



## FOREIGN TRADE AND INVESTMENT CLIMATE

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## Journey's End: Russia Joins the WTO

By Peter Rutland, Middletown

### Abstract

Russia originally applied to join the World Trade Organization (WTO) in 1993. Many years and many rounds of fruitless negotiations later, the WTO's ministerial meeting on December 16, 2011 finally granted entry. Russia will formally join 30 days after the State Duma ratifies the treaty, which must occur by July 2012. It was embarrassing that Russia, the world's sixth-largest economy and 15<sup>th</sup>-largest trading nation, was the only G20 country left outside the 153-member WTO. Countries not notably more transparent than Russia have been allowed in—from China in 2001 to Saudi Arabia in 2005 and nearby Ukraine in 2008. Why did this long-running saga finally come to an end, and what are the implications for Russia's development prospects?<sup>1</sup>

### The Path to Agreement

At several points during the odyssey it looked like Russian membership was imminent. Most of the principal barriers to Russian entry had been resolved by 2006, with the outstanding issues being intellectual property rights, financial market liberalization and meat imports. After six years of negotiations, Russia signed a bilateral protocol securing EU approval for entry in May 2004 and with the US in November 2006.

However, it is a WTO convention that all existing members must agree to a new entrant. Georgia revoked its consent for Russia's candidacy in 2006 in response to a ban on its wine and mineral water exports, and withdrew from the talks in May 2008 in protest of Russia's policy regarding the break-away regions of Abkhazia and South Ossetia. The August 2008 war led to the complete severing of diplomatic relations between the two countries.

This last obstacle fell in late October 2011 when Georgia agreed to a compromise over monitoring trade across the border between Russia and Abkhazia and South Ossetia. At the suggestion of Swiss mediators Tbilisi agreed to allow a third party, a private company, to monitor the transactions, rather than Georgian customs officials. Georgia was the last of the 153 member countries required to approve Russian entry.

The EU Commission's top diplomat for Russia and Central Asia, Gunnar Wiegand, visited Tbilisi on October 25 and reportedly threatened to go around the Georgia veto with a majority vote. This is possible under WTO rules, but it would have been unprecedented, and controversial.<sup>2</sup> The US also pressured Tbilisi to compromise. Many assume that President Mikheil Saakashvili's visit to the White House in January 2012—and the promise of a free trade agreement with the US—was a reward for his flexibility.

Another factor pushing the process forward was signs that Moscow was introducing protectionist measures. In January 2011 Russia introduced tougher rules for foreign automakers planning new plants inside Russia. The new rules raised the local component requirement from 30% to 60%, set a \$500 million minimum investment, and raised the production threshold from 25,000 to 300,000 vehicles. Several foreign car makers signed off on these terms—which allow them to import auto parts at a preferential 5% tariff. In October 2011 WTO negotiators agreed to allow the new rules to stand, but they will end in 2018.<sup>3</sup>

Another complication was the fact that in 2009 Russia, Kazakhstan and Belarus formed a Customs Union (renamed the Eurasian Economic Space from January 2012), and stated their intention to join the WTO as a group. This step threatened to further delay Russia's entry to the WTO, since there was no precedent for three countries joining as a bloc, and no other WTO member is in a customs union with non-WTO members. Once Russia joins the WTO, all WTO rules will become obligatory for the other Customs Union members.<sup>4</sup> On October 4, 2011, the State Duma passed an amendment to the Customs Union establishing that WTO rules would have priority over Customs Union regulations. The solution to this anomalous situation is for Belarus and Kazakhstan to join the WTO as soon as possible—but this process will take at least a couple of years. It is a particular challenge for Kazakhstan since that country had already negotiated some conditions with the WTO more liberal than those granted to Russia.

### The Terms of Entry

The terms of Russian entry were approved by the Working Group on November 10, 2011: the 31<sup>st</sup> meeting since

1 Thanks to Mike Nelson for comments.

2 John Miller, "EU presses Georgia to let Russia join WTO," *Wall Street Journal*, 26 October 2011. The next day the paper ran a correction retracting this specific claim.

3 Egor Popov, "Avtokomponenty razlozhili po kvotam," *Kommerstant*, 14 November 2012; First Deputy Prime Minister Igor Shuvalov, *PRIME-TASS*, 20 January, 2012.

4 Tat'yana Edovina, "Kazakhstan podkinet Rossii svobody," *Kommerstant*, 1 February 2012.

it first convened in 1995.<sup>5</sup> The most significant aspect of the agreement is that it serves to limit the policy discretion of the Russian government.<sup>6</sup> The document lays down in some detail how the WTO understands certain Russian rules to operate, and the Russian government pledges to bring all the specified rules in line with WTO practice in the future.<sup>7</sup> It's an old Russian business maxim that serious negotiations begin *after* the contract has been signed. But in the case of the WTO such practices will not work: the whole purpose of the organization is to set the rules of the game and limit the scope for deviation from them.

Apart from harmonizing trade rules, WTO entry also requires the lowering of direct and indirect trade barriers. Some of the most heated negotiations involved the reduction of import tariffs—which will benefit Russian consumers, but will expose Russian producers to foreign competition. In Russia's case, the aggregate tariff level was already quite low, some 10%, a result of the trade liberalization of the early 1990s. Under the new rules Russia's legally binding ceiling on import tariffs will be lowered to an average of 7.8%.

Most of the arguments revolved around protection for specific sectors. The tariff limit for agriculture products will be 10.8%, down from the previous 13.2%, while that for manufactured goods will be 7.3%, down from 9.5%. Dairy products will fall from 19.8% to 14.9%, alcohol from 20% to 12.5%, automobiles from 15.5% to 12%, and medicines from 15% to 5%. IT products will go from 5.4% to zero. One third of these lower tariffs will be implemented on the day of accession, with others phased in over several years—the longest transitions being seven years for cars and aircraft and eight years for pork. Quotas will be preserved for beef, pork and poultry, with higher tariffs for above-quota deliveries (55, 65 and 80% respectively, compared to in-quota tariffs of 15, 0 and 25%).

As for services, the 49% limit on foreign equity in telecom firms will be eliminated four years after accession. Russia will allow 100% foreign ownership of retail and wholesale businesses—and foreign universities will be allowed to set up branches. Presently foreign banks

can open subsidiaries, but not branches, and this will remain unchanged. In the future foreigners will be allowed to take ownership in Russian banks subject to an overall limit of 50% of all the capital in the Russian banking system (up from the current 15%). Russia does not have any immediate plans to join the WTO Government Procurement Agreement, which opens public procurement to foreign competition.<sup>8</sup> The maximum customs clearance fees will fall from \$3,000 to \$1,000. Last year Russia collected \$1 billion in such fees.<sup>9</sup>

Russia has already rewritten part IV of its Civil Code to address intellectual property issues. By July 2013 a new court will be created exclusively for IP issues with 30 specially recruited judges. Piracy remains a serious problem in Russia, but presumably the leading US IT and entertainment corporations concluded that henceforth it would be easier to tackle the problem with Russia inside the WTO. A new law passed in October 2010 obliges Russian producers of generic drugs to negotiate agreement with the patent holders with regard to use of clinical trial data.<sup>10</sup>

Russia agreed to eliminate all export-distorting industrial subsidies, and imported goods will be charged the same rail freight rates as domestic goods—an important concession, given the monopolistic position of Russian Railways and the distances involved in reaching Russian markets. Russia is allowed to continue subsidizing natural gas utility prices to households, but not to commercial customers. (Still, good luck to Russia's competitors who might seek to challenge Gazprom's hall-of-mirrors pricing system.) Russia will also have to lower tariffs on exports of Russian products, such as semi-processed metals. This will benefit the metals industry, but push up prices for Russian domestic manufacturers who buy those goods (such as auto producers).

One of the most important advantages for Russia from WTO entry is that existing members will no longer be able to impose unilateral restrictions on Russian exports. Russian exporters of chemicals and metals are currently subject to more than 100 anti-dumping quotas and tariffs. In the future such measures can be challenged through the WTO Dispute Settlement Mechanism.<sup>11</sup> EU anti-dumping law currently uses European gas prices for calculating product costs. That will change once Russia joins the WTO: the EU will have to accept

5 Ambassador Stefán Jóhannesson (Iceland) headed the 58 member Working Group. "Working Party seals the deal on Russia's membership," [http://www.wto.org/english/news\\_e/news11\\_e/acc\\_rus\\_10nov11\\_e.htm](http://www.wto.org/english/news_e/news11_e/acc_rus_10nov11_e.htm); "Dostatochno sil'ny dlya VTO," *Ekspert*, 21 November 2011. <http://expert.ru/expert/2011/46/dostatochno-silnyi-dlya-vto/>

6 The newspaper *Kommersant* obtained a copy of the unpublished protocol that was signed on December 16, a complex document with 1,452 clauses. Dmitrii Butrin, "Obyazatel'stva dlitel'nogo sroka khraneniya," *Kommersant*, 20 December 2012.

7 Dmitry Butrin, "Obyazatel'stva dlitel'nogo sroka khraneniya," *Kommersant*, 20 December 2011.

8 39 WTO members have joined this protocol. Tat'yana Edovina, "Goszakupkam otkroyut granitsy," *Kommersant-Gazeta*, 25 January 2012.

9 *RIA Novosti*, 9 February 2012.

10 Aygul Zhumanova, "Impact of WTO accession on IP regulation," *Moscow Times*, 20 December 2011.

11 Ali Aliev, "Ostorozhno, rynek otkryvaetsya," *Ekspert*, 17 November 2011. <http://expert.ru/2011/11/15/ostorozhno-rynok-otkryvaetsya/>

Russia's domestic prices, which are one third those of the EU.<sup>12</sup>

Agriculture is perhaps the most sensitive sector. Although Russia is a leading exporter of grains, its livestock farmers are vulnerable to cheaper imports of meat and dairy products. As part of WTO accession Russia agreed to cut the maximum allowed agricultural support from \$9 billion in 2012 to \$4.4 billion in 2018. These limits do not really constrain Russia's scope for subsidizing farmers, since actual subsidy spending in 2011 was only \$5.6 billion.<sup>13</sup> Moreover these limits only apply to direct subsidies (the "amber box" in WTO terminology) and not to general spending on roads, housing, irrigation, education etc. (the "green box"), nor to spending in depressed regions. Other sectors that are vulnerable include medicines and textiles—which already have 70% and 82% import penetration respectively.<sup>14</sup>

## Reactions

The announcement of Russia's WTO entry received a muted reaction in the Russian press, in contrast to previous years, when discussions of WTO would trigger vigorous protests from Communist, nationalists and economic interests threatened by trade liberalization.<sup>15</sup> Presumably such groups were more engaged with the political protests following the December elections, or were simply worn down by 18 years of debates over WTO entry. The leading figure in the opposition is Konstantin Babkin, head of the Rostselmash farm machinery company. In 2010 he founded the Action Party, drawing on former members of the Agrarian Party, which had merged into United Russia in 2008.<sup>16</sup> The Communist Party and Just Russia still oppose WTO entry, but United Russia has enough votes to push the measure through the Duma.

Aleksei Portanskii, the head of the Information Bureau for Russia's entry to the WTO, noted that there are some public fears that WTO entry might cause a spike in inflation.<sup>17</sup> But he argues that on the contrary consumers should benefit from falling prices for some goods, such as medicines and cars. Chief WTO negoti-

ator Maksim Medvedkov said that the negative impacts "will be within the range of statistical error."<sup>18</sup>

Farmers are lobbying for 400 billion rubles (\$13 bn) compensation—with support from the Russian Union of Industrialists and Entrepreneurs (RSPP) and the State Duma agriculture committee.<sup>19</sup> In 2011 the sector received 125 billion rubles (\$4 bn) in subsidies, and according to the RSPP's Aleksandr Shokin this turned the rate of return from negative 5.4% to positive 8.3%.<sup>20</sup> Shokhin called for cancellation of some of the farm sector's debts (which total 1.6 trillion rubles or \$50 bn) and an extension of the zero tax rate on farm profits, currently set to expire in 2013. Some of these steps might have to be taken *before* ratification of WTO entry, so we can expect to see a flurry of activity in the next few months. But the agrarian lobby is divided. The president of the Russian Grain Union Arkady Zlochevskii disagreed with the RSPP stance, saying that debt cancellation would merely reward inefficient farms, though the head of the National Union of Pork Producers head Yurii Kovalev supported the proposal. MGU economist Sergey Kiselev notes that currently only half of Russian farm subsidies are in the "green box," while in the EU that proportion is 80%—which leaves the Russian state a lot of room to expand indirect subsidies.<sup>21</sup>

Liberal economists see WTO entry as giving a new impetus to faltering efforts to modernize and diversify the Russian economy. Economic Development Minister Elvira Nabiullina said that accession was "not a finishing line but a starting point" for Russia.<sup>22</sup> Evgenii Yasin told a meeting at the Higher Economics School that it opens the door to "real modernization" and may help the economy escape from its oil dependency.<sup>23</sup> At the same gathering former finance minister Aleksei Kudrin said it will generate an extra 3–4% growth over ten years. Severstal director Aleksei Mordashev, who headed the RSPP working group for WTO entry, argued that the very process of preparing for WTO has been beneficial for the Russian economy, from devising strategies to improve the competitiveness of lagging sectors, to rewriting the Customs Code.

On February 10 Putin instructed Economics Minister Nabiullina to organize workshops to help companies prepare for WTO entry. According to a December

12 Maxim Medvedkov, the head of Russia's delegation in the WTO negotiations, speaking at the US Chamber of Commerce. *RAPSI*, 24 January, 2012.

13 Yelena Skrynnik, Minister of Agriculture, report to the State Duma, 8 February 2012. <http://www.mcx.ru/news/news/show/5270.78.htm>

14 Ekaterina Petukhova, "Pyat' mifov," *Forbes.ru*, 14 February 2012.

15 The "Stop WTO" opponents have a website: <http://stop-wto.ru/>

16 See his interview with Mikhail Delyagin, "Put' k gosudarstvennomu perevorotu lezhit cherez VTO?," 14 February 2012, <http://forum-msk.org/material/politic/8330509.html>

17 Alexei Portanskii, "Rossiya plavaet v basseine bez vody," *Argumenty & Fakty*, 15 February, 2012.

18 Ekaterina Shokhina, "VTO stoit dorogo," *Ekspert*, 17 November 2011. <http://expert.ru/2011/11/17/vto-stoit-dorogo/>

19 "Ne zabud'te truzhenikov sela," *Ekspert*, 20 February 2012. <http://expert.ru/2012/02/20/ne-zabudte-truzhenikov-sela/>

20 Evgeniya Pis'mennaya, "Agrarniki ekspluatiruyt strakh pered VTO," *Vedomosti*, 17 February 2012.

21 *RIA Novosti*, 7 February 2012.

22 [http://www.wto.org/english/news\\_e/news11\\_e/acc\\_rus\\_16dec11\\_e.htm](http://www.wto.org/english/news_e/news11_e/acc_rus_16dec11_e.htm)

23 Oleg Nikiforov, "Doping dlya Rossii," *Nezavisimaya gazeta*, 14 February, 2012.

2011 survey of businessmen, 52% thought WTO entry would have a positive impact for Russia, and 32% a negative impact. As for the impact on their own business, 48% saw it as positive and 46% as negative. Still, only 6% had a plan worked out for their own company.<sup>24</sup>

The economic gains from WTO are likely to be quite modest. Economist Sergei Aleksashenko concluded that “Russia’s accession to the WTO will not have any substantial impact on its economic landscape.”<sup>25</sup> This is because Russia had already liberalized many features of its international trade in the early 1990s. Also, oil and gas are the main drivers of Russian growth, and these commodities are not affected by WTO entry. Most current estimates of the impact on Russia’s annual GDP growth range from 1 to 3%. In one widely cited study, David Tarr and Natalya Volchkova estimated that entry would boost Russia’s GDP by 3.3 per cent a year, and possibly as much as 11 per cent.<sup>26</sup> But the bulk of these gains would come from the putative effects of more competition rather than increased exports, and the prognoses are therefore highly speculative. The unique features of the Russian economy—its size, its dependence on oil and gas, and the prominent role of the state—make it hard to extrapolate from the experience of other economies after they joined the WTO.

On the diplomatic front, WTO entry is an important signal of Russia’s acceptance by the international community. It is also a sign of *Russia’s* acceptance of the international rules of the game, and a desire to play a role in shaping those rules. Now all five BRICS countries are in the WTO, and it will be interesting to see whether Russia’s entry changes the dynamics of the WTO itself. The ongoing Doha Round of talks has been

deadlocked since 2008 over the question of agricultural trade. In February 2012 Putin welcomed WTO entry as an important step forward, of more than merely symbolic importance. He noted that “Russia is still learning how to systematically and consistently promote its economic interests in the world.”<sup>27</sup> Putin also acknowledged that “the Obama administration and the leaders of some major European states made a significant contribution to achieving the final accords.”

Securing Russian entry to the WTO has been a priority for successive US presidents, and Barack Obama was presumably hoping that this signal achievement would clear the air and refresh the stalled “reset” in US–Russia relations. Alas, this was not to be. In politics, timing is everything. WTO approval came in the midst of unprecedented popular protests in the wake of the rigged December 4 State Duma elections—protests which Vladimir Putin promptly attributed to US meddling. Relations deteriorated further with Russia’s veto of the UN resolution on Syria on February 4. As with the economic benefits of WTO entry, the political benefits will only come in the long term.

A further item of unfinished business is Section 401, Article 4 of the 1974 Trade Act, better known as the Jackson Vanik amendment. Under this act the US cannot grant Permanent Normal Trade Relations to any country that restricts emigration, and the president is required to report to Congress every year on Russia’s compliance with the legislation. Russian Foreign Minister Sergei Lavrov has threatened to suspend application of WTO rules for the US until the Jackson-Vanik amendment is repealed.<sup>28</sup>

#### *About the Author*

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24 Aleksei Shapovalov, ‘Chinovniki raz’yasnyat pravila igry v VTO,’ *Kommersant*, 14 February 2012.

25 Sergei Aleksashenko, “Russia in the WTO,” Carnegie Endowment, 7 December 2011. <http://carnegieendowment.org/2011/12/07/russia-in-wto/8knk>

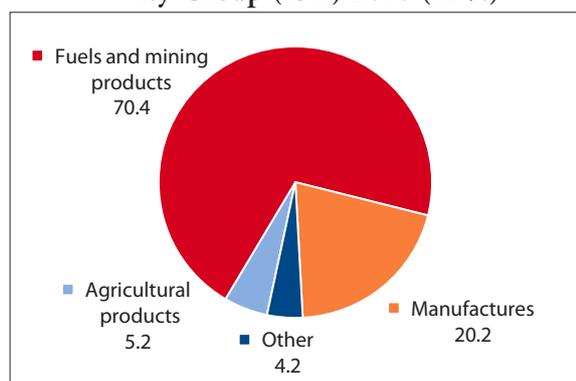
26 David Tarr and Natalya Volchkova, “Russian trade and foreign direct investment policy at the crossroads,” Policy Research Working Paper Series 5255, The World Bank, 2010. <http://ideas.repec.org/p/wbk/wbrwps/5255.html>

27 Vladimir Putin, “Russia and the changing world,” *Moskovskie novosti*, 27 February 2012. <http://premier.gov.ru/eng/events/news/18252/>

28 Interfax, 18 January 2012.

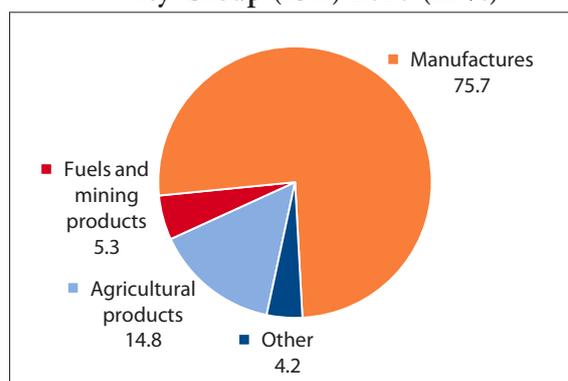
## Russia's Foreign Trade and Inflows of Foreign Direct Investment

**Figure 1: Total Exports by Main Commodity Group (IST) 2010 (in %)**



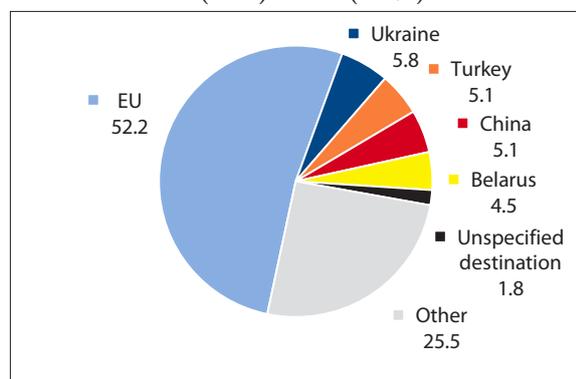
Source: WTO <http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=RU>

**Figure 2: Total Imports by Main Commodity Group (IST) 2010 (in %)**



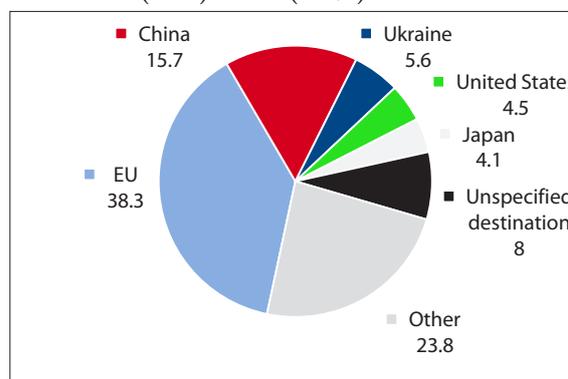
Source: WTO <http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=RU>

**Figure 3: Total Exports by Main Destination (IST) 2010 (in %)**



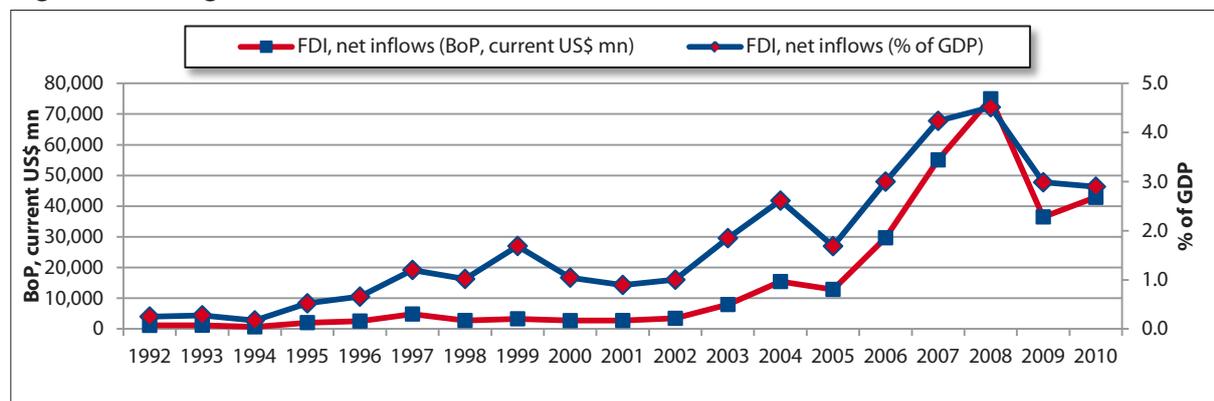
Source: WTO <http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=RU>

**Figure 4: Total Imports by Main Origins (IST) 2010 (in %)**



Source: WTO <http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=RU>

**Figure 5: Foreign Direct Investment, Net Inflows (% of GDP and BoP, current US\$ mn)**



Source: Worldbank Data <http://data.worldbank.org/country/russian-federation>

## Investment Climate: Political Risk Returns to Russia

By Ben Aris, Moscow

### Abstract

Russia returned Vladimir Putin to his previous job as president on March 4, but politics in Russia has been transformed by the popular demonstrations that began in December 2011. Putin's absolute control over the political process has been broken and he has lost control of the debate.

Russia has been a political millpond for most of the last 12 years, but since the first popular demonstration on December 11—on Bolotnaya Square in central Moscow and just across the river from the Kremlin—political risk is back.

As expected Vladimir Putin was swept back into office on March 4 with 63.6% of the vote, slightly higher than the 50% he was polling in the months leading up to the election. Communist leader Gennady Zyuganov came second with 17.2% also polling better than the 10% the communist party candidate has commanded in previous elections; as the only true opposition on the ballot in both the presidential and Duma elections last December, voting for the communists has also become a *de facto* protest vote.

In spite of the claims of fraud and vote rigging, the bottom line is the majority of Russians voted to return Putin to office as they trust him and see him as a guarantor of the prosperity he has delivered during his 12 years of power (1999–2008 as President; 2008–2012 as Prime Minister).

Indeed, these elections were probably the most open since Boris Yeltsin's re-election in 1996 thanks to the emergence of a genuine and popular, albeit immature, protest movement in December 2011. The factors that sparked this public display of dissatisfaction are many, but chief amongst them are: the heavy-handed way Prime Minister Vladimir Putin thrust Russian President Dmitry Medvedev aside in September, when he announced his bid for the presidency; the series of revolutions and popular protests in North Africa, Middle East, Europe and America that have heightened awareness of what people power can achieve among Russians; mounting frustration with the red tape and corruption that has been thrown into sharp relief by the economic slowdown following the 2008 crisis; and the obviously flawed Duma elections in December provided the straw that broke the camel's back.

The opposition movement has only been invigorated by Putin's clumsy responses to the protests, likening the white ribbons the protestors wear to 'condoms' and the people themselves to King Louis' band of monkeys from the popular book 'Jungle Book'. Putin seems to have badly misjudged the mood and Krem-

lin watchers say that he is increasingly out of touch with the population.

Yet, the chance of an Arab Spring-style overthrow of the government is low. The demographics of the protesters in Russia are very different from those in North Africa/Middle East, where a quarter of the population is under 25 years old and largely unemployed. The profile of the protester in Moscow has been of a middle-aged and middle-class professional, who has been the main beneficiary of the economic prosperity that Putin is responsible for. They have as much to lose from a violent change of government—and the subsequent chaos—as the state itself. As a result, Yevgenia Chirikova, a leading liberal opposition figure, says that Russia's would be 'the most civilised revolution in the world today'.

Indeed, most of the protesters are not calling for regime change at all, but rather their core message is for 'order'; an end to the endemic corruption within and poor management of public services. Russians are tired of routinely paying bribes to receive treatment in hospitals or degrees from universities. They simply want to work hard and enjoy the fruits of their labour without interference from the state.

While the slogan of the protest is 'Russia without Putin', the main demand is not for Putin's resignation, but for fresh parliamentary elections and the end of electoral manipulation. In other words, they are calling for a revolution that remains inside the parameters of the constitutionally mandated political process.

The street demonstrations have received blanket media coverage, but what is less well reported is the growing frustration amongst Russia's elite. While the immediate circle around Putin, as well as his oligarch allies, benefit directly from their close ties to the state, there is a growing class of oligarchs that are more dependent on Russia's burgeoning middle class for their wealth and power, whereby their wealth is predicated simply on the size of Russia's population as a domestic market and not on state-contracts or access to budget funds.

In 2011 Russia became the largest market in Europe for children's goods and milk. This year it will become the largest for dairy products (excluding milk), and every year from now until about 2020 it will add another sector until Russia becomes the biggest consumer market

in Europe. The business leaders in these sectors remain concentrated amongst a smallish group, whose interests are increasingly aligned with the middle-class protesters.

According to anecdotal evidence, a growing number of these men have been inspired by the protest marches and are also becoming more politically active. Business News Europe (BNE) has heard reports of so-called 'mini-gachs' flying in from their villas in Nice and Cannes on their private jets to join the latest demonstrations in the street. Unlike ordinary Russians, their motivation is the umbrage they have taken at the fact that the Kremlin 'has taken us for granted', as one senior business leader from this group put it.

### Putin Needs to Respond

The protests have put Putin in a difficult position, as he has to decide which audience to play to. For most of the last 12 years he has enjoyed extremely high popularity ratings in the polls; indeed he has genuinely been one of the most popular leaders in the world. This high rating has made him invulnerable in Russian domestic politics and put him above the political process. As George Washington University Professor Emeritus of Political Science and International Affairs Peter Reddaway pointed out early in Putin's first term, his success was not due to abuse of this power, but from building consensus amongst the various Kremlin fractions—mainly the security service '*Siloviki*' and the St Petersburg liberal fractions—by balancing their opposing interests.

However, domestic political power was almost entirely contained inside the walls of the Kremlin and the voting masses played little or no role in this process, other than lending Putin their support. They were simply 'sheep', as Aleksandr Solzhenitsyn described his fellow countrymen on his return to Russia in 1994.

The first demonstration in December changed all that, as people are demanding, first and foremost, a voice in politics, even if Putin remains as head of the government. Given his genuine popularity few doubt that Putin would win an open election.

Putin is clearly keen to show the elite that he is still in charge, which is why he has placed so much emphasis on a first round win in the March 4 elections. But many commentators have said that he would have been better off to 'let' the elections go two rounds and win in the run off.

This latter scenario would have represented a revolution in Russian politics, as Putin in effect would have had to abandon the elite in favour of true democracy, where he makes himself accountable to the voters. The danger (as Putin must have seen it) was that if he failed to win in the first round he would have been a 'weak' president, who would be vulnerable to a palace coup by an elite

that may attempt to replace him with someone stronger. The elite are in an uncomfortable position, as although they have amassed a great deal of wealth, unlike the oligarchs, they have not legitimised it through privatisations etc. and so are the ones that would end up in jail if there were a sudden regime change.

Putin has clearly decided that the elite is still the stronger of the two audiences. While the protest movement is big enough to sway the government's policy, it is still too young to force Putin to abandon the status quo. However, the cat is out of the bag now and there is no way the Kremlin can put it back in again without resorting to repression. The same issues will come up in the 2018 election and in that case the consensus is that the opposition will be big enough to force the switch in focus from the elite to the people.

Barring unforeseen flare-ups, the opposition movement is likely to take several years to mature—it still lacks an obvious leader or coherent demands—and in the meantime Putin will have to manage a transition in the way politics is done in Russia. To what extent he considers it necessary to do this is moot, but will become transparent as the year wears on, and with all the cards in Putin's hands.

He can placate the protestors through social spending, hiking state wages and pushing through real reforms, especially on the corruption front. But, at the same time, he could choose to crack down on the liberal press (which is already happening), launch smear (*kompromat*) campaigns against high profile opposition leaders (which is also already happening) and generally tighten the Kremlin's control. The most likely scenario is that Putin makes use of a mix of all these tools.

### Corruption is the First Order Problem

Russia's problem with controlling corruption lies at the heart of its current political problems; Sergei Guriev, rector of the New Economic School and a key advisor to the Kremlin on policy, says it is a first-order problem, with all questions of economic reform coming a distant second.

Dmitry Medvedev's one achievement (apart from abandoning winter time and merging a few regions) was to launch an anti-corruption campaign. Although widely derided, the campaign has produced some progress. Russia's corruption is not out of line with its peers in its income group and the level of corruption has begun to fall slowly in the last three years, according to Transparency International, when adjusted for income.

Yet, not much progress has been made. Nevertheless, Elena Panfilova, head of corruption watchdog Transparency International, believes that Medvedev has opened 'pandora's box'. Almost as important as policing cor-

ruption more effectively, he has removed the taboo surrounding the issue. Newspapers and TV shows that had avoided the topic before are now obliged to report with fanfare any and all high-profile arrests, of which there are an increasing number. Secondly, Medvedev broadened the definition of a 'bribe', from the few hundred rubles you give to the traffic cops—Putin's definition—to the \$10m the regional governor is skimming off state-contracts by giving jobs to his wife's company. Now the campaign has started, the Kremlin will have no choice but to see it through, believes Panfilova.

Solving the corruption problem (or at least making a dent in it) will be key to Russia's path in the next six years. Economists are forecasting about 4% growth a year for Russia in the medium term, but Putin has said on two occasions recently that this is 'not good enough' and wants to return to the 6%–7% Russia enjoyed prior to the financial crisis. The only way to achieve that, say economists, is to promote small- and medium-sized enterprises, which are unable to operate today due to the corruption and the accompanying malaise within bureaucracy.

The fight against corruption is going to be a long one, but the talk is not just window dressing. At the start of March, the Ministry for Economic Development said it is working on a law which will oblige those companies involved in public sector procurements to provide notification if their beneficial owners include officials (for state agencies), or management (for state-owned companies), or members of their families (parents, children, spouses, siblings) as another measure to reduce corruption. Many tenders have already been put on line and opened up to public scrutiny, and senior officials from almost every branch of government have been either sacked or jailed in the last two years.

'The legislation governing public sector procurement means that the anti-corruption drive kicked off by Russia's top leadership in late 2011 is graduating from rhetoric and ad hoc actions by the government to the "institutionalisation" phase. This lends greater credence to our out-of-consensus thesis that the current round of policy talk on combating corruption has more substance to it than most observers think', Alexey Zabolkin an analyst with VTB Capital said in a note.

### Managed Democracy

As Charles Roberson, chief global economist with Renaissance Capital, showed in a report last year,<sup>1</sup> authoritarian countries tend to have a revolution when per capita income rises over \$6000 (especially if there

is an economic slowdown), and so with a per capita income of around \$15,000 Russia's revolution is well over due. Robinson makes the caveat that petro-economies are the exception to the rule as the state simply pays out cash to placate the population.

However, Russia's middle class has progressed to the point where even the oil money is insufficient for the ruling elite to maintain control. Peter Westin, chief economist at investment bank Aton, argued in a paper in March that the monetary cost of 'buying' control is now higher than even the Kremlin can afford.

'If the total wage bill were to grow at the same rate as in 2000–08 in order to "buy" public support, we calculate it would require 20.7% growth in the average wage over the next three years, impossible under our current macroeconomic forecast', writes Westin.

Russia's political nature as a petro-economy is further undermined by the Kremlin's adoption of the 'managed democracy' model. While the international press focuses on the 'managed' part of this equation, there is some real democracy in Russia too.

While clearly Russia's democratic system is different to that in the developed countries of the West, it is also clearly not the out and out dictatorship that characterises most of post-Soviet Central Asia. The Kremlin retains control over key levers of power, but, at the same time, it needs to generate some genuine support to maintain stability. Compared to the other countries of the CIS, and especially Central Asia, Russia falls somewhere in the middle between true democracy and outright dictatorship.

At one end of the scale, Turkmenistan's president, Gurbanguly Berdimukhamedov, won a second term in office in February taking 97% of the vote and in so doing surpassing Kazakhstan's, Nursultan Nazarbayev, who won 95% of the vote in his re-election last year, to take the title of 'the most popular leader in the CIS'. Likewise, these two men command nearly total control over their parliaments.

At the other end of the scale, Ukraine's last parliamentary and presidential elections were probably the most democratic of any elections in Eastern Europe. Ukraine's ruling Party of Regions won only 34.4% of the vote in 2007—the lowest rating of any ruling party in the CIS—and President Viktor Yanukovich only just beat opposition firebrand, Yulia Tymoshenko, with 48.9% in 2010.

Ukraine is backtracking now, but there are still several other real democracies in the region including: Mongolia (where the ruling party won 52.7% in the last parliamentary elections and the president 51.2%), Georgia (59.2%, 53.5%) and most recently Kyrgyzstan (n/a, 63.2%).

Compared to these extremes, Russia's parliamentary election result in December puts it in the democratic camp, as United Russia won only 49.5%, although

<sup>1</sup> <http://www.renasset.com/library/rammonthly/detail/article/the-revolutionary-nature-of-growth-and-no-growth.html>

unlike the other members of this group, there was no real opposition in the election other than the Communists to vote for (so the process was clearly 'managed').

However, Dmitry Medvedev won a whopping 70.3% of the vote in the last presidential elections in 2008, putting Russia at the low end of the dictatorial camp, and Putin won 64% so Russia appears to have taken another small step towards greater democracy, although this result still leaves Russia at the dictatorial end of the spectrum, even if it is at the bottom end of this band.

### Election machine breakdown

However, it is likely that the changes will come faster in Putin's next six year term; his control of politics is being undermined on several fronts, but most important is the Kremlin's control over the regional governments is slipping.

The poor showing of United Russia in December's election was a shock, as it was widely assumed the Kremlin would fix the elections and return the party with a constitutional majority 66%, whereas it only scrapped a simple majority (and even then only after a noticeable amount of ballot stuffing). United Russia won 49% of the vote, against the opposition estimate of its 'true' popularity of 35%.

Despite Putin's strongman image, because Russia is so big and most of the regions are so far away from everything else, the Kremlin is very dependent on the regional governors' cooperation to put the government's ideas into action.

The Kremlin has two levers of control over the governors: the president can sack governors and only 11 of Russia's 83 regions are net contributors to the budget. The rest have to live on federal hand-outs that average RUB 2,727 per person per year nationwide.

Following United Russia's poor showing in the December parliamentary elections, Medvedev has sacked three governors (from Tomsk, Volgograd and Murmansk).

Unsurprisingly, the regions where United Russia won the most votes are almost all from the impoverished and war-torn regions in Russia's Islamic crescent in the North Caucasus, stretching into Siberia, which are all regions that are totally dependent on federal transfers. United Russia won over 90% of the vote in Dagestan, Mordovia and Ingushetia, plus an astounding 99.5% in Chechnya. And just the threat of sacking the governor is enough to keep many of the other regions in line: indeed, three of the 11 regions that returned more than 60% for United Russia are actually in profit (Tatarstan, Kemerovo and Tyumen).

However, after this band of loyal supporters, things start to break down. Only 27 of Russia's 83 regions provided poll numbers above 50% for United Russia. Two-

thirds of the regions returned less than 50% for United Russia and a bit more than a third (31) returned less than 40%.

In the last category of 'disloyal' regions, two-thirds (21) receive less than the average transfer of funds from the centre, and half of those receive less than half the average. Together, the 31 disloyal regions at the bottom of the table polled an average of 36.5% for United Russia. In other words, it looks like that in just over a third of Russia's regions there was a more-or-less free and open vote in December (see Table 1 on pp. 11–12).

It is probably too early to say that power is slipping out of the Kremlin's hands, but as more and more regions prosper, then the regional governors will be increasingly torn between the demands of their residents and those of the Kremlin.

And these changes could come sooner rather than later. At the end of February the Duma passed, in the first of three readings, a draft reform of the political system that would re-instate popular elections for governors, as well as making it easier to register political parties.

'Adopting the package in the spring would mean that it might start influencing regional politics as early as this autumn's election cycle', according to Alexey Zabotkin, analyst with VTB in Moscow, who adds that the impact of these reforms will remain up in the air until drafts of accompanying legislation that will determine voting districts among other things are also submitted to the Duma.

### What Next?

Journalists are fond of talking about 'crossroads', but for once the word is appropriate. Most analysts in Moscow are fairly clueless as to what is going to happen once Putin is back.

The optimistic scenario was expounded by Natalia Orlova, chief economist at Alfa Bank and a widely respected commentator, who believes that Putin first round victory will be good for reform, as he will have the authority to maintain the old system. The need for a new economic model is obvious to the liberal faction, who have held sway over policy since the 2008 crisis, and Putin may give them his ear, opening up the possibilities for positive surprises. Putin's own comments also suggest that he is thinking about more radical reform if he is serious about boosting growth back to the 6%–7% level. Moreover, at the Troika Dialog/Sberbank investment conference in February, he said that Russia needs to move from its current 124<sup>th</sup> place on the World Bank's 'ease of doing business' index to 20<sup>th</sup> place, which would require of a revolution of reforms.

The pessimistic scenario is that the opposition gets increasingly out of hand and violent. In this case, Putin

would reach for the tools of oppression, which would only increase Russia's poor international image. Recent moves to curb the freedoms of Russia's most liberal media, such as Echo Moskvy, are worrying signs in this regard.

However, the most likely scenario is the middle path of some reforms and glacial changes in the political system. Guriiev believes that while Putin was a confirmed reformer in the early 1990s, the high oil prices means that he has lost interest in this path of significant reform, preferring to simply spend the oil money and buy progress instead.

Indeed, Putin has been giving off mixed messages in recent months. However, even if there is only a half-

hearted reform effort, thanks to the combination of oil revenues and the catch up effect all transitionally economies enjoy, even Russia's 4% growth will still be significantly better than the developed world's and Russian's \$15,000 per capita income is already on a par with Portugal, and will make the country the most significant consumer market in Europe. This alone will continue to pull in investment despite, rather than because, of the government. At the same time, the increasingly interest in reform among the domestic businessmen riding the wave of rising consumerism in Russia, will also act as a force for change from below.

#### *About the Author*

Ben Aris is the editor/publisher of Business New Europe (<http://www.bne.eu/>), an online news resource and publication covering business, economics, finance and politics in Central, Eastern and Southeast Europe and the former Soviet Union.

To subscribe to BNE's newsletters covering events in Russia relevant to political risk visit <http://www.bne.eu/store/choose.php>

**Table 1: Regions, Transfers from the Centre and United Russia's Poll Results in the December 2011 Elections**

Federal subjects	Transfer per capita (RUB/yr)	United Russia vote % total
Chechnya, Republic of	10,472	99.5
Dagestan, Republic of	11,375	91.94
Mordovia, Republic of	4,087	91.62
Ingushetia, Republic of	13,476	90.96
Karachay-Cherkess Republic	9,680	89.8
Tuva, Republic of	30,138	85.29
Kabardino-Balkar Republic	6,178	81.9
Tatarstan, Republic of	surplus	81.65
Chukotka Autonomous Okrug	9,601	70.32
North Ossetia—Alania, Republic of	8,267	67.9
Tambov Oblast	7,181	66.66
Kalmykia, Republic of	6,919	66.1
Saratov Oblast	2,232	64.89
Kemerovo Oblast	surplus	64.24
Tyumen Oblast	surplus	62.21
Tula Oblast	1,209	61.32
Astrakhan Oblast	1,587	60.17
Bashkortostan, Republic of	1,136	59.3
Komi, Republic of	1,549	58.8
Krasnodar Krai	1,567	57.7

*continued overleaf*

**Table 1: Regions, Transfers from the Centre and United Russia's Poll Results in the December 2011 Elections (continued from previous page)**

Federal subjects	Transfer per capita (RUB/yr)	United Russia vote % total
Penza Oblast	3,736	56.3
Altay, Republic of	28,391	53.3
Mari El, Republic of	6,293	52.4
Belgorod Oblast	379	51.6
Bryansk Oblast	4,549	50.12
Rostov Oblast	2,382	50.08
Chelyabinsk Oblast	1,188	50.06
Republic of Sakha (Yakutia)	41,895	49.2
Stavropol Krai	3,250	49.11
Republic of Buryatia	11,183	49
Jewish Autonomous Oblast	12,044	48.11
Moscow (city)	surplus	46.21
Kursk Oblast	2,434	45.72
Kamchatka Krai	85,496	45.25
Udmurtia, Republic of	1,589	45.1
Kurgan Oblast	7,257	44.41
Nizhny Novgorod Oblast	439	43.74
Ulyanovsk Oblast	2,244	43.56
Amur Oblast	5,902	43.54
Chuvash Republic	3,626	43.4
Zabaykalsky Krai	5,388	43.28
Sakhalin Oblast	surplus	41.91
Magadan Oblast	47,234	41.04
Kaluga Oblast	570	40.42

Source: compiled by Business New Europe (BNE, <http://www.bne.eu>).

## ABOUT THE RUSSIAN ANALYTICAL DIGEST

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