Remarks of Ambassador John K. Veroneau
Deputy United States Trade Representative

"Rule of Law and Economic Growth"

U.S.-Russia Business Council (Moscow)
October 24, 2007
As prepared for delivery

Good afternoon.

Thank you, Richard, for that introduction. I appreciate your leadership and the important work of the Business Council. The Council plays a critical role in helping policymakers understand what is happening on the ground, and provides an important venue for discussing matters of common interest.

I was last in Moscow in the winter of 1999. After being back here for just a day, the changes over the past eight years are stunningly apparent. Moscow is clearly a city at the center of world commerce. And that is a good thing.

Today, I would like to speak about globalization, the forces behind globalization, and finally the U.S- Russia trade and investment agenda.

In his remarks at the Spaso House reception Monday night, Neville Isdell urged a sense of perspective when assessing the U.S.-Russia economic relationship, noting the tremendous changes in Russia over the past decade. Perspective is always a good thing, and too often in short supply. I would like to offer an even broader historical perspective for your consideration.

Modern humans emerged about 10,000 years ago. For most of this time, not much changed in the way people went about their daily lives. With the exception of a handful of aristocrats, the average person got by on the modern equivalent of $400-600 a year – barely above subsistent levels. Then about two hundred years ago, the Industrial Revolution unleashed a period of innovation and social organization that has quite literally reshaped the world.

A *Financial Times'* column last year was accompanied by a chart showing global gross domestic product per capita over the millennia. It showed a very flat line until the 19th century and since then, a steady and very steep climb. Year after year of economic development has permitted a way of living today that would be unrecognizable to our forebears. Since 1990 alone, some 300 million people around the world have escaped severe poverty and millions more have been able to build middle-class lifestyles.

I fully realize that not every person, family or indeed country is enjoying the benefits of globalization as we and they would like. But, as we focus on how best to spread the benefits of globalization more broadly, we should not overlook – nor take for granted -- the monumental gains in life quality for the vast majority of people.

In the early 1980s, I lived along the Cambodian border and can say without hesitation that globalization offers opportunities to subsistence farmers in that part of the world that simply did not before exist.

The primary engine of this prosperity has been technological progress.

Innovation has been responsible for unprecedented growth in productivity. This of course is a global phenomenon, but let me give two examples from the United States:

> In the mid-twentieth century, one third of Americans were farmers. Today, less than 3 percent of Americans are farmers. Yet farm output today dwarfs that of 50 years ago.

Similarly, fewer Americans today make cars for a living. Yet, we produce one third more cars today than we did in 1980.

As output per worker has increased through the adoption of labor-saving technology, consumers have benefited from having access to more products at better prices. And workers have been freed up to provide new products and services to consumers. There are *millions* of jobs today that simply did not exist 20 years ago.

The spread of technology has been assisted by trade liberalization. As trade barriers have come down, a freer flow of goods, services, capital, and people has allowed the global economy to become more efficient and productive.

Considerable work remains to be done in lowering trade barriers, which is why we continue to try to bring the Doha negotiations to a successful conclusion. But over the years, trade liberalization has made a tremendous contribution to global growth. As protectionist winds blow around the world, we should not take these gains for granted. Complacency is dangerous in the face of daily assaults on the legitimacy of the global trading system.

Policies of openness at the border are important tools of economic development, but policies of openness *inside* a country's borders will more directly affect a country's economic fate.

The World Bank released a compelling study measuring the wealth of nations in the 21st century. The authors sought to better understand the relative contributions to economic growth from different types of capital, such as natural resources and manufacturing capacity.

Interestingly, the study found that "human capital and the value of institutions (as measured by the rule of law) constitute the largest share of wealth in virtually all countries."

The study essentially quantifies the intangible value of education and social institutions. According to the study,

> Education accounts for about a third of a country's intangible capital, and incredibly
>
> Rule of law accounts for more than half.

The study reinforces other important research on the role of openness, rule of law and transparency in fostering long-term economic growth.

A paper last year with the ambitious title, *"A Conceptual Framework for Interpreting Recorded Human History,"* offered an historic dichotomy of countries based on whether they provide "limited access" or "open access" to its economy.

In limited access countries, the elite use the political system to create rents and to control economic and political power. In open access countries, competition is facilitated through enforceable property rights, rule of law and transparency which, in turn, permit what economists call "impersonal exchange."

While impersonal exchange may sound like something to be avoided, it is in fact a cornerstone of the modern economy.

Let me try to demystify the concept. Most of us need to borrow money to purchase our first home. If friends or family have the resources, they may be willing to lend you the money. This would be an example of *personal* exchange.

But most of us have to go into the mortgage market to finance our homes.

The remarkable thing about that transaction is that we are able to borrow funds from people whom we have never met and likely never will. This is possible only because lenders put their trust in strong institutions to enforce property rights and uphold rule of law.

The importance of these institutions cannot be overstated.

Peruvian economist Hernando DeSoto has spent a lifetime studying rule of law and its institutions. He found the lack of enforceable property rights and rule of law in Latin America to have been a serious drag on these economies .

The lack of clear property title, for instance, has rendered banks unwilling to lend money to people to purchase homes. Because banks could not reliably establish their legal rights, many people had access only to the limited capital of friends and family.

The burden of a weak rule of law -- in the case of Peru, the lack of clear property rights -- falls most heavily on the poorest since they are less likely to have friends and families with capital to lend.

In fact, a 2004 study in the *Journal of Economic Literature* found that the benefits of improved openness and rule of law accrue mostly to the poorest members of society.

This makes sense. In a closed society, the elite do well because they are by definition on the inside. It is the poor who stand to benefit the most from assuring openness and rule of law.

Impersonal exchange, supported by strong rule of law, has been a key enabler of the modern economy. Without it, our business structures would still tend to be simple exchanges between local parties. There would be no opportunity for an integrated global economy.

In 1852, Elisha Otis invented the modern elevator, and in so doing, provided a key infrastructure enabling the building of skyscrapers and thereby modern cities. Without elevators, there could be no tall buildings. Without tall buildings, there could be no large, modern cities.

The opportunity for impersonal exchange is like the skyscraper of the modern economy. Without it, there could be no modern economy. And without the rule of law, there could be no impersonal exchange.

In this sense, the rule of law serves as the "elevator" of the modern economy. Without a strong rule of law, the height of any country's development will be limited.

Each country will build institutions supporting the rule of law consistent with its own history and politics. Respect is owed each country as it works to build these institutions.

For sustainability and political legitimacy, institutions supporting rule of law and transparency must be built from within. They cannot be imposed from the outside. But institution-building can be aided through participation in international rules-based agreements and organizations.

In recent years, the United States has negotiated a series of bilateral trade agreements. Beyond tariff reduction, these agreements embody the principles of rule of law and transparency.

A number of our trading partners have sought these trade agreements as a way to help "lock in" domestic economic reforms, calling for greater openness, rule of law and transparency. Similarly, China's interest in joining the World Trade Organization stemmed in part from a belief that domestic reforms would be easier to implement in the context of a WTO accession agreement.

The United States strongly supports Russia's accession to the WTO. We would like this process to move as quickly as possible.

The WTO accession process is not easy. China's accession process took more than 14 years.

President Putin and his Administration deserve great credit for addressing many issues raised by WTO Members during the accession process. Some critical issues remain in the areas such as intellectual property and agriculture.

This week, WTO Members and Russian officials are meeting in Geneva to continue to work on these issues. We look forward to resolving these matters as quickly as possible.

While WTO accession remains our highest priority, the United States and Russia should also consider negotiating a Bilateral Investment Agreement (BIT). Such agreements are useful in attracting foreign investment because, among other things, they provide a framework for protecting legal rights and assuring the rule of law. To the benefit of both countries, bilateral investment flows are at historic levels. Russia is enjoying huge capital inflows. This may suggest that an investment treaty is not really needed at this time.

But, over the long term, foreign direct investment will be greater and more diversified if investments are reinforced through an investment treaty. For this reason, we are exploring with the Russian government the possibility of negotiating such an agreement.

Russia is a great and important country. Its recent economic growth is truly impressive. Historic prices for oil and other commodities in strong supply in Russia have certainly contributed to this growth. After a very difficult decade of the 1990s, economic stability and growth of today is no doubt welcomed by the Russian people.

Today's growth provides an opportunity to secure broad-based and long-term economic growth for the future by investing in intangible capital assets such as rule of law and transparency.

One of the great lessons of recent history has been the realization that the global economic pie is not fixed. One country does not gain at the expense of another. On the contrary, we share in each others' economic growth and development.

After too many years of seeing our bilateral relationship through a zero-sum prism, we must view our relationship through the win-win prism of economic growth and opportunity.

Russia's vast natural resources make it a great country. But, its greatest resource is its people. Russia has produced some of the world's greatest thinkers, artists and inventors. In the 21^{st} century, the countries that will enjoy the strongest economic growth will be those that are best able to unlock the potential of its people.

For decades, the relationship between the Russian and American people was defined by and through governments. There were limited exchanges between our business and other communities. That has all changed.

The U.S.-Russia Business Council and its members represent an important link between the people of two great countries.

Congratulations on a successful Annual Meeting.

Thank you for inviting me to be part of it.

Please continue your important work of strengthening the bonds of commerce and friendship between our countries.

Thank you.