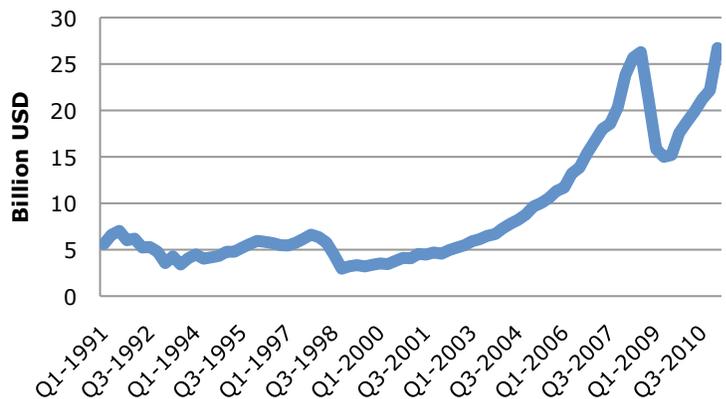
### **A. INCREASED TRADE AND INVESTMENT**

The primary and most tangible benefit to the United States will stem from the reform and liberalization commitments Russia has either already instituted or will be required to undertake in its bilateral trade relations with the United States. It is not surprising that Russia – the only G20 member not officially in the WTO – has more discriminatory trade measures on the books than any other G20 member.<sup>56</sup> Implementation of Russia's new tariff schedule, quota commitments, service sector regulations, SPS standards and IPR legislation – as well potential reductions in domestic subsidies for agriculture and heavy industry – would protect or create jobs for U.S. exporters and increase investment opportunities for U.S. companies in Russia, in several ways.

First, Russia is the world's second-largest import market for beef, poultry and pork products, and has historically imported significant amounts of these goods from the United States. Moscow frequently used questionable SPS inspections to punish U.S. exporters as a political tool in the past. However, accession requirements for new

standards, combined with reduced tariffs, would constrain such arbitrary trade disruptions while simultaneously increasing overall trade flows. For example, the Peterson Institute has estimated U.S. exports in this sector could double. Moreover, Russian enforcement of its new IPR regulations could make the country more inviting for investment by U.S. agrochemical companies.<sup>57</sup>

**Figure 12. Russia Imports by Quarter**



Second, U.S. industrial goods – currently the majority of its exports to Russia – could be expected to benefit similarly as trade barriers on U.S. exports of oil and natural gas field equipment, agricultural machinery, aircraft, construction and forestry equipment and other goods (as well as components for manufacturing these goods in Russia) are reduced. This is underscored by the fact that most Russian manufactured goods are at

a decided competitive disadvantage beyond the country’s protective domestic barriers, and by Moscow’s stated goals to modernize and privatize these sectors. An indication of the potential for Russia’s market is Deere & Co.’s March 2011 announcement that it would double its in-country manufacturing operation. In addition, U.S. automakers operating in Russia could benefit from that country’s economic growth and openness, especially if subsidies to local producer AvtoVAZ are curtailed. Specifically, Russia is the largest automobile purchaser in Europe, and its demand is projected to double from the current level of two million over the next decade. Ford and General Motors already have plans to invest a combined \$2.4 billion in Russia over the next four years.<sup>58</sup>

A similar logic applies for U.S. pharmaceutical and medical supply companies. Russia’s aging population, demographic challenges and troubled health care system make it the largest importer of pharmaceutical products and ingredients among the BRICs, but trade barriers mean U.S. exports to Russia in this sector are only a fraction of those to Brazil, China or India. Accession could lower import tariffs from 15 to six percent. Moreover, enforcement of IPR legislation could create opportunities for the high-tech partnerships between U.S. and Russian firms that Moscow is courting as part of its modernization drive.<sup>59</sup>

Third, accession’s potential impact on Russian economic growth could increase general

demand for U.S. imports. Rising income levels in Russia since 2000 encouraged robust consumer spending – it is already one of the largest consumer markets in Europe and its populace allocates more income for consumption than other major emerging economies. Moreover, the country’s GDP per capita levels are high for an emerging market economy, and even with high trade barriers it already imports a high proportion of its consumer goods compared to other BRICs. Russia currently runs the world’s third-largest trade surplus, but it often uses inefficient import substitution measures like high tariffs, subsidies and arbitrary SPS standards to try to protect domestic industries and diversify the economy from within. Accession could further open the Russian market to competitive U.S. merchandise and service exports by requiring Moscow to abandon or soften many of these policies. Beyond this, increased foreign ownership of Russian banks and insurance companies could bolster consumers’ access to credit and financial services, thereby furthering economic growth and demand for imported consumer goods.

Lastly, Russia’s combination of relatively high income levels and uncompetitive manufacturing minimizes the potential for cheap Russian imports competing on the U.S. market, or for U.S. jobs to be outsourced to Russia as a result of accession. In fact, U.S. companies operating in Russia often import their parts and finished products from the United States, even with current high tariffs. This should be seen in stark contrast to the effects WTO accession by a major manufacturing exporter like China would have on the U.S. economy.<sup>60</sup>

## **B. STRONGER BILATERAL TRADE TOOLBOX**

Membership could also build U.S. investor confidence in Russia and promote more mature trade relations by enmeshing Russia in a predictable and stable set of WTO institutions and commercial laws. By binding Russia’s tariff schedule, providing a legal framework for adjudicating trade disputes and promoting transparency and rule of law in general, the WTO could moderate and reduce investors’ legitimate concerns that their property rights not be violated arbitrarily, or that U.S.-Russia trade not be exploited as political tool. As Vice President Joseph Biden stated succinctly in Moscow in March 2011, WTO accession would give the United States “predictable access” to the Russian market.<sup>61</sup>

## **C. SPURRING BROADER REFORMS**

Many of the economic reforms Russia has pledged to undertake as part of its WTO accession commitments, if successfully implemented by Moscow, could potentially promote political reforms in a government whose respect for political rights and civil liberties, according to Freedom House, has become less free since Putin became president (it has been categorized as “not free” throughout this period). At the Davos Forum in January 2011, President Medvedev highlighted the connection between economic diversification and innovation on the one hand, and democratization on the other, as part of his outline for modernizing Russia’s economy.<sup>62</sup>

Indeed, many of the measures designed to spur foreign investment in Russia – respect for investors’ rights, privatization, greater transparency in business transactions and reduced corruption – would require more accountability from the country’s existing political and economic elites; infringe upon the favoritism currently enjoyed by many state-owned and politically loyal “strategic” industries; and loosen the linkage built by Putin between Russians’ economic prosperity and their political quiescence.

Furthermore, by diversifying the country’s vested interests away from natural resource exports, economic integration holds the potential to moderate some of the more bellicose aspects of Russia’s foreign policy. Moscow’s heavy dependence on the country’s sizable energy export revenues, combined with its major trading partners’ reliance on these exports for fuel and electricity, has created a situation where its leaders are emboldened by high energy prices to act aggressively in what Medvedev often refers to as Russia’s “privileged” sphere of interests – effectively the FSU. The most memorable examples in recent memory are Moscow’s 2006 and 2009 natural gas disputes with Ukraine, which left much of Eastern and Central Europe literally in the cold.<sup>63</sup> Economic growth in general could also lessen Moscow’s fears of popular discontent at home, and tamp down Russian leaders’ tendency to blame internal problems, real or imagined, on foreign actors (often the United States).

While many of these benefits could potentially be realized through accession, several things must be kept in mind. First, Russia’s economy expanded, but did not diversify, over the past decade while actually becoming *more* autocratic in the process. Further growth under such a political system might prove unsustainable in the long run, but that does not automatically mean Russia’s leaders will be willing or able to make the connection, either in thought or practice, between economic growth and liberalization.

Second, in contrast to Medvedev’s calls for modernization and WTO accession, Putin in August 2011 publicly accused the United States of “living like a parasite off the global economy.”<sup>64</sup> While it is improbable that Medvedev’s support for accession did not have Putin’s backing, the latter’s likely return to the presidency could strike at least a symbolic blow to the prospects of liberalization in Russia.

The Obama administration has been receptive to Medvedev’s message, and has sought to reinforce it at the expense of Putin’s and to secure accession before Russia’s March 2012 presidential election. In November 2010, Obama praised his Russian counterpart for making “every effort to move Russia in the right direction,” and four months later in Moscow Biden lauded Medvedev’s “personal leadership” and said the United States fully supports his “vision of a nation powered by innovation” and Russia’s WTO accession.<sup>65</sup>

Overall, the liberalization pledges are encouraging, but the key issue of implementation remains: Russia is saying many of the right things to attract foreign companies and

bolster investor confidence, but it has yet to enact many of the tough and costly policies needed to change the status quo.

#### **D. PROMOTE INTEGRATION AND COOPERATION**

By embedding Russia's economic self-interest in broader rule-based international institutions, accession could help limit Moscow's ability or willingness to engage in some of the destructive trade and other disputes that have damaged its relations with the United States and much of the E.U. and FSU in recent memory. Moreover, U.S. support for Russia's accession, which has been full-throated for years, could make it much more difficult for Russia to blame its own political and economic problems on foreign obstructionism and exclusion. This is related to the fact that Moscow's leaders' conduct toward their neighbors and the United States is intricately connected to their sense of receiving the respect they feel the country deserves as a leading global power. Thus, it was in the U.S. interest as much as Russia's that Washington facilitated accession while avoiding the appearance of wanting WTO membership for Russia more than Russia's leaders do.

Finally, there is the general hope that economic liberalization stemming from Russia's WTO commitments could possibly promote political liberalization in the country, especially considering much of the ruling class relies on state ownership of the economy and corruption to maintain political power. President Medvedev has even hinted at the potential for this to occur gradually, stating in September 2010 that "only a free person is capable of modernizing. Not someone who is afraid of the state, afraid for his life or his business."<sup>66</sup>

## Obstacles Beyond Accession

Russian membership in the WTO was approved in December 2011. The benefits of accession, however, are not automatic. A key political uncertainty is Moscow's willingness to undertake and adhere to its accession commitments, given their potential to disturb the current state-centric, energy-dependent economic status quo.

Beyond political difficulties, questions regarding the legal instruments of Russia's customs union with Belarus and Kazakhstan still need to be worked out. This is complicated by numerous facts: the customs union itself is new and evolving; Russia is applying to join the WTO without the union's other members; and Putin called for deepening and expanding the union in his first major foreign policy statement after announcing he would run for president in 2012.<sup>67</sup>

Furthermore, in addition to lingering concerns about Russia's state bank's finances, ITA accession, trade-related investment measures and protectionism in the automotive and agricultural sectors, WTO members have reservations about the prevalence of corruption and state-owned enterprises in Russia's economy. This is especially true as many of the

internal opponents to Russian accession have vested interests in maintaining barriers in the country's economic and political structure. Finally, the burden of proof remains on Russia for enforcing the regulations it has enacted on key issues like property rights as part of its accession commitments. None of these technical issues are seen as unsolvable.<sup>68</sup>

# Jackson-Vanik

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The Jackson-Vanik amendment to the Trade Act of 1974 denies eligibility for PNTR status to any country denying its own citizens the right of freedom of emigration, and was originally applied to the Soviet Union and other Eastern Bloc countries. Russia has been certified compliant annually since 1994, but has yet to be graduated from the legislation, for various reasons. If the United States does not grant Russia PNTR status now that the latter has acceded to the WTO, the United States is obligated not to recognize Russia's WTO membership. This could damage U.S.-Russia trade, and prejudice relations between the two countries overall.

## Background

Having supported Russian WTO accession throughout the process, the U.S. is pressed with the issue of repealing or replacing the Jackson-Vanik Amendment. This Cold War-era legislation denied normal trade relations (NTR) status to the Soviet Union and satellite states that restricted their citizens' freedom of emigration. The countries covered in the amendment cannot enjoy the same trade advantages – such as low tariff rates and high import quotas – enjoyed by other U.S. trading partners.

Although it was originally applied to the Soviet Union (among other countries), it still applies to Russia today, even though the issue of freedom of emigration has long since become moot. Indeed, Russia has been certified compliant with the emigration clause by U.S. presidents every year since 1994 and, according to Jackson-Vanik stipulations, is eligible for annual NTR status. In addition, the 1992 U.S.-Russia Bilateral Trade Relations Agreement provides for the mutual extension of normal trade relations between the two countries. In effect, Russia enjoys *de facto* "most favored nation" (MFN) status, which allows U.S.-Russia trade to occur under the same freedoms as it would between most other countries.<sup>69</sup>

## Current Status

Despite this commercial treaty and the annual compliance check, Russia still has not been graduated from Jackson-Vanik. Until Congress terminates the application of Jackson-Vanik regulations toward Russia, the U.S. president will have to certify that country's compliance annually and, therefore, will not be able to extend *permanent* normal trade relations (PNTR) status.

Currently, Russia is by far the largest U.S. trade partner lacking PNTR status; the United States graduated China as well as Georgia, Ukraine and other former Soviet republics

from Jackson-Vanik since the end of the Cold War. There are no technical issues remaining to be resolved before Russia can be graduated from Jackson-Vanik. Rather, it is a political question that faces multiple roadblocks – some of which overlap and interact with the hurdles that faced Russia’s WTO accession.

## Importance of Graduation

The primary importance to the United States of graduating Russia from Jackson-Vanik relates to WTO membership rules. The WTO requires all members extend unconditional free trade to all other members and, if it is not granted, mandates the non-fulfilling member invoke the principle of “non-application.” In essence, the benefits of Russian accession would not be applied to the United States. Furthermore, the non-application principle is reciprocal, and thus Moscow could discriminate against U.S. trade and take a less constructive interpretation of its obligations under the 2006 Bilateral Market Access Agreements. This could cause the United States to lose its existing market share to European and other competitors in key areas like industrial and agricultural exports.<sup>70</sup>

Beyond the economic rationale, bilateral relations could suffer more generally if Russia is not graduated from Jackson-Vanik. Moscow views Jackson-Vanik as a Cold War anachronism at best, and a symbol of abiding U.S. ill intentions toward Russia at worst. Prior to Russia, Moldova was the only WTO member whom the United States had not granted PNTR status, and in terms of self-perception Moscow certainly does not view itself as of a kind with that country. Should Washington not match its support for accession with PNTR status for Russia, Moscow could view U.S. offers for cooperation and improved relations as empty gestures, and could seek to retaliate on any number of issues.

This became evident even as the United States has considered replacement legislation for Jackson-Vanik (the Magnitsky Act of 2011) that would address U.S. concerns about human rights in Russia while also granting PNTR status. According to the Obama administration, senior Russian government officials have warned that should the Act pass, they will no longer support U.S.-led sanctions against Iran, North Korea or Libya, while also threatening to cut off rights for U.S. military equipment transiting Russia en route to Central Asia. Although Russian officials have since backed off these claims, Moscow has also threatened to respond to the Magnitsky Act with similar sanctions against U.S. officials.<sup>71</sup>

## Remaining Obstacles

Jackson-Vanik is a Cold War anachronism, and Russia has been determined in its compliance annually since 1994. Nevertheless, obstacles remain to being graduated from the legislation. First, Congress sees Jackson-Vanik as its only real point of leverage over the Executive Branch’s policy toward Russia, whether it concerns Moscow’s

behavior on strategic issues like Iran or Georgia, human rights abuses, internal political reform or commitments made in its WTO accession agreements. Moreover, because accession could impact U.S. trade interests, the committees with jurisdiction over Jackson-Vanik (Finance in the Senate, and Ways and Means in the House) historically have tied graduation to their satisfaction with the trade commitments negotiated by the United States with WTO candidate countries. This has created an interesting situation where Congress can, in effect, exercise a proxy vote on Russian WTO membership.

Second, a wide range of special interest groups has lobbied Members of Congress to avoid graduating Russia from Jackson-Vanik. Most notable among these has been Chabad-Lubavitch, a Jewish sect that wishes to repatriate a set of religious texts that the Russian government refuses to relinquish. Finally, in the view of Congress and many Americans, Putin's intention to run for president in 2012 signals a regression in bilateral relations, including Moscow's attitude toward human rights and political freedom.<sup>72</sup>

## Russia's Human Rights Record

Despite, or perhaps because of, the multiple impediments to graduating Russia from Jackson-Vanik, replacement legislation has been proposed to graduate Russia while allowing Congress to retain leverage over U.S. policy toward Moscow, specifically on human rights and corruption. While the situation in Russia is significantly better than it was in the 1970s, it has nonetheless deteriorated in recent years. Russia's domestic political makeup, and the character of its leadership, affects the country's foreign policy decision-making. Therefore, U.S. national interests, whether defined by its policymakers or general public, often include encouraging Russia to evolve in a certain direction politically.

With this in mind, the Justice for Sergei Magnitsky Act of 2011 and Sergei Magnitsky Rule of Law Accountability Act of 2011 were introduced in the U.S. House of Representatives in April and the Senate in May, respectively. The bills are named for Sergei Magnitsky, an attorney who died in a Russian prison in 2009 after being held without trial for his investigation of tax fraud that implicated a range of Russian officials. The House version (H.R. 1575: Justice for Sergei Magnitsky Act of 2011) would deny U.S. visas and freeze or prohibit U.S.-based financial transactions for anyone "whose acts were instrumental in causing the death of Sergei Magnitsky," who "concealed the legal liability of anyone responsible for the detention, abuse or death of Magnitsky" or who "conspired to defraud the Russian Federation of taxes on corporate profits because of fraudulent transactions and lawsuits against the foreign investment company Hermitage." The penalties would also extend to such individuals' immediate families.<sup>73</sup> By contrast, the Senate version (S. 1039: Sergei Magnitsky Rule of Law Accountability Act of 2011) is more prospective and expands beyond the Magnitsky case. It would target any Russian official committing "gross human rights violations" against individuals who seek to promote human rights or expose illegal activity by Russian government

officials.<sup>74</sup> Both bills contain robust presidential waiver authorities.

The bills currently have strong bipartisan co-sponsorship, including Senators Ben Cardin, Dick Durbin, Joseph Lieberman and John McCain, and enjoy a broad base of support in Congress. Replacement legislation – if not the Magnitsky Act per se – has some backing within the Obama administration as Michael McFaul said in May 2011 that “Jackson-Vanik is an outdated mechanism. Let’s have an updated mechanism that is more appropriate for 2011.”<sup>75</sup>

This reflects a general sense among U.S. policymakers and experts that Jackson-Vanik’s punishment – damaging U.S.-Russia trade – does not fit Russian human rights and corruption crimes precisely because Jackson-Vanik does not target current violations. Measures like the Magnitsky Act are intended to correct this by sanctioning high-level and prevalent abuses by individual officials in a country that, according to Freedom House, is plagued by worsening “electoral abuses, declining religious freedom ... growing police corruption and the repeated use of political terror against victims including human rights activists and journalists.”<sup>76</sup> The state of human rights in Russia is more than just a moral concern to Americans; such a domestic record impedes a vibrant economic environment, undermining foreign investment and leading to capital flight.

In addition to potential replacement legislation, there are existing tools that U.S. policymakers can utilize other than Jackson-Vanik trade restrictions when it comes to the future of human rights and corruption in Russia. Beyond public statements by the current and previous administrations and annual State Department reports on human rights in Russia, the Executive Branch maintains the authority to deny visas and freeze U.S. assets of foreign officials implicated in human rights abuses and corruption. This was evidenced by the State Department’s July 2011 visa bans on several Russian officials implicated in human rights violations, after pressure from Members of Congress. However, the State Department memo outlining the visa ban warned Congress of the Obama administration’s reluctance to impose measures that could provoke Russia to decrease cooperation with the United States on key issues like Afghanistan and Iran.<sup>77</sup>

The U.S.-Russia Bilateral Presidential Commission, co-chaired by Obama and Medvedev, was created in July 2009 as part of the Obama administration’s “reset” policy to promote bilateral cooperation on a broad range of issues. Expanding on similar groups set up by the Clinton and Bush administrations, the commission consists of a policy steering group and 16 working groups that issue annual updates to their respective presidents. Although one subgroup is dedicated to civil society, its U.S. co-chair Michael McFaul stated in a 2010 *RIA Novosti* interview, “there are many other mechanisms, means, presidential statements, meetings of our presidents where we can express our disagreement and our concern about human rights [and] corruption issues,” especially since his Russian counterpart Vladislav Surkov has elicited strong opposition from Congress stemming from his association with the clampdown on democracy and civil

society in Russia under Putin.<sup>78</sup>

Congress has already graduated 15 other countries from Jackson-Vanik in connection with their accession to the WTO – without passing replacement legislation – even though several of these countries have had troubling human rights records.<sup>79</sup> Of these, China provides the most illustrative example and important precedent as it, like Russia, is a major power with a blemished human rights record, yet one with whom the United States pursues many strategic interests. In that case, Congress agreed to graduate China from Jackson-Vanik during its WTO accession in 2000 – 2001. In an effort to maintain influence over China’s human rights record, as well as other political concerns, Congress created two commissions to review and report on U.S.-China bilateral relations, Beijing’s adherence to its WTO accession commitments, and the rule of law and human rights in that country.

Since 2000, the U.S.-China Economic and Security Review Commission has produced a report each year for Congress on trade relations and national security – including human rights – and provides policy recommendations. This embodies a prospective approach whereby China was graduated from Jackson-Vanik while creating a vehicle to monitor Beijing’s evolving policies on human rights and other important issues. One year later, Congress also created the Congressional-Executive Commission on China (CECC) to support efforts by U.S. government and nongovernment institutions to improve the rule of law in China, and to produce reports and hearings on Beijing’s human rights record. The CECC, whose commissioners include Members from both Houses of Congress and administration officials appointed by the president, also authorizes resources for monitoring and enforcing China’s adherence to its WTO accession commitments.

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