

# Russia Economic Report<sup>1</sup>

## Policy Uncertainty Clouds Medium-Term Prospects

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- I Recent Economic Developments
- II Outlook
- III In Focus: Paths to Diversified Development in Russia



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## ABBREVIATIONS AND ACRONYMS

ANS	Adjusted Net Savings
APEC	Asia-Pacific Economic Cooperation
CA	Current Account
CBR	Central Bank of Russia
CDS	Credit Default Swaps
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
DSB	Dispute Settlement Body
ECA	Europe and Central Asia
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
HDI	Human Development Index
HHI	Herfindahl-Hirschman Index
IEA	International Energy Agency
NPL	Non-Performing Loan
NWF	National Welfare Fund
OECD	Organisation for Economic Cooperation and Development
OPEC	Organization of the Petroleum Exporting Countries
RDIF	Russian Direct Investment Fund
SOE	State-Owned Enterprise
SPS	Sanitary and Phytosanitary Standards
TBT	Technical Barriers to Trade
PPP	Purchasing Power Parity
VAT	Value-added Tax
VTB	Vneshtorbank
WTO	World Trade Organization

## Executive Summary

**Russia's economy is stagnating.** Seasonally adjusted growth for the first two quarters of 2014 was near zero. Consumer and business sentiments were already weak in 2013 due to lingering structural problems and contributed to the wait-and-see attitudes of households and companies. Heightened market volatility and policy uncertainty due to geopolitical tensions during the first half of this year exacerbated this confidence crisis. The Russian economy needed to internalize several rounds of sanctions, countersanctions and measures to stabilize the economy; this environment of higher risk lowered domestic demand. While the macroeconomic stabilization measures were timely and successful, medium-term policy objectives are still being defined. This continued policy uncertainty about the economic course of the country is casting a shadow on Russia's medium-term prospects.

**Increasing uncertainty impacted investor and consumer decisions.** Consumption growth continued to slow, but it was deteriorating investment that became the main reason for the weak growth outturn in the first half of 2014. The first rounds of sanctions against Russia limited the country's access to international capital markets and increased the cost of borrowing for households and firms. High uncertainty also triggered massive capital outflows, and together with increased currency volatility and borrowing costs, it curtailed the willingness of businesses to invest through the first eight months of 2014. For consumers, higher borrowing costs meant that an increasing share of household income was used for paying off debts. Consumers also adjusted to the volatile environment with lower demand as renewed pressure on the Ruble and countersanctions restricting food imports in August translated into higher inflation. The impact of the latest rounds of sanctions and counter-sanctions will be more clearly reflected in outcomes starting with the second half of 2014. A small positive effect appears to be coming from import substitution. An expansion of sanctions related to the Russia-Ukraine tensions could send business and consumer confidence into another downward spiral, further reducing domestic demand.

**There are substantial risks to Russia's medium-term outlook.** Inertia on structural reform policies combined with high policy uncertainty—related to geopolitical tensions and the overall direction of the economy—remain the deciding factors for our outlook. Global demand is projected to be broadly stable, and oil prices are expected to remain around US\$100/bbl, according to World Bank projections. Our baseline projection is one of near stagnation with growth of 0.5 percent in 2014, 0.3 percent in 2015, and 0.4 percent in 2016. This baseline assumes no further escalation of geopolitical tensions and no additional sanctions. Geopolitical tensions would continue to impact the economy through the already observed transmission channels. An alternative optimistic scenario projects a small recovery, facilitated by an end to geopolitical tensions and the lifting of all sanctions by the end of 2014. Growth would improve from 0.5 percent in 2014 to 0.9 percent in 2015 and 1.3 percent in 2016. A pessimistic scenario envisions an increase in geopolitical tensions and additional sanctions, as a result of which, the economy would slip into a recession with output contracting by 0.9 percent in 2015 and 0.4 percent in 2016.

**Economic recovery will need a predictable policy environment and a new model of diversified development.** Since the beginning of geopolitical tensions, economic policy has been dominated by measures to maintain macroeconomic stability. This important policy effort should go hand in hand with renewed focus on improving the economy's structural fundamentals. However, some measures and economic policies under discussion have the potential to alter how the economy operates and might turn out to be detrimental to its competitiveness. A return to higher growth in Russia will depend on solid private investment and a lift in consumer sentiment, which will require a predictable policy environment and continued structural reforms. Developing a more balanced portfolio of national assets namely, natural resources, capital and economic institutions, will help overcome structural constraints to growth. Russia is abundant with natural resources and institutional weaknesses are now the main stumbling block on the road to greater economic efficiency and higher growth rates. Structural reforms would need to focus on improving economic institutions to ensure that public finances are stable and economic volatility well-managed; that there are improvements in education and infrastructure to make workers more productive; and that there are strong competition regimes to encourage private enterprise and entrepreneurship. Stabilization, transparent rules, better quality of public investment, and competition should be the reform priorities for the next decade.

**Prospects for further poverty reduction and shared prosperity are limited.** In the past, rising wages and pension transfers allowed Russia to reduce poverty significantly and to expand the ranks of the middle-class. Unless structural reforms to expand the economy's potential are pursued, low investment makes it less likely that plentiful well-paying jobs will be created. High inflation, moreover, will slow real income growth and hurt consumption growth, dimming the likelihood for further poverty reduction and limiting the ability of the bottom 40 percent of the population to share in prosperity.

## Part I. Recent Economic Developments

*Structural impediments slowed economic expansion to near stagnation even before the impact of increased policy uncertainty amid increased geopolitical tensions took hold. GDP growth was just 0.8 percent in the first half of 2014 compared to 0.9 percent in the first half of 2013. The reasons for Russia's slowdown remain on balance of structural nature, with the economy operating at close to its potential output level. Although Russia's growth was not dissimilar to that of the Euro Zone, it dipped under that of other country comparator groups, such as emerging and high-income economies. Due to Russia's integration into the world economy with the exports of resource-intensive products to high-income countries, their growth paths remain closely entwined. Current geopolitical tensions are adversely impacting these trade relationships.*

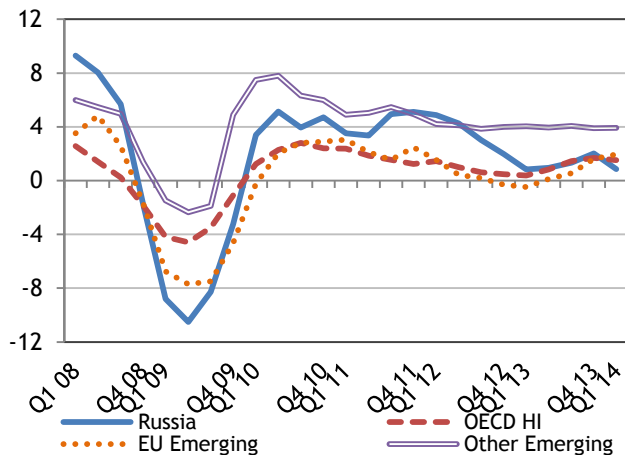


## 1.1 Growth - An Economy On The Threshold Of Recession

Russia's growth stagnated in the first half of the year and lingers near the threshold of a recession. Growth is negatively impacted by low business and consumer confidence in an environment in which heightened geopolitical tensions and sanctions generate increased policy uncertainty.

Russia's low-level growth is not that dissimilar to that in the Euro zone, but it contrasts with the cautiously firming growth in other high-income and emerging economies (Box 1). Russia's economy grew more slowly than emerging economies outside the EU in recent years and over the last couple of quarters its pace of expansion dipped even below that of emerging economies in the EU (Figure 1). This downturn came largely as a result of structural constraints (Figure 2). With the economy operating close to potential, growth is constrained by inefficient factor allocation, non-competitive markets, and a dearth of innovation. Those constraints led to a slowdown in growth that started in 2012 and was based on decelerating investment and consumption growth. That slowdown is now exacerbated by geopolitical tensions. Our special focus note explores more closely the nature of those structural constraints and proposes potential remedies.

Figure 1: Global GDP growth, y-o-y, percent

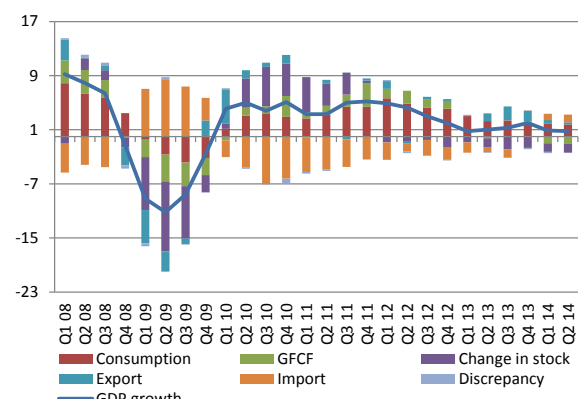


Source: OECD.

Note: Emerging EU economies include the six central European countries that are member both of the EU and the OECD: Czech Republic, Estonia, Hungary, Poland, Slovak Republic, and Slovenia. Other emerging economies include seven countries: Brazil, China, India, Indonesia, Mexico, South Africa and Turkey.

Near-zero quarterly growth in seasonally adjusted terms implies a continued slowdown of Russia's economy from 2.0 percent in the last quarter of 2013 to 0.9 percent growth in the first quarter 2014. Real GDP grew 0.8 percent in the second quarter, y-o-y (Figure 3). Growth in the first half of 2014 reached 0.8 percent compared to 0.9 percent in the first half of 2013. Already in 2013, economic activity in Russia was hamstrung by lingering structural problems and a wait-and-see attitude on the part of both businesses and consumers.

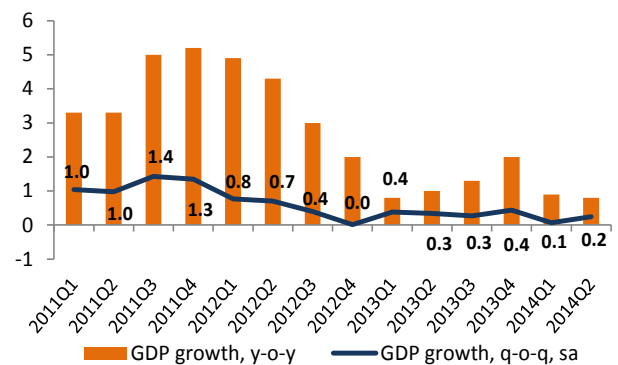
Figure 2: Composition of GDP growth, y-o-y and q-o-q sa, percent



Source: Rosstat and World Bank staff estimates.

Note: All data is from Rosstat, except the Q2 2014 GDP composition which is a World Bank staff estimate (Table 1).

Figure 3: GDP growth, y-o-y and q-o-q sa, percent



Source: Rosstat.

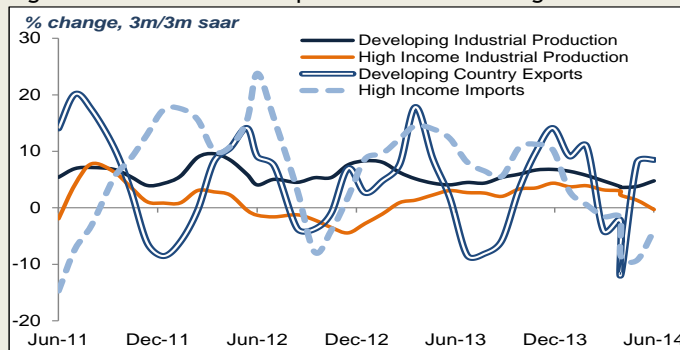


Box 1: Recent global trends

Global growth and trade picked up in the second quarter of 2014 after a weak start of the year (Figure 4). The second quarter rebound was largely driven by strengthening growth in the US, where the economy grew faster than expected, accelerating to 4.2 percent (q-o-q, saar) after a weather-related 2.1 percent contraction in the first quarter. In the Euro Area, second quarter GDP growth was still a disappointing 0.2 percent that partially offset the 1.1 percent expansion in the first quarter, held back by the continued weakness in France and Italy and a contraction in Germany (-0.2 percent in the second quarter from 0.8 percent in the first quarter). In Japan, GDP growth contracted by 6.8 percent in the second quarter, as a result of the 3-percentage-point sales tax hike in April, offsetting strong first quarter growth (6.1 percent). Accommodative monetary policies and firming import demand in high-income countries have supported growth and capital inflows in developing countries. China's second-quarter GDP growth was steady at 7.5 percent (y-o-y) supported by a rebound in exports and earlier stimulus measures. Global trade reported a healthy pick-up in the first half of 2014: in the three months to June, it increased by 4.2 percent. Advanced-economy imports of investment goods and consumer durables posted strong gains, benefiting trade partners in emerging markets, especially in East Asia.

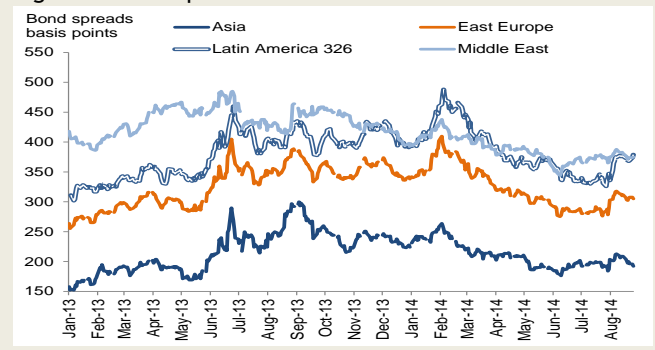
Gross capital flows to developing countries have remained strong since March, notwithstanding the ongoing US Fed tapering. Additional easing by the European Central Bank, combined with prospects of modest growth and stable inflation in the United States, helped depress bond yields and volatility worldwide (Figure 5). Despite geopolitical concerns in Israel, Syria, Ukraine and Iraq, spreads on emerging market bonds have narrowed more than 100 basis points since early February. The escalation of tensions in eastern Ukraine and the payment default of Argentina pushed up Credit Default Swaps (CDS) spreads for sovereign bonds of these countries, but the impact on other emerging economies has so far been muted.

Figure 4: Global industrial production and trade growth



Source: Datastream and World Bank Prospects.

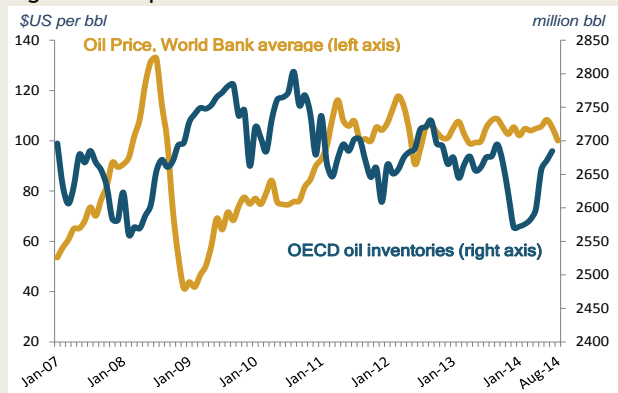
Figure 5: Bond spreads



Source: Bloomberg.

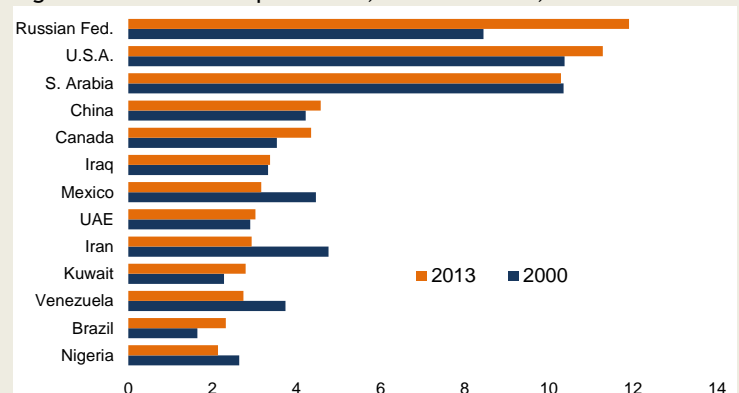
Oil prices were remarkably stable through midyear despite rising geopolitical tensions (Figure 6). Following a surge in mid-June, oil prices dropped to a 12-month low. Prices exceeded US\$108/bbl in June due to geopolitical concerns in Iraq, but retreated to below US\$100/bbl in August and September. Apart from that June surge, oil prices have been stable during the past few quarters and the rising geopolitical tensions seem to have not affected the global oil markets significantly. Despite intensified fighting in Iraq, oil production from Iraq's Kurdistan autonomous region doubled in August and is expected to increase further by the end of 2014. OECD inventories rebounded from the past decade's lowest level in December 2013, reaching 2,685 million bbl in June. According to the International Energy Agency (IEA), Russia will remain the world's largest crude oil supplier, with production expected to average 10.92 mb/d during 2014, marginally up from 10.88 mb/d in 2013 (Figure 7). However, Russia is advancing its strategy to divert its crude oil exports to Asian markets, a strategy it has been pursuing for several years. Russian crude exports to Asia during January-July 2014 were up 27 percent compared to a year ago while deliveries to Europe declined by 10 percent during this period.

Figure 6: Oil prices and OECD inventories



Source: Datastream and World Bank Prospects.

Figure 7: Crude oil output shares, 2000 and 2013, mb/d



Source: IEA.

The increased uncertainty brought about by the Russia-Ukraine tensions and related sanctions impacted investor and consumer decisions. First, equity and currency markets entered a prolonged period of high volatility as they needed to internalize this high uncertainty (Box 2). Second, the impact of Western sanctions on Russia's growth performance in the first half of 2014 was channeled through adjustments in financial flows. Third, it exacerbated the confidence crisis the economy had entered in 2013, weighing heavily on consumption and investment. Statistics on output dynamics by economic sectors for the second quarter (immediately following the start of the geopolitical tensions) indicate that the economy remains sluggish but with a small positive impulse coming from some import substitution (Box 3). Overall, the gradual implementation of trade sanctions started only in late July and will likely show their full impact only in the second half of 2014 and next year. An expansion of sectoral or trade sanctions related to the Russia-Ukraine tensions could send business and consumer confidence into another downward spiral, further reducing domestic demand.

Consumption was negatively impacted by the geopolitical tensions through the sharp depreciation of the Ruble and related inflation pressures. Consumption growth slowed and its contribution to growth fell to about 2 percentage points in the first quarter of 2014 from 3 percentage points in the first quarter of 2013 (Table 1). Nevertheless, despite this reduction, consumption remained the main growth engine. Other factors driving the consumption pattern in the first half of the year included increased household debt burdens and lower real income growth. Consumption growth is currently moderating to a new and lower growth trajectory in an environment of subdued consumer sentiments. Geopolitical tensions are weighing down further on consumption growth.

Investment activities contracted due to a more uncertain business environment and the increasing restrictiveness of credit conditions as a result of sanctions. Decelerating investment was the main cause for the weak growth outturn in the first half of 2014. In the first quarter, investment demand deteriorated sharply, with fixed investment contracting 7 percent after weakening 0.5 percent a year earlier. Dwindling profit margins, slowing consumption, and a weak growth outlook led the continued reduction in inventories, subtracting 1.3 percentage points from growth (Table 1). The Russia-Ukraine tensions negatively impacted already low business confidence in the economy and further depressed investor sentiment. More restricted access for Russian companies and banks to external financing is likely to have already affected investment decisions, leading to a delay or a scaling back of investment programs. We expect that this trend will worsen during the second half of 2014 and throughout 2015, when the impact of the additional sanctions will be felt and may lead to a period of near stagnation (see outlook section 2). Despite some import substitution potential (see Box 3), we believe that private investors will remain hesitant to invest as they continue to face increased policy uncertainty and structural and institutional constraints to business expansion (see our special focus note in section 3). The weak growth potential of the economy is reflected in the high capacity utilization—nearing historical highs—together with limited prospects for additional increases in productive capacity (Box 9 in the outlook section).

Table 1: Contribution to growth by demand components, percentage points

	2010	2011	2012	2013	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014e
GDP growth, percent	4.5	4.3	3.4	1.3	0.8	1.0	1.3	2.0	0.9	0.8
Consumption	2.6	3.7	4.7	2.4	3.0	2.3	2.4	2.1	2.0	1.8
Households	3.0	3.5	3.8	2.3	2.9	2.2	2.4	2.0	2.0	
Government	-0.3	0.3	0.8	0.1	0.1	0.1	0.1	0.1	0.0	
Gross capital formation	5.4	4.7	0.4	-1.5	-0.9	-1.6	-1.9	-1.5	-2.3	-2.4
Fixed capital investment	1.3	2.0	1.4	0.0	-0.1	-0.3	0.0	0.2	-1.0	
Change in stocks	4.1	2.8	-1.0	-1.5	-0.8	-1.3	-1.9	-1.7	-1.3	
Export	2.0	0.1	0.4	1.2	0.0	1.1	2.1	1.6	0.5	0.3
Import	-5.3	-4.3	-1.9	-0.8	-1.5	-0.8	-1.2	0.0	0.9	1.1

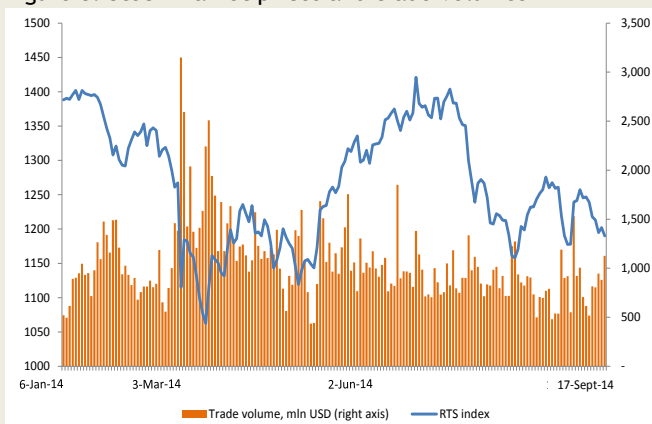
Source: Rosstat and World Bank staff calculations.

## Box 2: Sanctions and their impact on markets and the economy

Since the start of the Russia-Ukraine tensions, and up to September 17 when this report went to press, Russia has been subject to several rounds of sanctions from developed economies. First, there were sanctions introduced by the US, EU, and other countries aimed at specific individuals, groups and companies. They prohibit the entry of the sanctioned individuals, freeze their assets and ban business operations with these individuals and companies. Political sanctions were introduced by the US, EU, Canada, Australia, Albania, Iceland, Liechtenstein, Moldova, Norway, New Zealand, Ukraine, Switzerland, Montenegro, and Japan. Second, economic and sectoral sanctions aiming at Russia's military, energy and financial sectors were introduced. In the financial sector, access of the Russian six major state banks to the EU and US financial markets was severely limited. Since September 12, these companies can only apply for loans and issue debt not exceeding 30 days maturity. In the defense sector, the US and the EU cut access to financing exceeding 30 days maturity for Russia's major companies in the sector and introduced export ban for dual-use goods and technology for 14 mixed-defense companies. Sanctions on cooperation with Russia in the military sector were introduced by Great Britain, Israel, Switzerland, and Sweden. In the energy sector, the US and the EU limited access to finance for Russian major oil and gas companies. Also the EU and the US prohibited export of goods, services (not including financial services), or technology in support of exploration or production for Russian deep-water, Arctic offshore, or shale projects. Norway, Canada, and Australia largely joined sanctions introduced by the EU. Sanctions were also introduced against Crimea and Sevastopol: for instance, a ban on investment projects and mineral extraction there and a trade ban on wide range of goods (by the EU and Norway). On August 7, Russia banned the import of meat, fish, seafood, vegetables, fruit, milk, dairy products, and a wide range of processed foods from the US, the EU, Australia, Canada, and Norway for a year in response to their sanctions.

Sanctions and countersanctions hit the economy through three channels. First, they led to increased volatility on the foreign exchange market and a significant depreciation of the national currency (Figure 8 and Figure 9). Massive capital outflows triggered by the tensions led to a deterioration of the capital and financial account balance and a decrease in net international reserves. Yet, despite the depreciation, non-oil exports did not increase much, and although there was a small impulse to import substitution, its potential appear to be limited, given that there is little spare capacity due to structural constraints. Depreciation also exerted additional pressure on inflation. In response to high inflation pressures, the Central Bank significantly tightened monetary conditions. The policy appears consistent with its long-term inflation target, yet it increased domestic borrowing rates and further restricted access to domestic credit for investors and consumers. Second, the tensions also limited Russia's access to international financial markets, with markets pricing Russia's higher risk into the cost of credit and sending sovereign Credit Default Swap spreads for Russia soaring. Foreign borrowing decreased in the first half of 2014. These tighter domestic and external credit conditions are likely to have negatively affected investment and consumption decisions, leading to a delay or a scaling back of respective plans. Finally, already low domestic business and consumer confidence in future growth prospects continued to diminish and reduce consumption and investment activities. We expect that these trends will worsen during the second half of 2014 and throughout 2015, when the impact of the additional sanctions will be felt, leading to a period of stagnation.

Figure 8: Stock market prices and trade volumes



Source: MICEX.

Figure 9: Exchange rate dynamics, Euro-Dollar basket



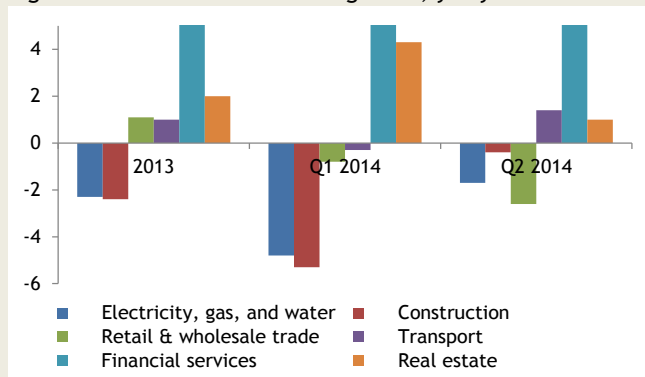
Source: CBR.

**Demand for Russian exports was robust.** The contribution of exports to GDP increased to 0.5 percentage points in the first quarter of 2014 from nil a year earlier (Table 1). On the other hand, imports decreased due to the depreciation of the Ruble and weak domestic demand. Owing to import contraction and stable export growth, the contribution of net exports to GDP growth increased to 1.4 percentage points in the first quarter of 2014. However, if the Russia-Ukraine tensions would lead the West to introduce more sanctions against Russia, beyond the ones in place as of September 17 when this report went to press, the impact on Russia's economy could be profound.

Box 3: Output growth by sectors in first half of 2014

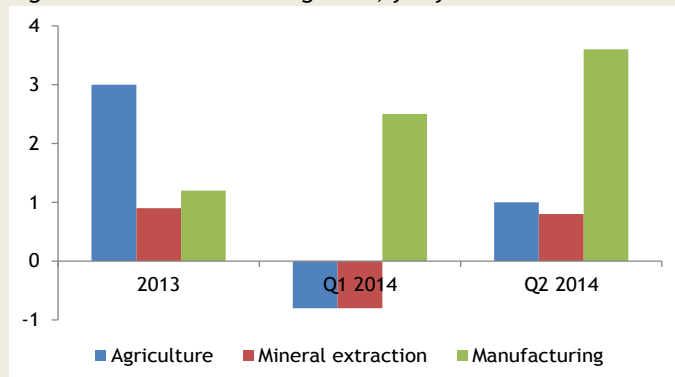
**Growth in the non-tradable sector—the main growth driver in recent years—moderated to a lower level (Figure 10).** Consumer demand for non-tradable market services is increasingly constrained by slowing income growth, high inflation and rising household debt burden, which was in particular reflected in the slowdown in retail and wholesale trade. The construction sector remained depressed. However, in the tradable sector, the Ruble depreciation appears to have helped to revive economic activities in the manufacturing sector, which reported an acceleration of output (Figure 11). Activities in other tradable sectors such as agriculture and mineral extraction improved marginally in the second quarter relative to the first quarter of 2014. There was some positive impulse to a few manufacturing sub-sectors from import substitution, which appears to be carried over into the third quarter. As a result, the rate of capacity utilization increased back to 2012 levels when the recent economic slowdown began. With capacity utilization approaching historical highs and a continuously tight labor market (see section 1.2), the positive effect of import substitution might be short-lived and limited by structural constraints (Box 9 in part 2).

Figure 10: Non-tradable sector growth, y-o-y



Source: Rosstat.

Figure 11: Tradable sector growth, y-o-y



Source: Rosstat.

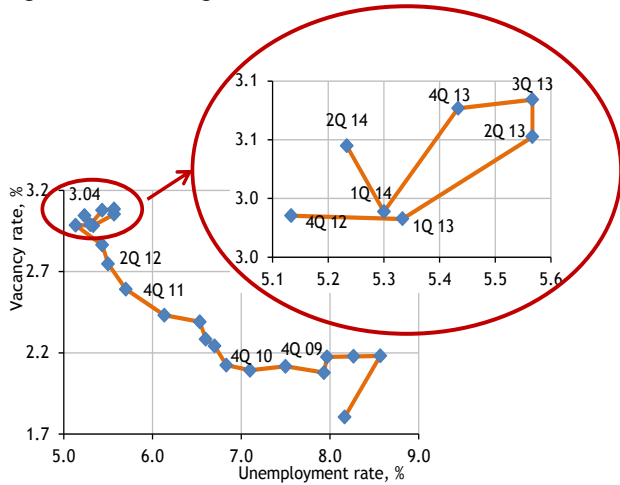
## 1.2 Labor Market - Still In A Tight Spot

*The economic stagnation has been accompanied by employment at near maximum historical levels and low unemployment. Some increase in labor mobility between sectors helped reallocate scarce labor resources. Growth in wage and transfers slowed during the first half of 2014, negatively impacting real disposable-income growth.*

**Stable, low unemployment reflects continued tightness in the labor market.** Despite slower growth, the demand for labor as measured by the vacancy rate<sup>2</sup> remained little changed (Figure 12). The number of employed also changed little. We saw that an increase in the number of employed in expanding sectors (such as financial services and real estate) compensated for a decline the number of employed in contracting sectors, indicating some labor mobility between sectors. Although labor supply—measured by the economically active population—remains near its historical maximum, it is slowly declining, reflecting long-term demographic changes (Figure 13). The seasonally adjusted unemployment rate eased to 5.3 percent in the first half of 2014 from 5.6 a year earlier. Female employment remains below male employment levels, but the female unemployment rate moved in line with overall trends, decreasing to 4.8 percent in the first half of 2014 from 5.2 percent in the same period of 2013. Regional unemployment dynamics continue to be very unequal and indicate that geographically there remain strong limitations to labor mobility. Historically, the poorest regions tend to have high unemployment, including the Northern Caucasus federal district of Ingushetia (36.1 percent), Chechnya (22.4 percent), and the Tuva Republic (22.0 percent). At the same time, the large metropolitan areas remain the regions with the lowest unemployment rates: Moscow-city (1.2 percent), St. Petersburg (1.5 percent), and the greater Moscow region (2.6 percent).

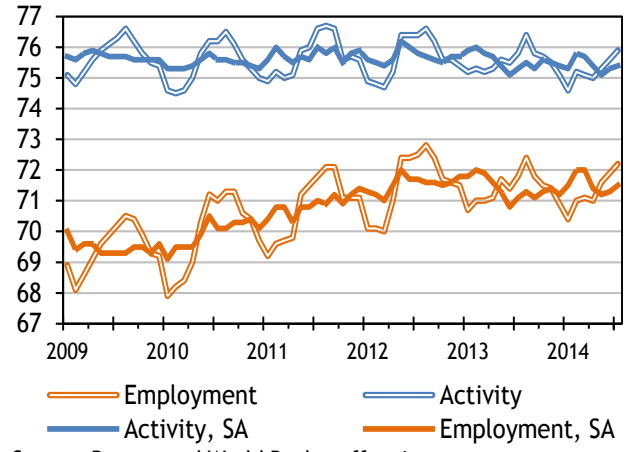
<sup>2</sup> Number of vacancies as a share of total number of jobs.

Figure 12: Beveridge curve



Source: Rosstat and World Bank staff estimates.

Figure 13: Number of employed and economically active population, million people



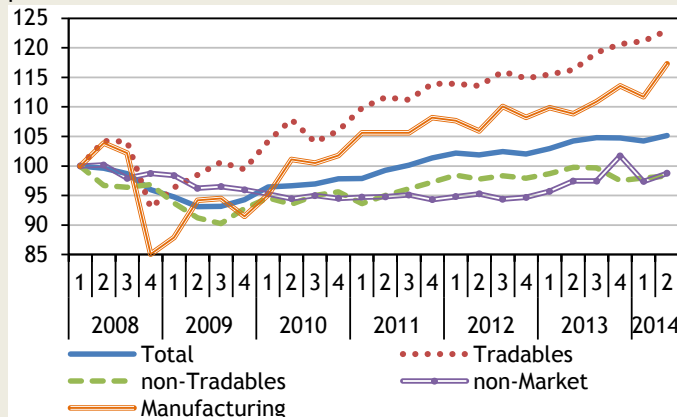
Source: Rosstat and World Bank staff estimates.

**Growth in real disposable income slowed to nil in the first eight months of 2014 from 4.3 percent a year ago** (Figure 16). Real wage growth weakened in all sectors, but especially for public employees. The contribution of the public or non-market sector to wage growth is still the largest, but less so than it was in 2013 (Figure 17). Public wages and transfers contributed negatively to income growth in the first half of 2014. Pension growth weakened in real terms despite two nominal increases in the first half of 2014. Pensions were raised by 6.5 percent in February and by 1.7 percent in April, both indexed to the headline CPI. Already increasing household debt burdens, combined with lesser opportunity to roll over short-term debt due to higher loan costs and tighter credit conditions, is further reducing household's disposable income.

Box 4: Recent productivity trends

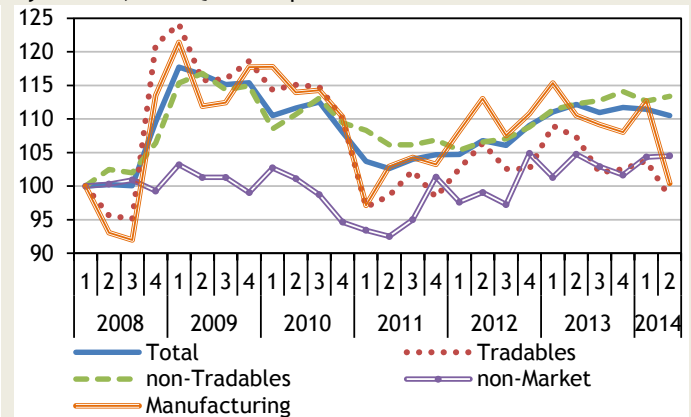
**Real wages grew in line with productivity for the economy as a whole.** In the first half of 2014, productivity growth was higher in the tradable sector than in non-tradable sectors (Figure 14). Nonetheless, favorable wage dynamics in the private non-tradable sector led to some improvement in the productivity gap (Figure 15). Developments in the manufacturing sector were more volatile than in other industries however, with productivity growth lagging wage growth in the first quarter before a sharp reversal in the second.

Figure 14: Productivity per worker by sectors, 2008Q1 = 100 percent



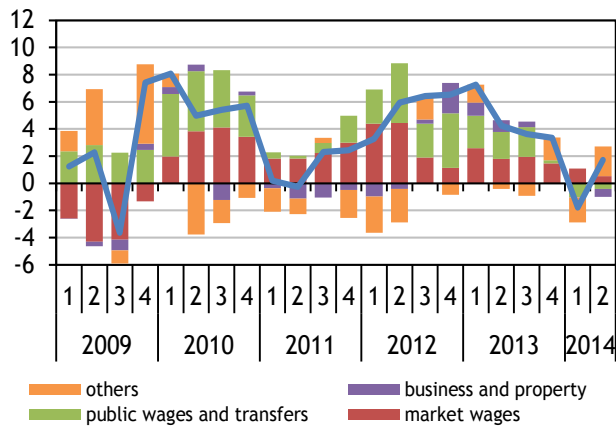
Source: Rosstat, Haver and World Bank staff estimates.

Figure 15: Gap between real wages and productivity growth by sectors, 2008Q1 = 100 percent



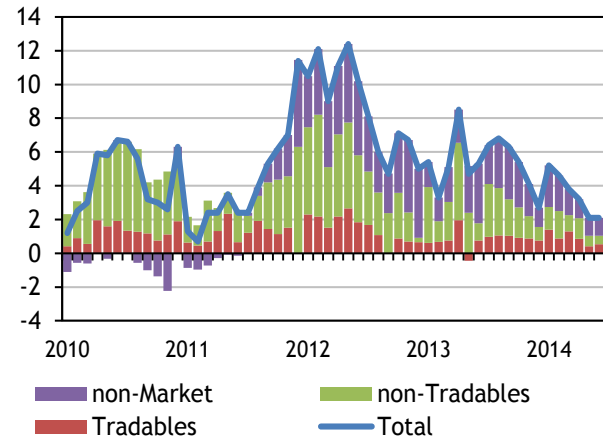
Source: Rosstat, Haver and World Bank staff estimates.

Figure 16: Contribution to real income growth (all population), y-o-y, percent



Source: Rosstat and World Bank staff estimates.

Figure 17: Households' real wages dynamics, y-o-y, growth, percent



Source: Rosstat and World Bank staff estimates.

### 1.3 Monetary Policy And The Financial Sector - The Elusive Inflation Target

*In response to persistently high inflation pressures, the CBR significantly tightened monetary policy. The geopolitical tensions led to increased volatility on the foreign exchange market and a significant depreciation of the Ruble. The financial sector is becoming increasingly affected by the geopolitical tensions and related sanctions, which is eroding the depositors' base and limiting access to credit.*

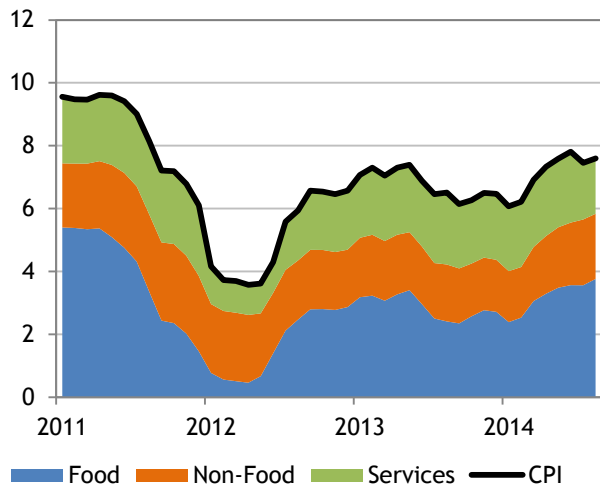
**Inflation remained high and prompted the Central Bank to tighten policy further in mid-year.** The geopolitical tensions that began in March destabilized the foreign exchange market and led to a sharp depreciation of the Ruble. As a result, demand for money fell sharply, adding to already high inflation pressures. In addition, higher-than-expected prices for food (10.3 percent in August, year-on-year) continued to push inflation up despite seasonal declines in fruit and vegetable prices in July and August. By the end of August, 12-month inflation rose to 7.6 percent and core inflation to 8 percent (Figure 18). Climbing headline inflation and an accelerating core inflation will make it difficult for the Central Bank to achieve its 2014 inflation target of 3.5-6.5 percent. The CBR announced at mid-year that inflation is likely to come out at the upper end around 6.0-6.5 percent; the Bank revised its projection in September saying that inflation might exceed 7 percent by the end of the year. The CBR reverted to further tightening at the end of July in an attempt to rein in persistently high inflation. This was the third hike of key policy rates this year, bringing the cumulative increase to 250 basis points (Figure 19). This time, the CBR expressed particular concerns regarding new risks to inflation arising from potential changes in tax and tariff rates, increased geopolitical tension (with increasing sanctions and the latest food ban) and its potential impact on the Ruble exchange rate dynamics. Those factors could become the source of elevated inflation expectation and pressures.

**During the first half of 2014, the exchange rate went through three episodes of high volatility, leading the Central Bank to scale up its interventions significantly.** First, pressure on the Ruble increased in January 2014 as a result of uncertainty around the impact of the US Fed tapering of its quantitative easing policies and speculation around CBR's move to a more flexible exchange rate regime. To support the Ruble, the Central Bank more than doubled the amount of intervention to US\$8.6 billion compared to December 2013, and it continued intervening in February (US\$6.4 billion). On March 3, the exchange rate entered a second period of increased volatility due to the start of the Russia-Ukraine tensions. CBR hiked its main policy rates by 150 basis points to 7.0 percent, while purchases for the Reserve Fund were immediately put on hold. In addition, the CBR strengthened its intervention rule.<sup>3</sup> Although some confidence into the Ruble was restored, the CBR had to continue intervening and spent close to US\$25 billion in March alone to support the Ruble. Pressure on the Ruble decreased substantially in April and

<sup>3</sup> On March 3, CBR raised the amount of cumulative interventions sufficient for moving the foreign exchange corridor by 5 kopecks from US\$350 million to US\$1.5 billion, moving the currency corridor up by 35 kopecks, and intervened in the amount of US\$11.3 billion which is close to the historical maximum of US\$15 billion on January 19, 2009. CBR officially announced these changes to its exchange rate policy as temporary and confirmed their intention to move to a flexible exchange rate regime by 2015.

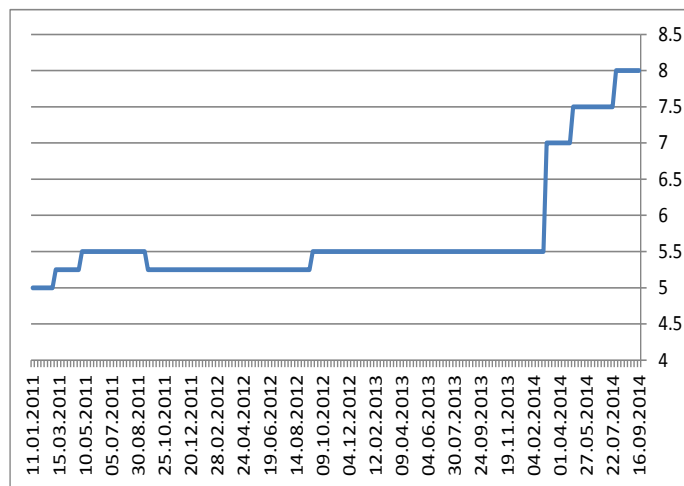
May, reflecting the temporary easing of geopolitical tensions. Consequently, the CBR discontinued interventions on May 12 and relaxed the rules for its foreign exchange interventions in late May and again in June.<sup>4 5</sup> However, at the end of July, the exchange rate entered its third round of high volatility this year on the back of renewed Russia-Ukraine tensions. Yet, CBR refrained from interventions on the market and further relaxed intervention rules in mid-August (Figure 19). In the first half of 2014, the Ruble depreciated compared to end-December levels by 9.2 percent versus the US Dollar and 9.6 percent versus the Euro-Dollar currency basket, despite interventions in the amount of US\$40 billion for which CBR had to draw on its foreign reserves, which fell by US\$26 billion from US\$509 billion at the end of 2013. The Ruble/US\$ exchange rate broke its historical maximums on September 17, reaching 38.71. While the recent policy moves suggest that CBR remains fully committed to finalizing its move to inflation targeting by the end of 2014, it might become challenging to operate in an environment that has now both high inflation and low growth risks (see part 2).

Figure 18: CPI inflation by components, y-o-y



Source: Rosstat and World Bank staff estimates.

Figure 19: CBR's key policy rate



Source: CBR.

**Russian banks are increasingly impacted by the geopolitical tensions and related sanctions.** With a loan-to-deposit ratio of 120 percent, a substantial part of Russian banking is financed by borrowing abroad or at home. Financial sector sanctions are likely to lead to a further increase of funding cost for banks.<sup>6</sup> Already by mid-year, the rates for interbank lending increased by 0.7-2.2 percentage points from the end of 2013, depending on the maturity. With the eroding depositors' base and growing funding cost, Russian banks seek increasingly additional liquidity from the CBR. By end-July, the total amount of loans from the CBR to the banking sector reached RUB5.6 billion or 9 percent of total liabilities, compared to 7.7 percent at the end of 2013. In effect, the CBR remains a lender of last resort. Non-financial corporations are also increasingly suffering from liquidity constraints due to curtailed access to international capital markets as a result of sanctions. In this environment, they will have to resort to domestic financing, which could create additional pressure on the money market and lead to further increased cost of credit for the private sector.

<sup>4</sup> On May 22, the CBR changed the rules of its foreign exchange interventions: the amount of its interventions was lowered from US\$200 million to US\$100 million when the Ruble is traded in the range of 1.5-2.5 Rubles from the center of the CBR band. In addition, it lowered the amount of its support from US\$400 million to US\$300 million when the Ruble is traded 0.95 Ruble apart from the edges of the CBR band. CBR kept its temporary March measure of moving the foreign exchange corridor by 5 kopecks for cumulative interventions of US\$1.5 billion. The regulator only conducted purchases of currency for replenishment of the Reserve Fund (US\$1.5 billion in June). Purchases were suspended on June 24, when the total amount of purchases for the Reserve Fund this year reached US\$5.7 billion, close to the initially planned amount of about US\$6.1 billion.

<sup>5</sup> On June 17, CBR moved the operational band that does not require its interference from 3.1 to 5.1 rubles, reducing the amount of interventions in the zone 0.95 Ruble apart from the edges of the Ruble band from US\$300 million to US\$200 million. Also, CBR lowered the cumulative amount of interventions required for shifting of the Ruble band by 5 kopecks to US\$1.0 billion from US\$1.5 billion.

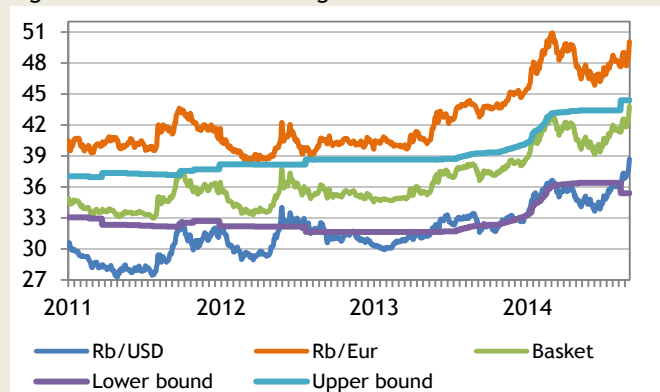
<sup>6</sup> Sanctions include the six large commercial banks (Sberbank, VTB, VTB24, Gazprombank, Rosselkhozbank, and Bank of Moscow) with a combined market share of around 57 percent.

Box 5: CBR continued its transition to a floating exchange rate

On August 18, 2014, the Central Bank of Russia announced a significant easing of its foreign exchange management policy, leading to more exchange rate flexibility. The following measures were introduced:

- (1) The corridor for the bilateral currency basket was expanded from RUB7 to RUB9, the first expansion since mid-2012. The new corridor was set in the range of RUB35.40-44.40;
- (2) The CBR will no longer conduct interventions when the exchange rate is within the corridor;
- (3) Interventions will be conducted only at the bounds of the corridor, and the amount of accumulated interventions required to make a 5 kopek shift in the corridor is lowered from \$1 billion to \$350 million, back to the amount at the beginning of the year, before the geopolitical tensions.

Figure 20: The Ruble exchange rate and its bilateral band



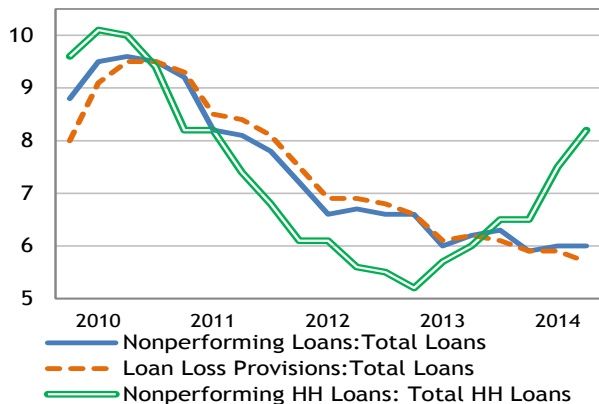
Source: CBR and World Bank staff estimates.

**Prudential indicators for the banking system remain stable and the Central Bank continued with the closing of financially non-viable banks to reduce risks.** The ratio of non-performing loans (NPLs) to total loans outstanding remained stable during the first half of 2014 at 6.1 percent (Figure 21). Disaggregated statistics, however, indicate some deteriorating trends. Among loans to households, the share of NPLs rose to 8.2 percent in June from 6.5 percent at the end of 2013 as households found it increasingly difficult to service debt due to slowing income growth and rising levels of indebtedness. Banks continued to report adequate levels of provisioning and capitalization and the sector-wide ratio of provisions to NPLs rose slightly. The increased need for provisioning weighed on banks' liquidity and put additional strains on the money market, which is already squeezed by CBR's tightening and by restricted access to international funding. The cleaning up of the banking system is a welcome initiative and helps safeguard against the risk of maintaining adequate quality of the credit portfolio. In the first eight months of 2014, the CBR revoked the licenses of 49 banks (compared to 32 banks in 2013) on account of money laundering, inappropriate party lending, fraudulent reporting, inability to pay creditors, overvalued assets, and asset-quality issues. Most banks were small, participated in the deposit insurance scheme and their closure did not significantly affect household borrowing. The insurance payment to depositors was organized in due manner and through the bank-agents determined by the CBR and the Deposit Insurance Fund.

**Credit growth slowed in the first seven months of 2014 on the back of an eroding depositors' base and higher cost of credit.** The slowdown was largely driven by credit to households, whose pace of expansion fell to 19.7 percent in the year through June from 32.6 percent in December 2013 (Figure 22). An increasing level of household indebtedness (the debt/income ratio rose to 22.9 percent in the first quarter of 2014 from 19.8 percent in the first quarter of 2013), slowing income growth and a growing number of bad loans increasingly restricted the ability of banks to extend credits. The latter and the increased cost of funding curbed growth in lending to companies to 16.0 percent in July; this was up, nonetheless, from 14.3 percent at end-2013. All in all, the total credit stock rose to 52.7 percent of GDP by June from 50.5 percent a year before. Deposit growth also slowed in July to just 8.3 percent (y-o-y), compared to 21.0 percent in December 2013 and 21.9 percent in July 2013. On one hand, this was the effect of the rising geopolitical uncertainty and a weaker national currency, which resulted in large withdrawals, especially during March (a reduction of 2 percent). But depositors returned to the banks during April-July (with a cumulative increase of 3.4 percent relative to March level) before the latest round of geopolitical tensions started. The erosion of the depositors' base was also influenced by slowing income growth and some declining trust in the banking sector (due to the ongoing process of sanitizing the banking system). In order to reverse this trend, banks may start increasing interest rates on individual deposits, yet this might have negative implications for the cost of credit if banks pass this additional funding cost on.

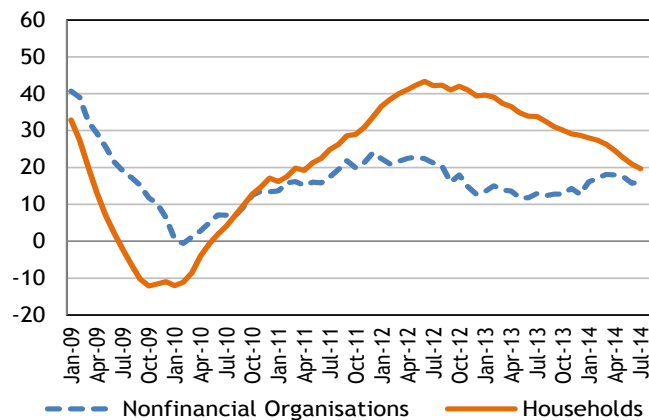


Figure 21: NPLs as a share of total credit, y-o-y, percent



Source: CBR.

Figure 22: Credit growth, y-o-y, percent



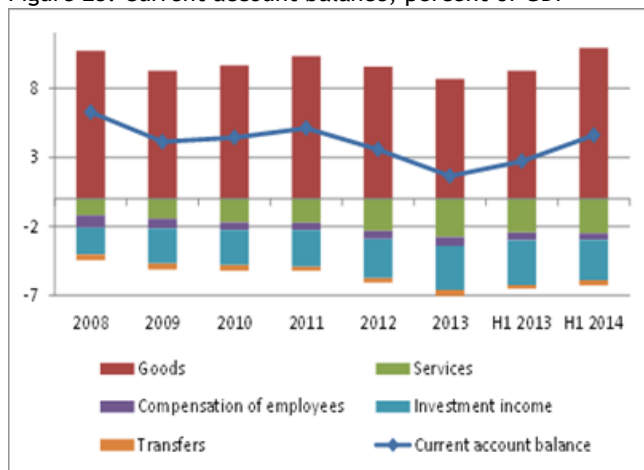
Source: CBR.

## 1.4 Balance Of Payments - The Big Flight

Balance of payments dynamics reflected the geopolitical tensions, dominated by heightened uncertainty and a depreciating Ruble. While the current account received a strong boost from weaker imports, the financial account deteriorated as net capital outflows surged.

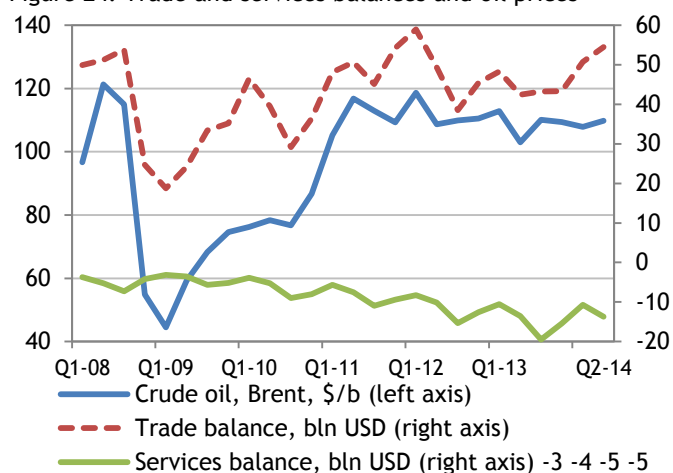
Russia's current account strengthened significantly in the first half of 2014. The current account (CA) surplus nearly doubled in the first half of 2014 to US\$44.2 billion (4.6 percent of GDP) from US\$26.8 billion (2.7 percent of GDP) a year ago (Figure 23 and Table 2). This reflected two main trends. First, import demand weakened as the economy grew at a slower pace and uncertainty increased in the wake of the rising geopolitical tensions. This helped reduce the non-oil current account deficit from US\$144.1 billion (14.6 percent of GDP) in the first half of 2013 to US\$131.3 billion (13.6 percent of GDP) in the first half of 2014. Second, exports of oil products and gas increased. Overall, consumer and investor demand for imports was negatively affected by the uncertainty and the Ruble depreciation. For example, the value of imported machines, equipment and transport vehicles fell by 5.5 percent in the first half of 2014 from a year earlier. As for energy exports, gas export volume grew by 7 percent in real terms in the first half of 2014 (y-o-y) after little change in the first half of 2013, dominated by an increase to CIS countries. Exports of non-energy goods, meanwhile, do not appear to have benefitted substantially from the depreciation of the Ruble, raising questions about the competitiveness of Russia's non-energy economy. The impact of the sectoral sanctions that the West started to introduce since late July and the import ban on food products by Russia in early August will be only observed in the second half of 2014.

Figure 23: Current account balance, percent of GDP



Source: CBR and World Bank staff estimates.

Figure 24: Trade and services balances and oil prices



Source: CBR, Bloomberg and World Bank staff estimates.

**Massive capital outflows triggered by the Russia-Ukraine tensions led to a deterioration of the capital and financial account balance and a decrease in net international reserves.** Russia's capital and financial accounts balance worsened to a deficit of US\$75.3 billion (7.8 percent of GDP) in the first half of 2014 compared to a deficit of US\$21.2 billion (2.1 percent of GDP) in the first half of 2013. High geopolitical uncertainty led to a more than doubling of net capital outflows from the private sector to US\$74.4 billion in the first half of 2014 from US\$33.5 billion in the first half of 2013 when adjusted for currency swaps and correspondent accounts of resident banks in the CBR. They exceeded annual net capital outflows from the private sector of US\$61 billion in 2013 (Table 3). However, it is likely that some of those capital outflows will return to Russia in the form of FDI, as reflected in the historically high amount of so-called round-tripping FDI (Box 6) that originates from Russian individuals and companies seeking to avoid adverse features of the Russian investment climate or offshoring to obtain undue tax advantages. Households' net purchases of foreign currency constituted an important part of the net capital outflows in the first half of 2014 and amounted to US\$12.1 billion, compared to US\$3.9 net sales of foreign currency in the first half of 2013. Those foreign currency purchases spiked at the onset of the geopolitical tensions in March. Massive capital outflow created substantial pressure on the Ruble and led to CBR intervention of US\$37.7 billion in the first half of 2014 compared to US\$22.1 billion for the whole of 2013.

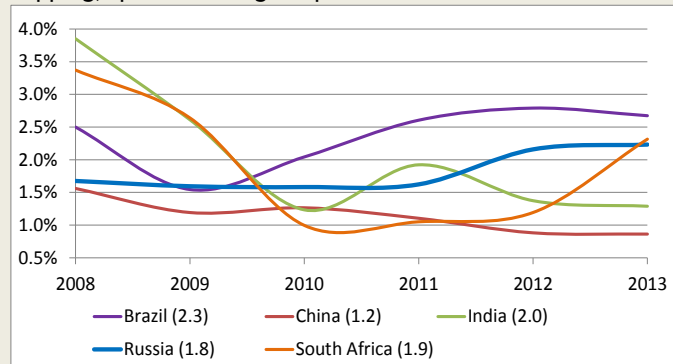
**Box 6: The link between capital flight and FDI**

**FDI performance in Russia was in the past closely intertwined with capital outflows.** Russia's FDI contains a large share of inbound FDI reported as originating from Cyprus and other tax havens, which is likely to be round-tripping FDI of Russian origin or, in other words, repatriated capital which was previously observed as capital outflows from Russia. However, round-tripping FDI of domestic firms that earn additional rents from the fact that they are able to obtain tax advantages is less likely to carry with it benefits of growth-enhancing effects, such as technology and other productivity improving practices, as compared to genuinely foreign FDI. After removing FDI with a reported origin from likely tax havens, the ratio of Russia's FDI inflows over 2007-2013 is around 1.8 percent, comparable to that for India and South Africa (Figure 25). This comparison may understate the amount of round-tripping in Russia's inbound FDI since it may involve also other reported sources.

**Non-tax haven FDI declined precipitously in 2013, but was partly replaced by FDI from tax havens** (Figure 26). FDI from sources other than tax havens dropped in the first quarter of 2014 to US\$6.6 from a record high of US\$29.9 billion in the first quarter of 2013. FDI from tax havens has been highly volatile lately, but ticked up to US\$5.5 billion in the first quarter of 2014. Thus, an increasing percentage of total FDI inflows are from tax havens: 45 percent in the first quarter of 2014 as compared to 14 percent in 2012 and 25 percent in 2013. This suggests that substantial parts of the capital outflows in early 2014 may have returned to the country disguised as FDI. Historically, investors sought to avoid adverse features of the Russian investment climate by relocating investments offshore and engaging in round-tripping (Fabry and Zeghini, 2002), but off-shoring for tax reasons is equally likely.

**Certain sectors are more attractive for round-tripping FDI.** For example, 89 percent of the Russian FDI stock in basic metals and metal products originates in the tax-haven countries of Cyprus, Bermuda and the Caribbean. Close to half of FDI in the services sectors and in construction is of the round-tripping type, with particularly high percentages in financial intermediation and real estate. By contrast, FDI in mining and quarrying and in most lines of manufacturing (other than iron and steel) is more likely to be high-quality FDI, proxied by the share of FDI that does not come from an obvious tax haven. Recent large cross-border mergers and acquisitions of Russian companies were carried out through tax havens. Six of the nine largest transactions since 2008 have included either Cyprus or the Jersey Islands as a buyer or seller or as part of the chain of ownership.

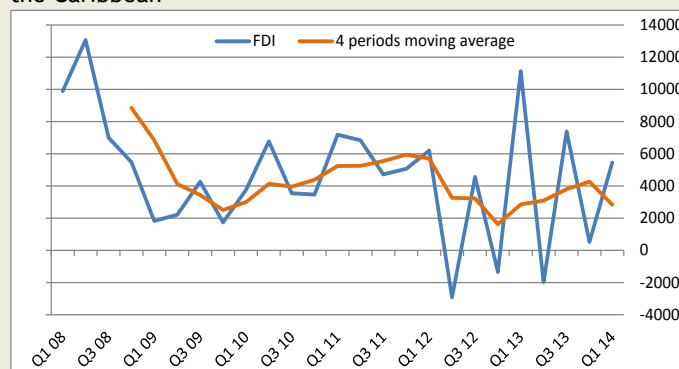
Figure 25: Annual FDI flows in percent of GDP, net of round-tripping, period average in parentheses



Source: CBR.

Note: Round-tripping sources of FDI are defined as Bermuda and the Caribbean, plus (for Russia) Cyprus, and (for China) 40 percent of FDI of Hong Kong origin (midpoint of range in Geng Xiao, 2004). Round-tripping for 2013 is estimated based on 2007-2012 average.

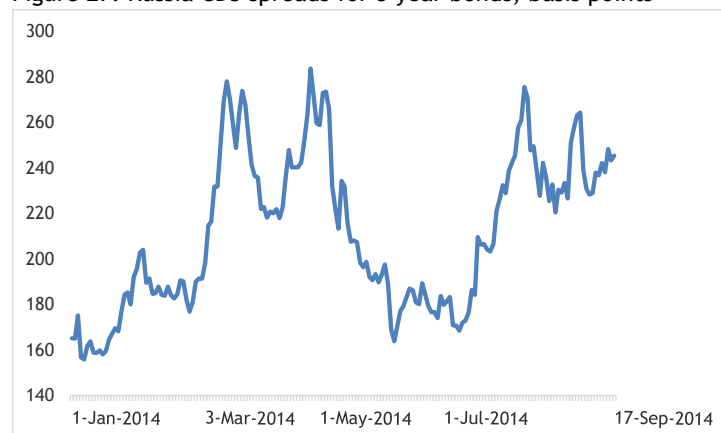
Figure 26: Russian inbound FDI from Cyprus, Bermuda and the Caribbean



Source: CBR.

**Foreign borrowing decreased in the first half of 2014.** Heightened geopolitical tensions, expectations of sanctions and a worsened medium-term outlook increased the cost of borrowing for all sectors of the Russian economy and limited their access to international financial markets.<sup>7</sup> After hovering at the level of 160 bps at the beginning of the year, Credit Default Swap (CDS) spreads on 5-year bonds spiked in March to 278 bps and stayed close to this level after a second spike at the beginning of August (Figure 27). Compared to other global bond spreads, Russia's CDS spreads were more volatile in the first half of 2014, especially in March-April and in July-August at the heights of geopolitical tensions (Figure 4). Reduced new borrowing and debt rollover is reflected in the decrease in Russia's external debt

Figure 27: Russia CDS spreads for 5 year bonds, basis points



Source: Bloomberg.

to US\$707.7 billion (48.5 percent of goods and non-factor services exports) in the first half of 2014 from US\$720.9 billion (48.9 percent of goods and non-factor services exports) at the end of 2013 (Table 4). External government debt decreased by US\$7.1 billion in the first half of 2014 from US\$61.7 billion in the end of 2013 as government cancelled its initial plan to borrow US\$7.2 billion in 2014 on the international markets because of unfavorable market conditions. A significant sell-off of government securities at the secondary market by non-residents also contributed to this decrease. The external exposure of banks decreased by US\$7.8 billion in the first half of 2014 from US\$214.3 billion at the end of 2013 due to banks' inability to roll-over debt. Non-banking sector debt increased by US\$6.9 billion in the first half of 2014, with credits coming mainly from foreign direct investors. Principal and interest payments due on the external debt of Russian banks and companies amounts to US\$99.4 billion in the second half of 2014 (a significant part of these are Rosneft's debt payments) (Table 5). Financial sector sanctions since late July targeted selected Russian banks and companies, limiting their access to parts of the international financial markets. The CBR has announced that it would provide support to banks and companies hit by sanctions and in the medium term, there is still space for such maneuver as CBR's foreign reserves stand at US\$465.2 billion as of the end of August 2014.

Table 2: Balance of Payments, 2008-2014, US\$ billions

	2008	2009	2010	2011	2012	2013	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Q1 2014*	Q2 2014*
Current account balance	103.9	50.4	67.5	97.3	71.3	34.1	25.0	1.8	-0.7	8.0	27.1	17.1
Trade balance	177.6	113.2	147.0	196.9	191.7	181.9	48.6	42.8	43.7	46.8	50.7	54.5
Non-oil current account balance	-206.2	-140.3	-186.6	-244.5	-275.5	-316.1	-61.9	-82.2	-88.2	-83.9	-57.0	-74.2
Capital and financial account	-139.8	-40.6	-21.6	-76.0	-30.9	-45.4	-13.3	-7.9	-4.7	-19.4	-48.8	-26.6
Errors and omissions	-3.1	-6.4	-9.1	-8.7	-10.4	-10.8	-6.8	1.6	-1.9	-3.8	-5.7	-0.9
Change in reserves (- = increase)	38.9	-3.4	-36.8	-12.6	-30.0	22.1	-4.9	4.4	7.4	15.2	27.4	10.3
Memo: average oil price (Brent, US\$/barrel)	96.9	61.5	79.7	111.1	112.0	108.9	112.9	103.0	110.1	109.4	107.9	109.8

Source: CBR. Note: \*Preliminary estimates.

Table 3: Net capital flows, 2008-2014, US\$ billions

	2008	2009	2010	2011	2012	2013	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Q1 2014*	Q2 2014*
Total net capital inflows to the private sector	-133.6	-57.5	-30.8	-81.4	-53.9	-61.0	-28.2	-5.5	-10.4	-16.9	-48.8	-25.8
Net capital inflows to the banking sector	-55.2	-32.2	15.9	-23.9	18.5	-7.5	-17.4	-4.4	10.9	3.4	-21.2	-17.1
Net capital inflows to the non-banking sector	-78.3	-25.3	-46.7	-57.4	-72.4	-53.5	-10.9	-1.1	-21.3	-20.3	-27.6	-8.8

Source: CBR. Note: \*Preliminary estimates.

<sup>7</sup> As geopolitical risks for Russia increased, Moody's and Fitch rating agencies changed outlook for Russian rating to negative. S&P cut Russia's external debt rating to lowest investment grade.

Table 4: Russia's external debt, 2011-2014, US billion

	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14
Total debt	538.9	557.5	570.6	598.9	636.4	691.7	707.8	716.3	728.9	715.8	720.9
Corporate	492.6	509.1	517.1	538.8	566.4	614.6	632.9	636.0	651.2	646.9	650.2
Banks	162.8	169.2	175.4	189.9	201.6	205.9	211.9	207.1	214.4	211.9	207.1
of which Private Banks	89.5	90.6	78.7	84.1	86.2	81.1	82.4	79.4	81.4	76.3	n/a
Non-financial corporations	329.8	339.8	341.7	348.9	364.8	408.8	420.9	428.9	436.8	432.8	443.7
of which Private Non-fin. Corporations	227.8	236.0	234.2	237.7	251.3	255.5	259.5	265.3	271.6	264.3	n/a

Source: CBR. Note: End of the month data.

Table 5: Projected debt payments in 2014 - 2015, principal plus interest, US million

	Q2 2014	Q3 2014	Q4 2014	2015
Government	2,512	1,852	1,170	6,603
Banks	26,529	14,508	15,711	35,867
Other sectors	21,885	28,386	37,804	69,822
Total	50,926	44,746	54,685	112,292

Source: CBR.

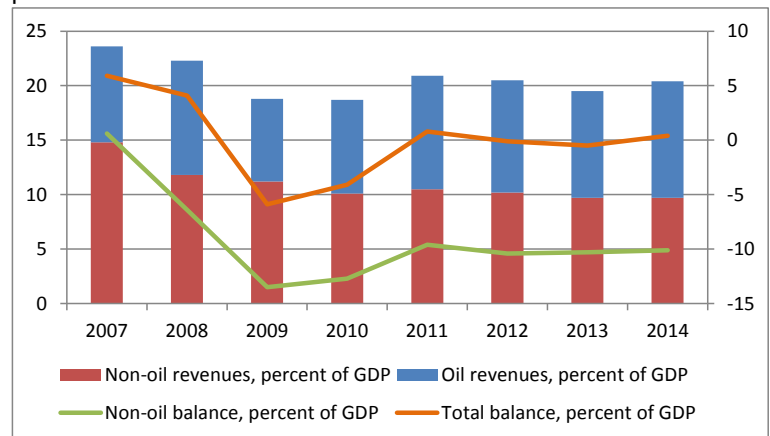
## 1.5 The Government Budget - Currency Depreciation And Oil Windfall Mask Medium-Term Challenges

The budget balance improved in the first half of 2014 thanks to the depreciating Ruble, higher oil prices than assumed in the budget, and prudent expenditure management. However, key medium-term challenges persist. First, the non-oil deficit remains stubbornly high above 10 percent of GDP. Second, subnational fiscal weakness continues with debt levels on the rise. Russia's fiscal buffers remain below their levels before the global economic and financial crisis, yet investment rules for the National Welfare Fund were recently loosened significantly.

The federal budget balance for the first seven months of 2014 exceeded expectations because of the currency depreciation and higher-than-projected oil prices, but a high non-oil deficit persists (Figure 28). Larger oil-related revenues helped boost federal budget revenues to 10.7 percent of GDP in January-July 2014 from 9.8 percent a year earlier (Table 6). In line with global oil prices, the average oil price during January-July (US\$107 per barrel) remained above the \$101/bbl assumed in the original 2014-2016 Budget Law and the \$104/bbl in the budget revision. The Federal government also tightly controlled budget spending during the first seven months of 2014: expenditures amounted to 18.8 percent of GDP, a ¼ percent lower than a year earlier. Federal expenditures for defense, administration, and intergovernmental fiscal transfers rose from a year earlier, but fell for social policy, health and education.

These trends resulted in a federal budget surplus of 1.7 percent of GDP in January-July, three times as large a year earlier. These numbers compare with a budget surplus of 0.5 percent of GDP under the original budget and 0.4 percent under the revised one (Box 7). However, given the weaker-than-expected non-oil revenue performance, the non-oil deficit is likely to remain persistently high—above 10 percent of GDP—despite the government's short- and medium-term goal of reducing it significantly. In fact, non-oil deficit targets of recent years were persistently revised upwards. In addition, given the commitment of large parts of Russia's fiscal buffers to growth-stimulation and other measures, Russia's fiscal position is becoming even more tightly linked to oil revenues and global oil price trends.

Figure 28: Federal Budget Revenue and Balance in 2007-2014, percent of GDP



Source: Ministry of Finance.

Box 7: Amendments to the 2014-2016 Federal Budget Law

In June, the amendments to the 2014-2016 Federal Budget Law were signed into law. Based on revised macroeconomic assumptions, including real GDP growth of 0.5 percent in 2014 instead of 3 percent and an uptick in the Urals oil price from US\$101 to US\$104 per barrel, oil revenue is projected to be 1.6 percent of GDP higher than originally budgeted and non-oil revenue is forecast to drop by 0.1 percent of GDP. Without changes on the expenditure side, the original budget deficit of 0.5 percent of GDP is projected to turn into a budget surplus of 0.4 percent, while the non-oil deficit would rise from the previously projected 9.4 percent of GDP again over the 10 percent mark to 10.1 percent of GDP (Table 6).

Table 6: Federal budget, 2012-2014, percent of GDP

	2012	2013	2013, Jan.- Jul.	2014, Jan.-Jul.	2014	2014
	Execution	Execution	Execution	Execution	Budget Law	Amended Budget Law
Expenditures	20.6	20.0	19.1	18.8	19.0	19.5
Revenues	20.5	19.5	19.8	20.4	18.5	19.9
Balance	-0.1	-0.5	0.6	1.7	-0.5	0.4
Oil Revenues	10.3	9.8	9.8	10.7	8.9	10.5
Non-Oil Revenues	10.2	9.7	10.0	9.7	9.6	9.4
Non-Oil Balance	-10.4	-10.3	-9.2	-9.0	-9.4	-10.1
Urals oil price, US\$/barrel	110.4	106.4	106.8	107.0	101.0	104.0

Source: Ministry of Finance, Economic Expert Group and World Bank staff calculations.

Russia's fiscal buffers in the National Welfare Fund and the Reserve Fund are increasingly committed to providing resources for off-budget stimuli. Recently, claims on National Welfare Fund (NWF) resources have been rising and there was talk of relaxing the fiscal rule, which largely determines the replenishment level of the Reserve Fund. In August, the Reserve Fund was replenished by more than US\$6 billion, reaching US\$91.7 billion or 4.7 percent of GDP (as of September 1, 2014). The replenishment represents oil revenue accrued to the federal budget in 2013 that is higher than originally budgeted. The NWF currently holds reserves equivalent to about 4.4 percent of GDP. Nevertheless, both funds remain well below the pre-crisis 2008 levels of 9.8 percent of GDP and 6.3 percent of GDP respectively. In June, the government decided to raise the limit on NWF resources that can be used to finance domestic infrastructure projects to 60 percent from 40 percent. Of those 60 percent, 40 percent (or 1.16 trillion Rubles as of January 1, 2014) can now be used to implement projects through the state-owned Vnesheconombank, ten percent (or 290 billion Rubles) for projects implemented with the participation of the Russian Direct Investment Fund (RDIF)<sup>8</sup> and another ten percent (or 290 billion Rubles) for projects implemented by the state corporation Rosatom<sup>9</sup>. Already about 900 billion Rubles of the NWF have been committed to purchase domestic stock and bonds associated with priority infrastructure projects<sup>10</sup>.

Following the recent economic sanctions, further discretion in the investment decisions of NWF resources was introduced. A new Government resolution of August 22, 2014 allows the NWF to invest in privileged stock of two sanctioned Russian banks: Vneshtorbank (VTB) and Rosselkhozbank in the amount of 239 billion Rubles, a mutual settlement for subordinated loans given to those banks and their affiliates during 2009 crisis. There are discussions to expand NWF investment into the stock to several other banks such as Gazprombank that received subordinated loans back in 2009 and that currently suffer from sanctions. Companies on the sanctions list such as Rosneft, Russia's state oil company, presented applications for support from the NWF (in the amount of 1.5 trillion Rubles, claiming almost half of NWF), and it is understood that more firms are lobbying for NWF resources. In order to allow the Reserve Fund and NWF to continue playing important roles as fiscal buffers and long-term investment vehicles, prudence on decisions how to use them in the most efficient way is advisable.

<sup>8</sup> The RDIF was established in June 2011 at the initiative of the President and Prime Minister to attract foreign investment into leading sectors of the Russian economy.

<sup>9</sup> Rosatom is the State Corporation established to develop a variety of nuclear energy projects in civil and military sectors, including nuclear energy production, nuclear research, design and construction of nuclear power stations, extraction and enrichment of uranium, etc.

<sup>10</sup> These projects include the construction of high-speed train tracks between Moscow and Kazan, a new Central Ring Road in Moscow, upgrades to the Trans-Siberian railway and to Moscow's airports, and other projects to improve energy efficiency and internet connectivity.

As part of the consolidated budget,<sup>11</sup> subnational finances weakened, resulting in an increase in subnational debt stock. The consolidated budget was in surplus (3.2 percent of GDP) at half-year point, yet is expected to turn again into a deficit of 1.0 percent of GDP for 2014 as a whole (Table 7). This is due to the expected acceleration in subnational expenditure execution during the second half of 2014, following historical performance trends and patterns. These expenditure dynamics on the subnational budgets are also expected to override the large increase in consolidated budget revenue from 36.4 percent of GDP in the first half of 2013 to 37.5 percent in the first half of 2014. This improvement in revenue was driven by a higher collection rate of export duties and VAT, increasing by 0.6 percent of GDP and 0.3 percent respectively. The revenue increase in the consolidated budget was also accompanied by a moderate drop in execution of consolidated expenditure by 0.4 percent of GDP. Increasing fiscal pressure on the consolidated budget is continuing to come from weaker subnational budget performance: over the previous years, an acceleration in the accumulation of public debt was observed here, given lower-than-projected revenues (due to the economic slowdown) and higher-than-expected outlays, due to commitments for higher wages in the social sector of the economy at subnational level in the President's decrees of May 2012. There was a steady increase of debt stock from 2.1 percent of GDP in 2012 to 2.6 percent in 2013, and to 2.4 percent of GDP in the first half of 2014 (Table 7).

Table 7: Consolidated government finances, percent of GDP

	2012	2013	2012 H1	2013 H1	2014 H1	2014
	Execution	Execution	Execution	Execution	Execution	Forecast
<b>Consolidated Budget</b>						
Expenditures	36.6	37.4	34.6	34.7	34.3	37.8
Revenues	37.0	36.1	38.5	36.4	37.5	36.9
Balance	0.4	-1.3	4.0	1.7	3.2	-1.0
<b>Consolidated Subnational Budget</b>						
Expenditures	13.3	13.2	12.1	11.8	11.7	13.0
Revenues	12.9	12.2	13.5	11.8	12.0	11.8
Balance	-0.4	-1.0	1.4	0.0	0.3	-1.2
Subnational Debt	2.1	2.6	1.8	2.0	2.4	NA

Source: Ministry of Finance and World Bank staff calculations.

<sup>11</sup> The consolidated budget includes the federal budget, the subnational budgets and extra-budgetary funds, e.g. pension and social security.

## Part II. Outlook

*Over the medium term, growth will continue to be determined by slow progress in structural reforms and policy uncertainty emanating from geopolitical tensions. To account for the heightened geopolitical risk, the report presents a baseline scenario and two alternative scenarios. The main challenges for Russia's outlook are twofold: consumption growth is likely to weaken even further than projected in the March version of the Russia Economic Report<sup>12</sup>, and recovery in investment demand will be slower than previously expected. The effects of weak growth for a second consecutive year, an increasing in households' debt burden, and continued high inflation expectations, are likely to depress consumer demand further, slowing this main engine of growth in Russia. These effects are expected to persist for the next two years. With no major structural reforms planned, and microeconomic fundamentals unchanged, investment will remain subdued and there will be only a limited positive effect from import substitution. Similarly, the multiplier effect from the planned increase in public and quasi-public investment expenditures is likely to be modest.*



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<sup>12</sup> See World Bank Russia Economic Report №31: *Confidence Crisis Exposes Economic Weakness*.

## 2.1 Growth Outlook - Stagnation In The Face of Policy Uncertainty

*The report presents three scenarios, the baseline, an optimistic one, and a pessimistic one. Our baseline outlook is one of near stagnation, given the most likely path of continuing Russia-Ukraine tensions and the persistence of related sanctions. The optimistic scenario projects a small recovery, facilitated by an end to geopolitical tensions and the lifting of all sanctions by the end of 2014. The pessimistic scenario envisions an increasing intensity in geopolitical tensions and further sanctions leading the economy into a low-level recession.*

**There are substantial risks to Russia’s medium-term growth prospects.** Based on recent developments, we see a large degree of stability in the economy despite the geopolitical tensions. Macroeconomic stability prevailed and Russia remains in possession of large buffers to uphold stability in the near future—as long as its access to oil and gas markets is not restricted permanently. The less good news is that we still see little movement on the structural reform agenda that could boost Russia’s growth potential in the medium-term. These observations together result in our most likely—baseline scenario—of a positive but low growth outlook of near stagnation in 2015 and 2016.

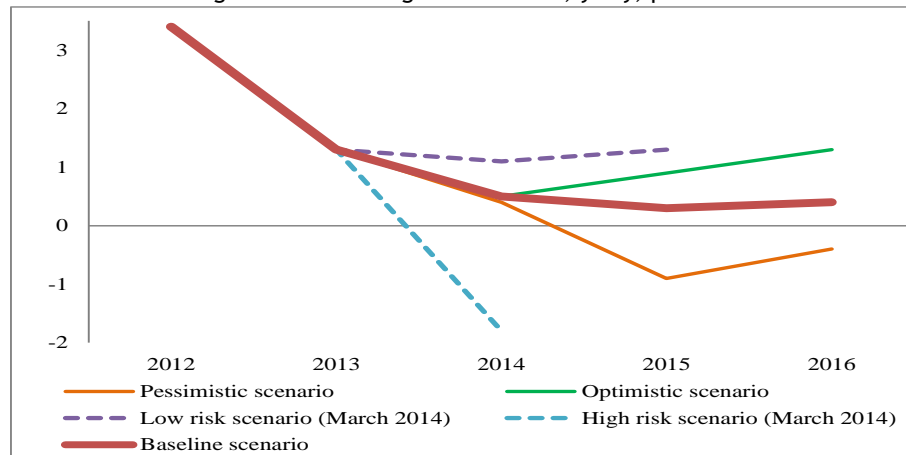
**Structural reform inertia, combined with high policy uncertainty related to political decisions around the geopolitical tensions, remains the deciding factors for our outlook.** It is now policy uncertainty about the economic course the country will take that is casting the longest shadow on Russia’s medium-term prospects. Since the beginning of the geopolitical tensions, economic policy has been dominated by measures to maintain macroeconomic stability and safeguard the economy from the impact of these tensions. This important policy effort should go hand in hand with renewed focus on improving the economy’s microeconomic fundamentals to allow for more efficient markets. While macroeconomic stabilization measures were timely and successful, medium-term policy objectives are still being redefined. However, some measures and economic policies under discussion have the potential to alter how the economy operates and might turn out detrimental to its competitiveness. A return to higher growth in Russia will depend on solid private investment growth and a lift in consumer sentiment, which will require a predictable policy environment and addressing the unresolved structural reform agenda (see part 3).

**The key parameters for our outlook framework evolved from our March projections.** Initially the geopolitical tensions brought with it much uncertainty about how this shock would impact the economy. After observing how the geopolitical uncertainty played out in the first half of 2014, we expect to see continued sharp but short-lived market responses if tensions increase, with a quick pricing-in of additional risks. However, overall there was a quick adjustment to a relatively stable but slightly lower trajectory. This is also the essence of our revised scenarios. We regress from our previous model of a one-time deep shock and project now a more drawn-out impact of the geopolitical tensions. Nevertheless, in our view, much geopolitical uncertainty prevails. To acknowledge this risk environment, the World Bank kept for its outlook a growth spectrum with two alternative scenarios straddling Russia’s baseline scenario (Figure 29).

**The core assumptions of our forecast scenarios are connected to an environment of heightened geopolitical risks and policy uncertainty.** While global demand is projected to be broadly stable and oil prices are expected to remain around US\$100/bbl (Box 8), we acknowledge the following main challenges. First, we believe that high uncertainty, combined with the effects of weak growth for a second year in a row, increasing household debt burden, and high inflation expectations, are likely to depress consumer demand profoundly, slowing this main engine of growth for Russia for the next two years. As a result, consumption growth is likely to weaken even further than we projected previously, even in our optimistic scenario. Second, as we cannot foresee major changes to the microeconomic fundamentals in which the economy operates—with no major structural reforms being initiated—we project a limited impact of import substitution and a relatively small multiplier effect of the planned increase in public and quasi-public expenditure to foster investment. This is reflected in the projection of a slower and more drawn-out recovery in investment demand compared to our previous estimates.



Figure 29: Russia's growth outlook, y-o-y, percent



Source: World Bank staff estimates.

### Baseline Scenario Projections

The World Bank baseline scenario is one of near-stagnation due to the continuation of the geopolitical tensions and related sanctions, paired with a lack of structural reforms to increase the economy's output potential. The baseline scenario takes into account the status quo of geopolitical tensions and international sanctions as of September 17, when this report went to press, and as spelled out in Box 2 (in part 1). It assumes no significant reform effort that would improve Russia's growth potential over the projection period. The main features of this scenario are that the already observed transmission channels of the geopolitical tensions would continue to impact the Russian economy and that consumer and investor confidence would recover only very gradually in this environment. As a result of weakening domestic demand, growth is projected to moderate from 0.5 percent in 2014 to 0.3 percent in 2015 and to slightly tick-up in 2016 (Table 8).

**Investment and consumption activities will remain depressed in 2014 and marginally recover in the following years.** In 2015, higher public investment within the existing fiscal rule and the use of off-budget resources through the National Welfare Fund are expected to increase investment, lifting gross capital formation marginally into marginally by 0.3 percent in 2015 and by 1 percent in 2016. Private investment activity is projected to remain depressed despite some import substitution in the absence of other reforms that would fundamentally change the business environment (Box 9). Gross fixed investment dynamics will come almost exclusively from government infrastructure projects. We assume that construction of some of the priority infrastructure projects will commence towards the end of 2014, picking up somewhat in 2015. Without structural reforms, the economy is projected to essentially stagnate throughout 2014-16, despite some fiscal and quasi-fiscal stimulus and robust external demand. Consumption is projected to be constrained by lower income growth than in previous periods, especially due to non-changing public wages—reflecting reprioritization of public expenditure to investment—despite some increased public consumption during 2015. We estimate that consumption growth slows from 2.0 percent to 0.5 percent in 2015. Import demand will decrease on the back of lower income growth and continued import restrictions. As a result, the contribution of net exports to growth will become slightly negative.

Table 8: Main economic indicators: baseline scenario

	2012	2013	2014	2015	2016
GDP growth (%)	3.4	1.3	0.5	0.3	0.4
Consumption growth, percent	6.8	3.5	2.1	0.5	0.6
Gross capital formation growth, percent	0.6	-6.0	-8.1	0.3	1.0
General government balance (percent of GDP)	0.4	-1.3	-1.1	-2.1	-1.0
Current account (US\$ billions)	71.3	34.1	62.8	57.9	54.3
percent of GDP	3.6	1.6	3.1	2.8	2.5
Capital account (US\$ billions)*	-32.3	-62.2	-113.0	-60.1	-55.6
percent of GDP	-1.6	-3.0	-5.6	-2.9	-2.6
Oil price assumption (US\$ per barrel)	105.0	104.0	102.9	99.5	100.1
Consumer price inflation	5.1	6.8	8.0	7.0	5.0

Source: World Bank staff estimates. Note: \*Current account minus change in reserves.

Box 8: Global outlook

**Global growth is to remain subdued in 2014.** Global growth estimates for 2014 have been revised further down, following signs of persistent stagnation in the Euro Area, Japan, parts of Latin America and emerging Europe. Conditions are gradually improving, but repeated forecast downgrades lead to a cautious assessment of the underlying strength of the recovery going forward. The world economy is forecast to grow at 2.6 percent in 2014, up from 2.4 percent in 2013. Gradually improving labor markets, accommodative monetary policy, and easing fiscal consolidation are expected to support growth in high-income countries, which, in turn, will benefit activity in developing countries through stronger trade, investment, and capital flows. From 2015, growth in both high-income and developing countries is expected to accelerate, reaching 2.4 percent and 5.3 percent.

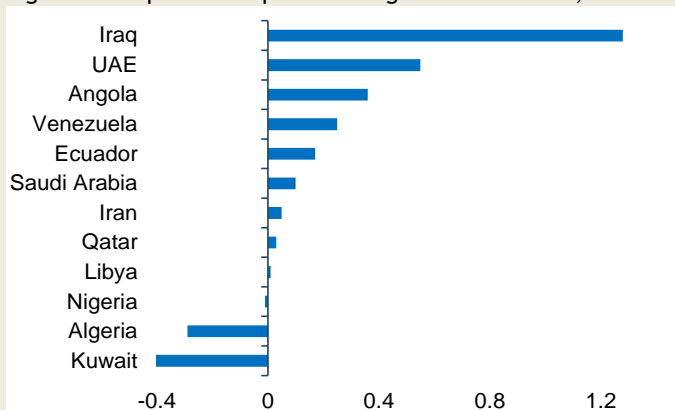
Table 9: Global real GDP growth, percent

	2009	2010	2011	2012	2013	2014f	2015f	2016f
World	-1.9	4.3	3.1	2.5	2.4	2.6	3.2	3.4
High Income	-3.6	3.0	1.8	1.5	1.2	1.8	2.4	2.5
Developing Countries	3.0	7.8	6.3	4.8	4.8	4.5	5.0	5.3
Euro Area	-4.4	1.9	1.6	-0.6	-0.4	0.9	1.4	1.8
Russia	-7.8	4.5	4.3	3.4	1.3	0.5	0.3	0.4

Source: World Bank Global Economic Prospects Group and World Bank Russia team.

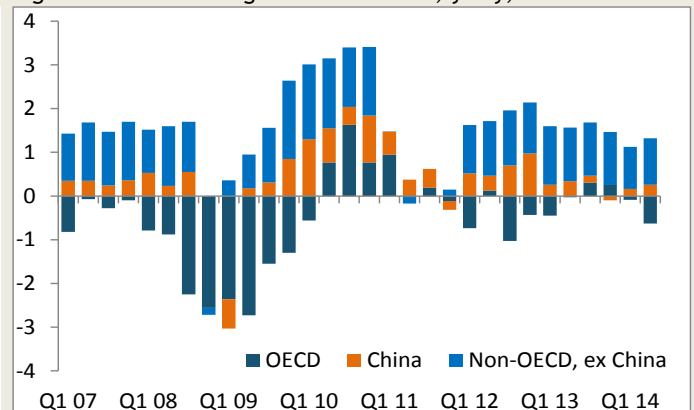
**World demand for crude oil is expected to moderately increase, offset by good supply prospects from non-conventional sources.** In 2014, global oil demand is expected to increase by 1.1 million barrel per day (mb/d) to reach 92.7 mb/d in 2014 and 94.0 mb/d in 2015. As in the recent past, all of the demand growth will originate in non-OECD countries. In fact, demand by OECD economies contracted during the first two quarters of 2014 (by 0.09 mb/d and 0.63 mb/d respectively). China is expected to be a key contributor to demand growth: during the past decade China has increased its consumption at almost 0.5 mb/d a year. On the supply side, increase in crude output is expected for Iraq and Libya. Libya could boost its production to 1 mb/d by the end of September, up from 0.5 mb/d during the summer. Iraq is expected to account for 60 percent of OPEC’s additional capacity during the next five years (Figure 30). In the United States the Energy Information Agency forecasts US crude oil output to reach 9.28 mb/d day next year, the highest annual average since 1972. In fact, the crude oil shortfalls in various OPEC countries of the past few years have been counterbalanced almost barrel for barrel by rapid expansion of unconventional oil production in North America (shale oil in the US and tar sands in Canada).

Figure 30: Expected oil production growth until 2019, mb/d



Source: IEA.

Figure 31: Growth of global oil demand, y-o-y, mb/d



Source: IEA and World Bank staff calculations.

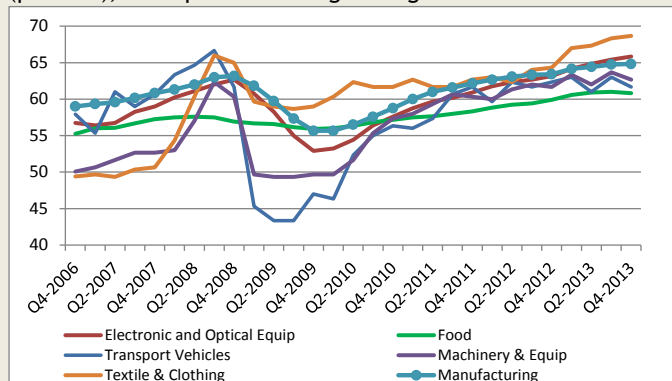
**We expect the continuation of recent trends at the oil market and project an average oil price of 103/bbl in 2014 and of \$100/bbl in 2015.** Over the longer term, oil prices are expected to recede slightly in real terms due to growing supplies of unconventional oil, combined with efficiency gains and (to a lesser extent) substitution away from oil. The assumption behind such projections reflect the high cost of developing additional oil capacity, notably from the oil sands in Canada, which is currently assessed by the industry at about US\$90/bbl in 2014 constant terms. OPEC, which usually limits supplies in order to sustain prices, may actually slightly increase supplies not to let prices rise too high for fear of inducing technological innovations that eventually could reduce oil demand. Removal of fuel subsidies, especially in Asia, is gaining momentum and will likely dampen further oil demand, especially in the longer term—fossil-fuel consumption subsidies worldwide accounted for US\$544 billion in 2012, half of which goes to oil products.

**Box 9: The potential impact of import substitution**

**Manufacturing industries took advantage of the sharp Ruble depreciation and import contraction in the first half of 2014.** The Ruble real effective exchange rate lost 6.4 percent in the first half of the year relative to the same period a year ago, which resulted in a contraction of imports. It appears that manufacturing industries reacted positively to changes in relative prices, reporting an acceleration of economic activities in the second quarter. Capacity utilization rates inched up (Figure 32). The positive impulse to manufacturing production from import substitution appeared to have been carried over into the third quarter. The seasonally adjusted HSBC Russia Manufacturing PMI remained above the 50 threshold in July-August 2014 indicating cautious expansion, despite overall slowing consumer demand. The introduction of restrictions to food imports by Russia in August 2014 added to the potential positive impact of import substitution on economic activities.

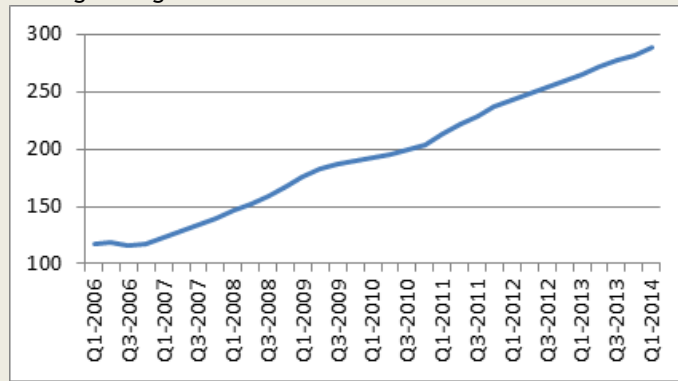
**However, the impact of import substitution could be short-lived and limited by structural constraints.** In the third quarter of 2014, the Ruble stabilized around its medium-term equilibrium and the rate of depreciation slowed. This could close the depreciation window, through which manufacturing industries received some competitive advantage, by the end of 2014. Manufacturing firms might also again face capacity constraints. Although the nominal capacity utilization rate appears low (Figure 32), major tradable sectors were already at comparable levels of production capacity in 2013 as in 2007, when growth was approaching 8 percent. A further increase in the capacity utilization rate may be constrained and require capital investment. Firms also continue facing a tight labor market, which is reflected by steady growth in unit labor cost (Figure 33). As a result, import substituting firms will continue facing increasing cost pressures. Given constrained capacity, they may choose to increase prices rather than production. Agriculture—with relatively low capital intensity and short production cycle—could benefit from the import ban on food throughout 2015. Overall, the positive impact of import substitution will likely taper off in the second half of 2015, unless investments in capacity expansion are carried out.

**Figure 32: The rate of capacity utilization in manufacturing (percent), four quarter moving average**



Source: Haver Analytics.

**Figure 33: Unit labor cost in Russia, 2005 = 100, four quarter moving average**



Source: Haver Analytics.

**Our baseline scenario has the following assumptions in regard to monetary and fiscal policy.** The CBR completes its move to inflation-targeting by 2015 and refrains from interventions on the exchange rate market, allowing a free float of the Ruble from January 2015. For the remainder of 2014, we assume that the CBR will not intervene in the foreign exchange market and the exchange rate for the bilateral currency basket stays within the targeted band. In such an environment, Russia’s foreign reserves should stay largely intact and will depend on the movement in US\$/Euro exchange rate. Inflation pressure will persist in the remaining four months of 2014 assuming a slightly weakening Ruble and the impact of Russia’s ban on food imports. We estimate that inflation will increase to around 8.0 percent by year-end, above CBR’s upper bounds of the inflation target range of 6.0-6.5 percent for 2014. Inflation pressure is expected to subside somewhat in 2015 with a smaller Ruble depreciation but assuming a potential accelerated indexation of utility prices. As a result, we project inflation will moderate to 6-7 percent in 2015 before moving close to the CBR’s target range by 2016. Our fiscal projections for the baseline assume that the fiscal rule remains intact. Expenditures are projected in line with the revised parameters of the medium-term budget (Box 10). In addition, no changes to the tax regime will be introduced that could significantly affect the revenue structure. Provided that government has limited capacity to scale up expenditure due to the fiscal rule, the consolidated fiscal position is projected to remain relatively stable with a deficit of 1.1 percent in 2014 cushioned by the flexible exchange rate and favorable oil prices. In 2015, the deficit is projected to increase to 2.1 percent due to some expenditure expansion and slightly lower projected oil prices than in 2014.

Box 10: Government's medium-term budget framework for 2015-2017

The government's medium-term draft budget policy document *Key directions of the budget policy for 2015 and for the planning period of 2016 and 2017* is currently discussed by the government and parliament. The draft contains a preliminary, medium-term budget forecast and some estimates for budget execution of 2014 budgets. Similar to the envisioned objectives of the medium-term framework documents of previous years, a gradual fiscal consolidation is planned, with the key assumption being that the non-oil federal budget deficit will fall over time, from 10.1 percent of GDP in 2014 to 9.0 percent of GDP in 2017. The consolidated budget deficit is expected to rise to an altogether higher level than projected in the current Budget Law of 2014-2016 to 2.4 percent of GDP in 2015, a 1.4 percent of GDP increase over 2014. At the same time, consolidated revenue and expenditure are projected to decline by 1.4 percent of GDP and 0.9 percent of GDP respectively (Table 10). This constitutes a noticeably worsened of projections for the consolidated budget parameters compared to the previous framework of 2014-2016 and reflect changes in the geopolitical environment.

Table 10: Government budget medium-term framework for 2014-2017, percent of GDP

	Current Budget Law of 2014-2016			Amended Current Budget	Medium Term Budget Document of 2015-2017		
	2014	2015	2016	2014	2015	2016	2017
<b>Consolidated Budget</b>							
Expenditures	37.2	37.3	37.0	37.8	38.9	38.1	36.9
Revenues	36.4	36.4	36.8	36.9	36.5	36.3	35.5
Balance	-0.8	-0.9	-0.2	-1.0	-2.4	-1.8	-1.4
<b>Federal Budget</b>							
Expenditures	19.0	19.3	18.9	19.5	20.0	19.5	18.9
Revenues	18.5	18.3	18.3	19.9	19.4	18.9	18.3
Balance	-0.5	-1.0	-0.6	0.4	-0.6	-0.6	-0.6
Non-Oil Balance	-9.4	-9.6	-8.4	-10.1	-10.3	-9.7	-9.0
Urals crude oil price, US\$/barrel	101.0	100.0	100.0	104.0	100.0	100.0	100.0

Source: Ministry of Finance.

Our baseline projections for external balances assume relief will come in the second half of 2015 from a lifting of sanctions. The impact on trade flows of the already introduced sanctions and Russia's import ban is projected to be relatively limited in 2014. We assume relatively stable capital flows in the last four months of 2014, with the capital account deteriorating to an estimated US\$113 billion (mostly due to larger outflows in the first three quarters of the year). Banks and corporation will be able to rollover their external liability even with the current restricted access to international capital markets. As a result, the CA will improve in 2014 to US\$62.8 billion, taking advantage of import contraction and improved income balances. Given sluggish growth due to weakening domestic demand and the continuation of current sanctions in the first half of 2015, the CA will marginally deteriorate in 2015 to a surplus of US\$57.9 billion. As CBR completes its transition to a flexible exchange rate management, improvement in the capital account should generally reflect the projected deterioration of the CA, with net capital flows decreasing as geopolitical tension subsides. Restricted access to capital markets will continue for some time and will have a negative impact on the debt-rollover profile of Russian banks and corporations. This will result in a deficit of US\$60.1 billion in the capital account.

The baseline scenario is accompanied by an optimistic scenario and a pessimistic scenario (Figure 29). Those two alternative scenarios update the previous low-risk and high-risk scenarios from March.<sup>13</sup> However, we narrowed significantly the projection continuum we developed at beginning of the geopolitical tensions. For 2014, the baseline and the optimistic scenarios assume growth of 0.5 percent while the pessimistic one projects an expansion of 0.4 percent. In 2015, the baseline expansion of 0.3 percent is straddled by an expansion of 0.9 percent in the optimistic scenario and a contraction of 0.9 percent in the pessimistic scenario. By 2016, baseline growth is assumed to remain broadly unchanged at 0.4 percent, while growth under the optimistic scenario is projected to quicken to 1.3 percent and the contraction under the pessimistic scenario is assumed to moderate to 0.4 percent.

<sup>13</sup> See World Bank Russia Economic Report №31: *Confidence Crisis Exposes Economic Weakness*.

### Alternative Scenario Projections

The optimistic scenario projects a small recovery following the full resolution of the geopolitical tensions and an end of all sanctions by the end of 2014. This assumes that the tensions would be contained in a peaceful fashion and an orderly resolution will ensue. This would restore access to international capital and financial markets and confidence would start to gradually improve during 2015, although some impact of the tensions would linger. The result would be a slow recovery in private consumption and private investment, supported also by some renewed focus on structural reforms in late 2015. Growth would improve from 0.5 percent in 2014 to 0.9 percent in 2015 and 1.3 percent in 2016. The growth outlook in this scenario has the same expectations as the baseline scenario in regard to the external conditions in 2014-2016. Only expectations regarding domestic demand differ (Table 11). Consumption growth would initially decrease in this scenario from around two percent in 2014 to 0.9 percent in 2015, negatively affected by slowing income growth in the preceding periods and still elevated inflation levels. In 2016, it would recover back to 1.5 percent as sentiment gradually improves and growth regains some momentum. In addition to the public investment boost assumed in the baseline scenario, private investment growth would gradually recover towards the end of the projection period, given strengthening confidence in the face of subsiding policy uncertainty and signals of a renewed focus on structural reform. Gross capital formation is projected to increase by 1.5 percent in 2015 and 2.5 percent in 2016. Robust export demand and lower import demand due to weaker consumption will result in a slightly negative contribution of net exports to growth.

For the optimistic scenario, the baseline assumptions about fiscal and monetary policy remain intact, while outcomes for external balances are expected to be similar. However, the optimistic scenario contains slightly more favorable projections on inflation dynamics and Russia's external position. As in the baseline, inflation accelerates to around 8.0 percent by year-end of 2014, but inflation pressure would subside somewhat faster in 2015 with the potential elimination of the food import ban and a lesser Ruble depreciation. Inflation would stand in 2015 at around 6 percent and reach by 2016 a level close to CBR's medium target. The 2014-2015 balance of payments outcomes under the optimistic scenario are similar to the baseline, with differences reflecting the extent of the Ruble depreciation and capital flows. The removal of the all sanctions by the end of 2014 and a more vibrant economy could result in a faster shrinking of the CA surplus to US\$42.9 billion. Given the assumed full transition to a flexible exchange rate management, improvements in the capital account should reflect the projected deterioration of the CA with net capital flows decreasing as geopolitical tension subsides. The banks and non-financial corporations would restore their roll-over capacity faster than in the baseline, which would result in somewhat lower deficit on the capital account of US\$45.0 billion.

Table 11: Main economic indicators: optimistic scenario

	2012	2013	2014	2015	2016
GDP growth (%)	3.4	1.3	0.5	0.9	1.3
Consumption growth, percent	6.8	3.5	2.2	0.9	1.5
Gross capital formation growth, percent	0.6	-6.0	-8.1	1.5	2.5
General government balance (percent of GDP)	0.4	-1.3	-1.1	-2.3	-1.2
Current account (US\$ billions)	71.3	34.1	62.8	42.9	28.6
<i>percent of GDP</i>	3.6	1.6	3.1	2.0	1.3
Capital account (US\$ billions)*	-32.3	-62.2	-113.0	-45.0	-25.5
<i>percent of GDP</i>	-1.6	-3.0	-5.6	-2.1	-1.1
Oil price assumption (US\$ per barrel)	105.0	104.0	102.9	99.5	100.1
CPI inflation	5.1	6.8	8.0	6.0	5.0

Source: World Bank staff estimates. Note: \*Current account minus change in reserves.

The pessimistic scenario projects an increasing intensity of geopolitical tensions, which would see the economy slipping into a protracted low-level recession. Access to the international capital market would become increasingly restricted for Russian companies and banks, further increasing borrowing costs and hampering investment activities. Additional sanctions (including short-term gas trade limitations) over the projection period would translate into heightened policy uncertainty and capital flight, high exchange rate volatility and Ruble depreciation with a detrimental impact on confidence and investment activities. Yet, this scenario assumes that the international community would still refrain from oil trade sanctions. The economy is projected to contract by 0.9 percent in 2015 and by 0.4 percent in 2016 (Table 12). Domestic demand would stay depressed longer than we projected in our baseline scenario, continuing to contract throughout 2016. Even an

assumed relaxation of the fiscal rule would not result in enough public investment growth to compensate for the contraction in private investment, leading to continued decline in gross capital formation in 2016. Lower income growth, high inflation and higher consumer credit defaults, together with depressed sentiments, would bring consumption growth to a crawl, stalling the economy's main growth engine during the coming years.

Table 12: Main economic indicators: pessimistic scenario

	2012	2013	2014	2015	2016
GDP growth (%)	3.4	1.3	0.4	-0.9	-0.4
Consumption growth, percent	6.8	3.5	2.0	-0.3	-0.3
Gross capital formation growth, percent	0.6	-6.0	-8.5	-4.3	-1.2
General government balance (percent of GDP)	0.4	-1.3	-0.7	-2.8	-1.2
Current account (US\$ billions)	71.3	34.1	69.3	82.2	80.8
<i>percent of GDP</i>	3.6	1.6	3.6	4.5	4.3
Capital account (US\$ billions)*	-32.3	-62.2	-128.0	-82.3	-80.0
<i>percent of GDP</i>	-1.6	-3.0	-6.6	-4.5	-4.3
Oil price assumption (US\$ per barrel)	105.0	104.0	102.9	99.5	100.1
CPI inflation	5.1	6.8	8.0	10.0	8.0

Source: World Bank staff estimates. Note: \* Current account minus change in reserves.

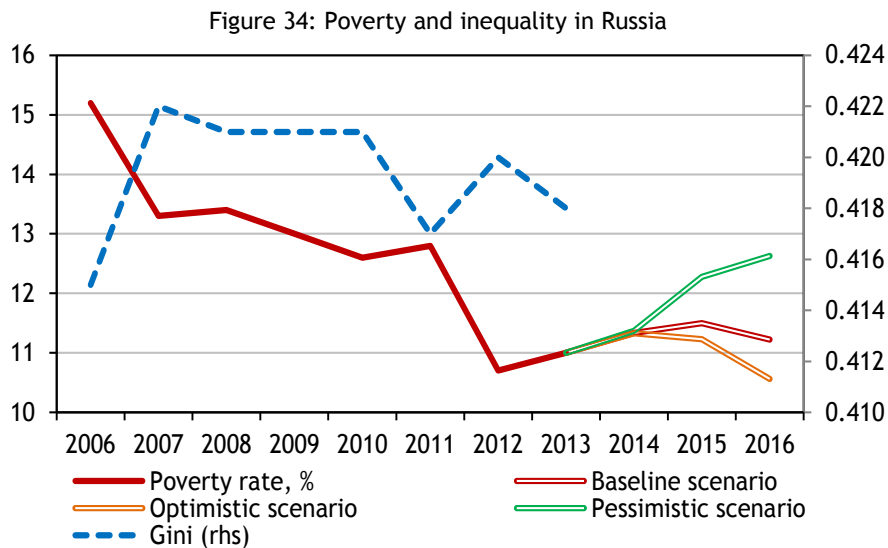
**Under the pessimistic scenario, the assumptions for fiscal policy differ from the baseline scenario, while the monetary policy assumption remains little changed.** However, in 2014, the Ruble will remain under high pressure due to a return of large geopolitical uncertainty. Given that the CBR has already lost about US\$44 billion of its foreign exchange reserve from the end-2013 till the mid-September of this year, the reserve position will further deteriorate by end-2014 as the CBR reverts to interventions in the fourth quarter of 2014 to support the Ruble at the upper limit of the bilateral currency basket. Continued rapid depreciation of the Ruble coupled with non-monetary factors (articulated in the baseline scenario) will result in inflation accelerating to 10 percent in 2015, assuming no further tightening of monetary conditions by CBR in the upcoming months. As in the other two scenarios, the CBR completes its move to inflation-targeting by 2015, refrains from foreign exchange interventions and sees foreign exchange reserves stabilize. The fiscal position is expected to deteriorate as the government relaxes its fiscal rule in order to scale up expenditures to provide additional fiscal stimulus in 2015 in an attempt to lift the economy out of the recession. We anticipate that the cap on expenditure will be lifted up by 1 percentage point of GDP, allowing the government to scale up the ongoing investment programs and to increase the indexation of social transfers. However, such an additional fiscal stimulus is likely to have only a marginal and short-lived effect on economic growth, given the low level of multiplier for government spending in Russia and lingering structural constraints. The fiscal position is expected to deteriorate to a deficit of 2.8 percent in 2015.

**In the pessimistic scenario, external balances would be more profoundly altered as compared to the baseline.** Higher import contraction in both 2014 and 2015 due to a continued depreciation of the Ruble and additional trade sanctions could result in a larger CA balance of US\$69.3 billion in 2014 and US\$82.2 billion in 2015. With new sanctions in place, Russian banks and corporation will find it increasingly difficult to roll over their external debt in 2015, which will also contribute to net capital outflows. Russia would also face an acceleration of net capital outflows due to further deterioration of market sentiment, reduced FDI inflows and reallocation of assets away from Russia. As a result, the deficit on the capital account is projected to remain large at US\$82.3 billion in 2015.

## 2.2 Development And Policy Challenges

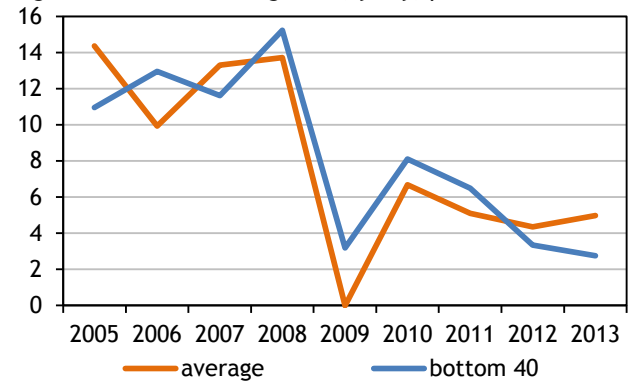
### Poverty And Shared Prosperity Risks

Our poverty forecast projects little potential for further improvement in the near term (Figure 34). This forecast is driven by the core assumptions of high food and service inflation—outpacing headline inflation—and stagnating or declining real incomes. In our three growth forecast scenarios<sup>14</sup>, we expect the poverty rate to increase slightly in 2014 (up to 11.3 percent under the baseline and the optimistic scenario and up to 11.4 percent under the pessimistic scenario). However, in 2015 and 2016, the differences between the scenarios would become more significant. As income is assumed to stagnate under the baseline scenario, we project a further minor uptick of the poverty rate under the baseline scenario to 11.5 percent in 2015 and some correction to 11.2 percent in 2016. In the optimistic scenario, we expect the poverty rate to stagnate in 2015 and then revert back to historically low levels of around 10.6 percent in 2016. In the pessimistic scenario, while income is expected to decelerate, the poverty line will continue to grow fast in a high-inflation environment. This would result in an increase of the poverty rate to 12.3 percent in 2015 and 12.6 percent in 2016.



Another challenge will be to further increase shared prosperity. In recent years, the shared prosperity indicator—as measured by the average income growth of people in the bottom 40 percent of the income distribution relative to the average growth rate of income—worsened in Russia. Consistent with the trends described above, real income growth of the bottom 40 percent of population significantly decelerated in 2012-2013 to 3 percent from almost 10 percent in 2005-2011 (Figure 35). That was lower than for the whole population, whose income growth was relatively stable at 4-5 percent a year, according to the Household Budget Survey. This deceleration of income growth for the bottom 40 percent already negatively affected poverty reduction and is likely to limit further the evolution of the shared prosperity indicator in the future.

Figure 35: Real income growth, y-o-y, percent



<sup>14</sup> The shape of distribution is assumed to be stable. Changes in poverty are driven by the average income and poverty line dynamics.

### Box 11: Recent poverty and inequality trends

**Low income growth resulted in less positive poverty dynamics during the first half of 2014.** We estimate that the seasonally adjusted poverty rate for first quarter of 2014 was the same as a year ago, 10.6 percent (Table 13). The total poverty rate for Russia is low compared to other countries in the Europe and Central Asia region, yet the variation across Russia's regions remains significant (Figure 37). Among the regions with lowest poverty rate are the resource-rich Yamal-Nenets Autonomous Area (6.9 percent) and the Tatarstan Republic (7.2 percent), along with the Belgorod oblast (7.6) and Moscow oblast (7.7). The highest poverty rates are in the Tuva and Kalmyk republics (35.1 and 35.4 percent). There was a small increase in the absolute number of poor since 2013. Due to the strong seasonality in poverty and income dynamics, annual data is the more reliable indicator: the yearly poverty rate was almost flat at 11.0 percent in 2013 compared to 10.7 percent in 2012. The average income growth was offset by faster growth in prices for goods in the poverty-line basket.

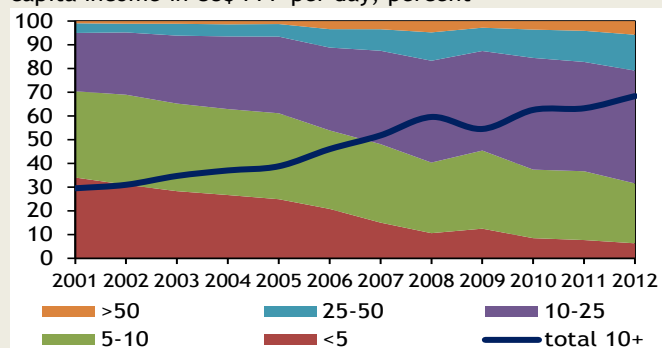
Table 13: Poverty rates in Russia, percent

period (cumulative)	2010	2011	2012	2013	1Q 2013	2Q 2013	3Q 2013	4Q 2013	1Q 2014	2Q 2014
poverty rate, per cent	12.5	12.7	10.7	11.0	13.8	13.0	12.6	11.0	13.8	13.1

Source: Rosstat and World Bank staff estimates.

**The inequality measure for Russia remains stable.** The Gini coefficient remains at the level of 0.418 (Figure 34), in line with the average for 2007-2013 when it stood at 0.420. As this indicator is not very informative in recording the changes in the shape of the distribution, we also looked at indicators for recent middle-class dynamics in Russia. We defined the middle class as people with per capita income exceeding 10 US\$ PPP per day<sup>15</sup>. In 2011, the share of the population belonging to this group increased slightly to 63.3 percent from 62.6 percent in 2010 (Figure 36). In 2012, this already high share increased further to 68.4 percent. Within the Europe and Central Asia region, Russia is one of the best-performing countries when this middle-class definition is applied. However, a closer look to the distribution indicates that this growth was driven by the expansion of the share of the relatively better-off people within that group. The share of population with a per capita income of 25-50 US\$/day increased from 11.9 percent in 2010 to 15.1 in 2012. The increase in the share of the population with an income of 50 US\$/day and more was even steeper in relative terms—from 3.6 percent in 2010 to 5.7 percent in 2012. In contrast, the share of the population with an income of 10-25 US\$/day stagnated at around 47 percent (47.1 in 2010 and 47.5 in 2012, Figure 36).

Figure 36: Income distribution: share of population with per capita income in US\$ PPP per day, percent



Source: World Bank staff estimates based on RLMS data.

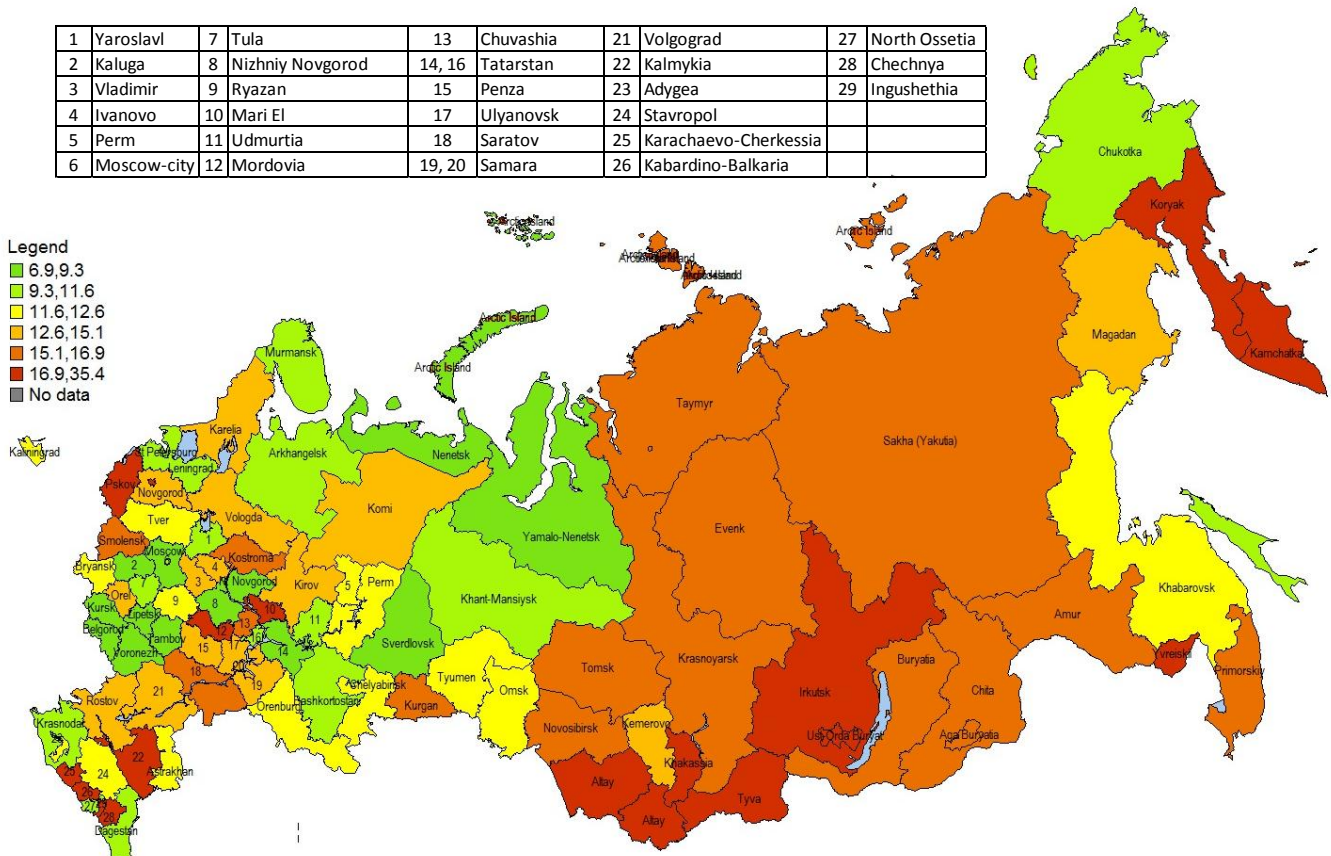
### Policy Risks

**Economic recovery in 2015 and afterwards would depend on solid private investment growth and a lift in consumer sentiments.** In addition to macroeconomic stability, this would require a positive shift in business and consumer confidence based on a predictable policy environment. Without significant structural reforms directed to strengthening regulatory and market institutions and tackling inefficiencies in factor allocation across the economy, this is unlikely to happen and would subdue long-term growth prospects. The current stalling of structural reforms represents a down-side risk to Russia's medium- and long-term outlook. While it will remain important to pursue policies to maintain macroeconomic stability and policies to safeguard the economy from the impact of the current geopolitical tensions, this policy effort should go hand in hand with renewed focus on improving the economy's microeconomic fundamentals and allow for more efficient markets. The special focus part of this report will suggest structural reform priorities to unlock Russia's growth potential within the framework of finding a more diversified development path for the country.

<sup>15</sup> These estimations were done on RLMS data in the comparable approach with the Focus note of the Russia Economic Report no. 31. However, all this estimation should be taken with caution as survey data is usually biased downward due to underreporting of incomes and expenditures and under-representativeness of people with high incomes.



Figure 37: Poverty rates in 2013, percent



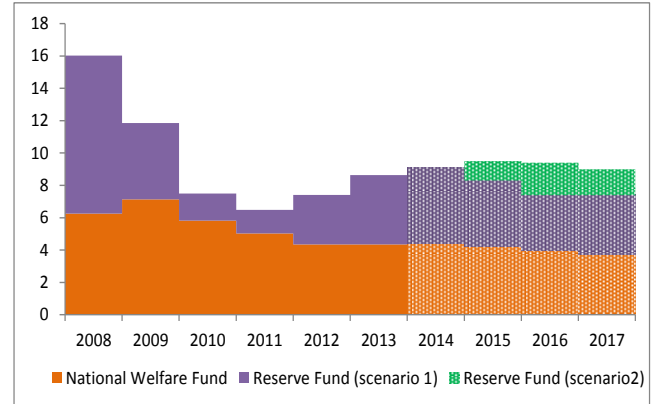
Source: Rosstat and World Bank staff estimates.

**Structural constraints in the economy also diminish the effectiveness of the Central Bank’s disinflation policy.** It appears that Russia’s output gap remains effectively closed, with the economy operating near its capacity limits. A tight labor market, a high level of capacity utilization and depressed investment activities make CBR’s disinflation policy increasingly difficult. In the current environment of heightened geopolitical tension and increased uncertainty, a loosening of its monetary stance could lead to increased pressure on the Ruble and accelerating capital outflows. This leaves the CBR no option but to keep monetary conditions tight if it is to achieve the longer-term inflation target of 4 percent. However, this inflation target might underestimate the impact of structural constraints on inflation dynamics. We see some stagflation risk, unless the process of removing structural constraints to economic growth begins.

**In the current environment of elevated inflation risk, it will be particularly important to adhere to fiscal prudence, given also that the economy operates near its production frontier.** There is increasing pressure for higher fiscal expenditure and off-budget stimuli to the economy. Such stimuli might lead to some marginal and short-term growth impulses, but it would likely come at the cost of even higher inflation, thus not presenting a credible alternative. Counterbalancing the effects of structural constraints in the economy is beyond best Central Bank policy or fiscal policy, and, in this case, a fiscal stimulus could not mask them for long. However, adherence to a clear medium-term fiscal target, such as a non-oil deficit target or the current fiscal rule, could prevent the temptation to expand counter-cyclical policy to a level that would jeopardize long-term fiscal sustainability. Difficult times test the credibility of policies, and now is the right moment to display policy commitment.

In its medium-term fiscal outlook for 2015-2017, the government acknowledges the risks to fiscal stability and quantifies the parameters of utilization of the Reserve Fund to finance unforeseen budget deficits in case such risks materialize. Key risks to the budget identified and quantified by the Ministry of Finance are: (1) lower oil and non-oil revenues, (2) lower privatization proceeds, and (3) fewer domestic and foreign borrowing options. Under the scenario of materialization of all budget risks, the Reserve Fund is projected to diminish to 2.9 percent of GDP by end 2017. Otherwise, the Reserve Fund is projected to increase to about 5.3 percent of GDP by 2017. The NWF is forecasted to decline to about 3.7 percent of GDP by 2017 (Figure 38).

Figure 38: Reserve and National Welfare Funds in 2008-2017, percent of GDP



Source: Ministry of Finance and World Bank staff calculations.

In the short-term, the positive impulse of import substitution might increasingly be used to promote protectionist measures. Even before the current geopolitical tensions started, government showed interest in supporting selected firms and sectors that would benefit from import substitution, an example being the ban of pork products at the beginning of this year (Box 9). There is a risk that government will continue protectionist measures once import substitution effects vanish. This could delay the structural reforms that would help the Russian economy become globally more competitive.

#### Box 12: Russia and the World Trade Organization

Russia formally joined the WTO on August 22, 2012, but its WTO commitments are designed to be implemented on a phased basis. They are laid out in a series of schedules included in the WTO Protocol of Accession. For example, tariffs are to be reduced gradually from the date of accession through 2019. Some liberalization in services is also on a phased-in basis, e.g. limitation of foreign equity for telecoms companies (2016) and market access for foreign insurance companies (2021). Russia has already joined the Information Technology Agreement. The country is obligated to join by 2016 the WTO Government Procurement Agreement.

Questions remain whether Russia's regulatory standards affecting imports fully comply with WTO norms. During its accession process, Russia declared to the WTO Working Party that its regulations in the areas of technical barriers to trade (TBT) and sanitary and phytosanitary standards (SPS) conform to the relevant provisions of the WTO TBT and SPS Agreements. However, many products that satisfy safety and health requirements in non-Russian markets appear not to satisfy Russia's current regulatory standards. Russia's standard-setting measures are based on a Soviet-era historical model, the GOST standards.<sup>16</sup> The WTO Agreements require that national regulations shall be directed at legitimate objectives such as human health or safety; the health of animals, plants and the environment; national security requirements and the prevention of deceptive practices. It shall not be applied in a manner that would constitute a disguised restriction on international trade or create unnecessary obstacles to trade.<sup>17</sup> There are concerns among Russia's trading partners as to whether Russia's current TBT and SPS practices conform to international standards, or provide the degree of market access envisioned by the relevant WTO agreements. These concerns give rise to potential challenges of such practices in the Dispute Settlement Mechanism.

In January 2014, Russia excluded the import of live pigs, pork, and pork products from the European Union by its SPS policy. Altogether, these products amounted in 2013 to US\$1.3 billion in imports. On April 18, 2014, the EU requested consultations with the WTO Dispute Settlement Body (DSB) with regard to the ban of pork products. The pork product ban followed the detection of four cases of African swine fever in wild boar in Lithuania and Poland. However, the ban applies to live pigs, pork, and pork products from throughout the European Union. One issue in the dispute involves localization requirements, which refer to attempts by a country or customs territory (such as the EU) to impose measures for control of diseased animals on part of its territory—such as quarantines—and to have the rest of the territory certified as disease-free. Russia maintains that EU localization measures are not sufficient, that additional information is required, and the EU has not provided it. The EU states that it has sought to provide relevant information and that measures that would ban pork from, for example, Spain, because of SPS issues in Lithuania and Poland, are not scientifically grounded. It further states that Russia does not appear to effectively control the disease on its own territory, citing nearly 1,000 cases of the same disease among Russian wild boar and domesticated animals since 2007. On July 22, 2014, the DSB established a panel for the dispute.

The recent sanctions and countersanctions may pose additional challenges to the WTO. The Dispute Resolution Mechanism with appeal requires about 15 months to operate and, in practice, can take many years when there are strong disagreements between the parties. Moreover, parties have invoked national security concerns in connection to their sanctions. The WTO agreements contain a broad exception for countries to determine what national security measures they apply to trade (GATT 1947, Article XXI (b)(iii)<sup>18</sup>). Such claims have rarely been challenged historically, and there is little WTO jurisprudence on the potential contestability of national security measures.

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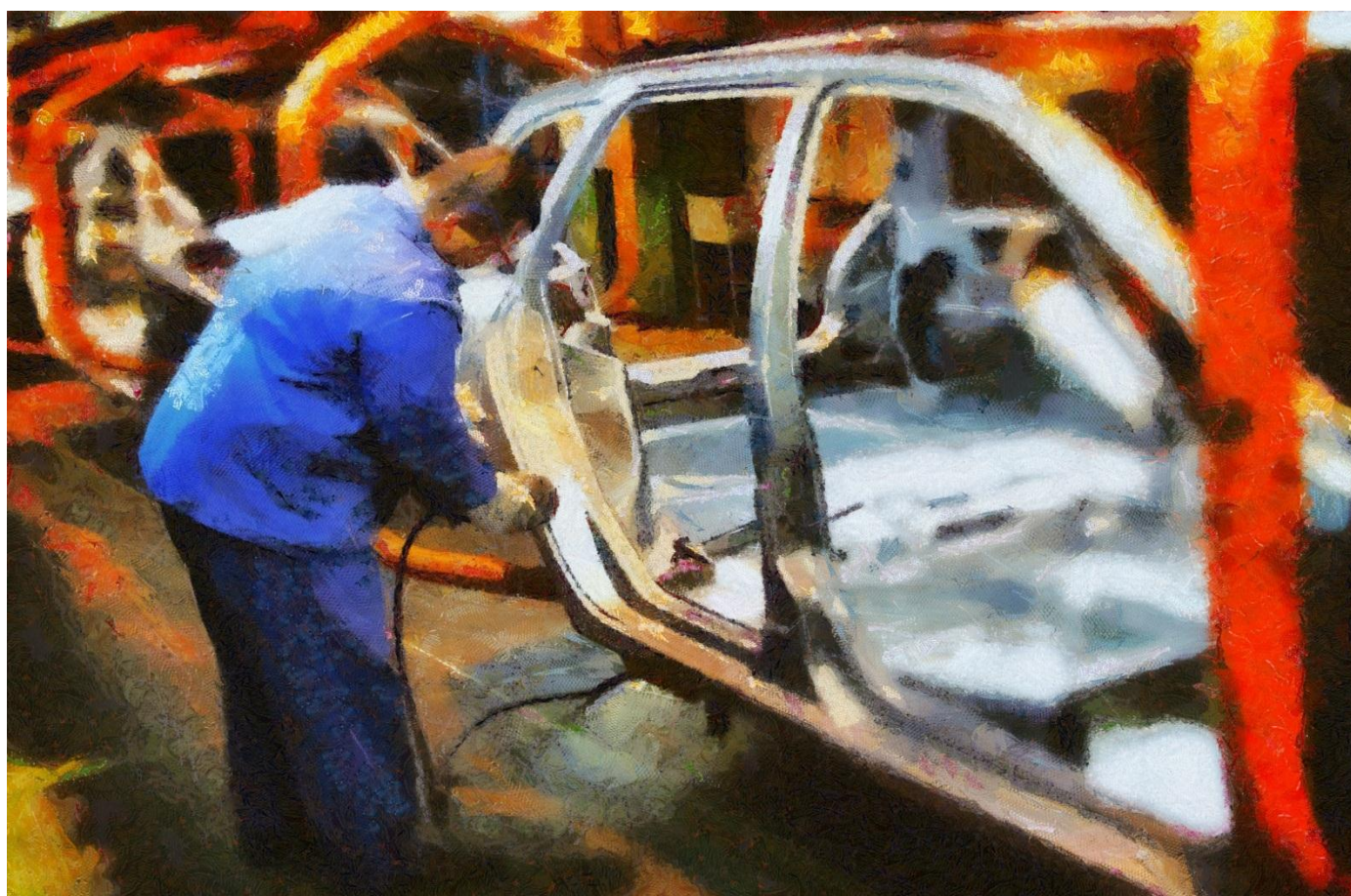
<sup>16</sup> The name GOST is derived from a Russian phrase meaning “state standard” (*gosudarstvenny standart* in Romanized form, *государственный стандарт* in Cyrillic.)

<sup>17</sup> This language is adapted from Article 2 of the SPS Agreement and Article 2 of the TBT Agreement.

<sup>18</sup> Article XXI(b)(iii), with its chapeau, states: “Nothing in this Agreement shall be construed...to prevent any contracting party from taking any action which it considers necessary for the protection of its essential security interests...taken in time of war or other emergency in international relations.”

### Part III. Paths to Diversified Development in Russia<sup>19</sup>

*World Bank research on resource-rich nations suggests that economic diversification is neither necessary nor sufficient for economic development. Interventions to diversify economies appear to work only when they are supported by policies to diversify their assets. There is a stronger correlation between diversified assets and greater efficiency. This means the government needs to worry less about the composition of exports and the profile of production, and more about the diversity of its national asset portfolio—the blend of natural resources, built capital, and economic institutions. This diversification approach implies a rich reform agenda for Russia, as its portfolio is heavy in tangible assets such as oil and gas, and even hard infrastructure such as schools, but it is still light in intangibles, such as institutions for managing volatile resource earnings, providing high-quality social services, and even-handedly regulating enterprises. It was investments in intangibles that allowed economies dominated by extractive industries to become innovative and successful.*



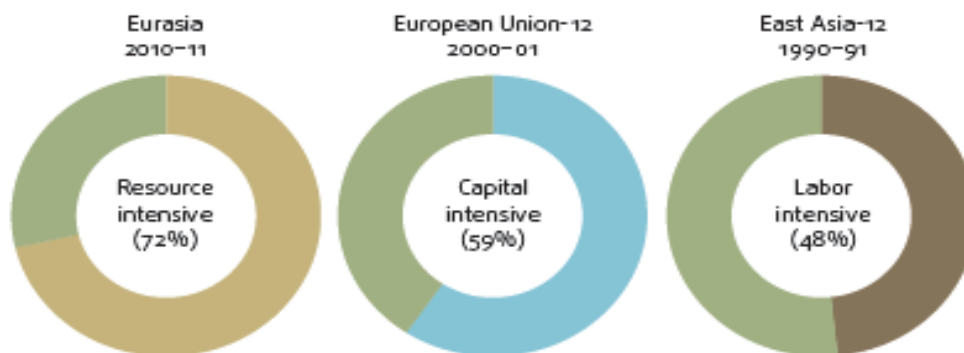
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<sup>19</sup> This note is based on the recent World Bank Europe and Central Asia Regional Flagship Report: *Diversified Development: Making the Most of Natural Resources in Eurasia*. Washington, DC 2014. The authors of the report are Indermit Gill, Ivailo Izvorski, Willem van Eeghen, and Donato De Rosa. This note was produced by Donato De Rosa, Elena Bondarenko and Ekaterina Ushakova.

### 3.1. Introduction

How to make most of its natural resources is the main question for Russia, which integrated into the world economy by exporting resource-intensive products. This question is one of several on diversified development that are discussed in a recent World Bank report (2014) which seeks to contribute to the debate on what governments must do to develop their countries. It also derives lessons from success stories of other countries that integrated into the world economy with the export of resource-intensive products. Russia and several Eurasian countries are large exporters of resource-intensive products. Their growth path in the past two decades differed in that respect from other countries: Asia's rapidly growing economies integrated with labor-intensive products into the global markets. Their growth path was dominated by importing capital and know-how and exporting goods and services that require a great deal of labor. Central European economies entered the global economy by exporting capital-intensive goods and services. Their deep and comprehensive integration with the policies and institutions of the European Union led to the largest inflows of foreign capital and Western know-how in history (Figure 39).

Figure 39: Three ways to integrate and grow: export product share, by factor intensity



Source: World Bank staff calculations based on Comtrade.

Note: Eurasia: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, the Russian Federation, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. European Union-12: Bulgaria, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, Slovenia and Croatia.

East Asia-12: Cambodia, China, Indonesia, the Republic of Korea, the Lao People's Democratic Republic, Malaysia, Mongolia, Papua New Guinea, the Philippines, Singapore, Thailand, and Vietnam.

Factor intensity is measured with the export data classified by Standard International Trade Classification (SITC) Revision 1. The modified version of commodity classification by Krause (1987) is used. Resource intensive includes products related to hydrocarbon and minerals only. Goods related to agriculture are contained in labor intensive (unskilled labor intensive). Here, capital intensive is represented by both technology intensive and human capital intensive.

**Natural resources allowed Russia to reach high-income status in less than a decade, but the global economic crisis exposed the structural weaknesses of the commodity-driven growth model.** After bottoming out in 1998, the economy grew until 2008 on the back of rising commodity prices and spare capacity, leading to large productivity gains and expanding the output frontier. GDP grew by 95 percent, incomes per capita doubled in real terms, and poverty was drastically reduced. The share of the population living on US\$5 or less a day fell from more than 35 percent in 2001 to 10 percent in 2010. But starting in 2008, Russia experienced an abrupt end to its economic boom as a sudden reversal of capital flows caused a credit crunch and a sharp contraction in demand. In 2009, Russia's output contracted almost 8 percent. Between 2009 and 2013, economic growth averaged 1.1 percent per year, far lower than other large, emerging economies<sup>20</sup> (5.1 percent) and other resource-rich countries<sup>21</sup> (3.5 percent). Private investment plunged at the onset of the crisis by 9.2 percent in 2009 compared to the previous year. Today it remains low, with weak credit growth to the private sector and falling business creation. Productivity growth slowed from an average 4.1 percent in 1998-2008 to 1.6 percent in 2008-2012. This makes it likely that the recent slowdown in Russia's economic growth is largely due to structural rather than cyclical factors, implying that the economy as it is structured is reaching the limits of its potential output.

<sup>20</sup> BRICS countries - excluding Russia: Brazil, China, India, and South Africa.

<sup>21</sup> Resource-rich countries: Australia, Azerbaijan, Botswana, Canada, Chile, Kazakhstan, Malaysia, Nigeria, Norway, Ukraine, United States, Uzbekistan, and Venezuela.

**Structural constraints to Russia’s potential output pose the key question how to increase that potential, so that the economy can sustain high growth rates.** Given the observed slowdown in the Russian economy and its resource-based growth model, the problem is: How should the government diversify exports and the economy away from activities that depend on natural resources? The recent growth strategy based on direct government presence and active industrial policies to diversify the economy did not open the door to higher potential output. Also, at present, the margin for maneuver for expansionary fiscal policy appears to be small, limiting the scope for direct transfers for social objectives and direct interventions to help diversify production. Russia was left after the 2008 crisis with a large non-oil fiscal deficit of 14 percent in 2009 and 10 percent in 2013. Large fiscal buffers—Russia’s Reserve Fund and the National Welfare Fund—were created before the crisis, but dropped from 14 percent of GDP in 2008 to 8.7 percent in 2013. The challenge will be to identify better strategies to save some of the earnings from the oil and gas for future generations or use public resources to foster specific activities that are less extractive and more innovative. Only a broader approach to future growth potential can help Russia’s economy become more innovative as well as extractive.

**This note looks at paths to diversified development that would rebalance Russia’s portfolio of national assets: natural resources, capital and economic institutions.** The paper discusses the observed slowdown in Russia’s potential growth, assesses strengths and weaknesses of its current asset portfolio, and suggests priorities to unlock Russia’s growth potential. Russia’s growth path will remain entwined with its resource endowment, which has undoubtedly contributed to its previous success. But Russia is also rich in human capital: a highly educated population similar to Central Europe’s and great potential to increase its physical capital base, notably infrastructure. The paper will explore what challenges and opportunities those assets could hold for Russia. Moreover, the central issue for greater economic efficiency and a higher growth potential for Russia might be related to a more intangible asset: the quality of its institutions, which manage resource revenues, provide social services and regulate enterprises. Our main hypothesis is that investments in intangibles will make the difference between a more productive economy and a stagnating one.

### 3.2. Increasing Potential Output

**Russia appears to have reached its potential output.** Over 2000-2006, increases in Total Factor Productivity (TFP) were the dominant driver of output expansion. The main force behind TFP growth during this period was efficiency gains from the transition process, with the reallocation of excess capacity to more productive sectors of the economy. Over time, capital accumulation grew to account for a larger component of output expansion, while labor’s contribution became more limited. At the same time, TFP growth slowed as productivity gains from first generation reforms wore off (Figure 40). Although hard to estimate, it is likely that much of the slowdown in Russia’s economic growth is due to structural, rather than cyclical, factors, implying that the Russian economy may be reaching the limits of its potential output (Figure 41 and IMF 2014).

**The quality of physical capital and a lack of competition are a drag on productivity.** Firm-level data show that variables connected with adequate public services (infrastructure and education) and with the business environment (regulation and competition) explain up to 36 percent of aggregate log Total Factor Productivity (TFP).<sup>22</sup> Distortion of competition, in particular, has a strong adverse impact on productivity. Firms facing domestic competition display an estimated 19 percent higher productivity and are 8 percent more likely to export than firms that do not face such competition.<sup>23</sup> Among other variables, innovation, labor skills, and exporting and importing activities are all associated with higher TFP (World Bank, 2013).

**Product markets are often dominated by incumbents.** In 2001-07, the share of highly concentrated markets increased from 43 percent to 47 percent, which is high compared with most developed economies.<sup>24</sup> Most markets are dominated by a few incumbent players. Price-cost margins—an empirical measure of intensity of competition—are higher in Russia than in Europe, indicating less competition. Firms in sectors with higher price-cost margins tend to be older and larger, have smaller export orientation and R&D intensity, are more likely to operate in local markets, and, in some sectors, are less likely to operate in a competitive market structure.

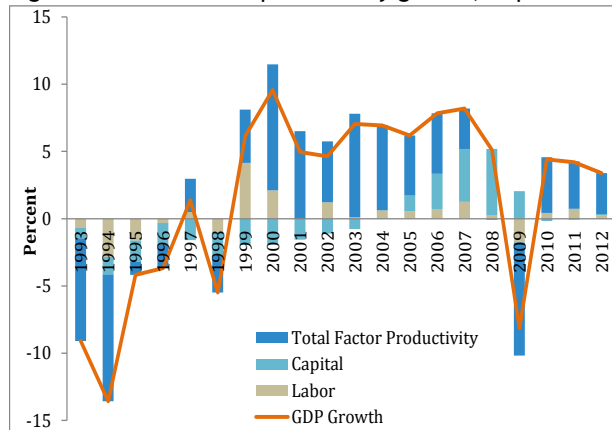
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<sup>22</sup> Variables connected with public services and with the business environment were broadly termed as the “investment climate.” In addition to “investment climate” variables, other factors explaining aggregate log TFP included in the analysis were export propensity, foreign ownership, innovation, employment, industry/region/size effects, and the constant technical efficiency term (constant term of the TFP equation).

<sup>23</sup> To evaluate how competition is related to the endogenous variables of the system, four variables approximating four measures of competition were defined: domestic, foreign, customer, and informal.

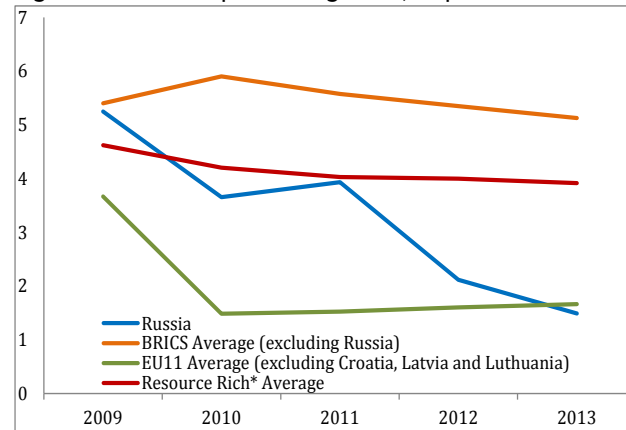
<sup>24</sup> Concentration ratios are calculated using the Herfindahl-Hirschman Index (HHI) and CR3 methodologies. A highly concentrated industry is defined as one in which the HHI is greater than 2,000. See Conway et al. (2009).

Figure 40: Total factor productivity growth, in percent



Source: Conference Board and World Bank staff estimates.

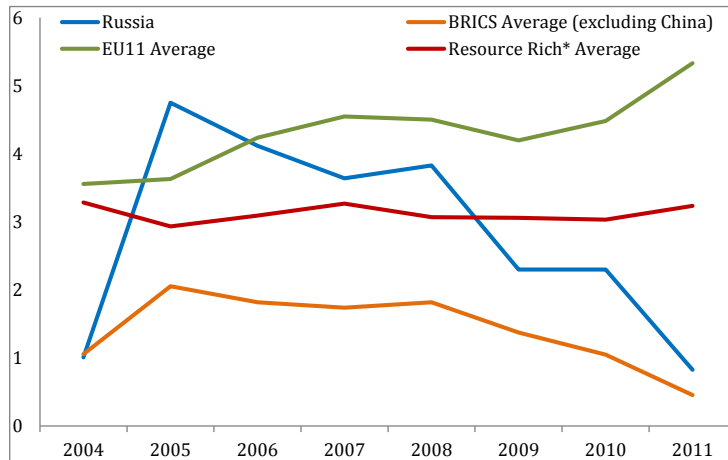
Figure 41: Russia's potential growth, in percent



Source: OECD, IMF and World Bank data<sup>25</sup>.

Note: Potential output for all countries is calculated using the production function approach.

Figure 42: Newly registered firms (LLC) per 1000 working age population



Source: World Bank.

**Uncompetitive markets are the ultimate cause of weak entrepreneurship.** The diminished access to credit following the global economic crisis is associated with a sharp decline in levels of entrepreneurship. It is, however, only one of the factors shaping the incentives to establish new firms. Levels of entrepreneurship in Russia were low (and declining) even before the crisis (Figure 42). Adjusted for the size of population, entrepreneurs register twice as many companies in Malaysia and three times as many in Chile than in Russia. The ultimate reasons for low entrepreneurship in Russia lie in an unfriendly regulatory environment, with rules that are often arbitrarily enforced, and markets dominated by incumbents.

The slowdown in potential output calls into question Russia's recent growth strategy based on direct government presence and active industrial policies to diversify the economy. Economic diversification has been a key priority for over a decade. Various tools were deployed to subsidize the non-extractive economy and jump-start an innovation-based enterprise sector that would reverse Russia's "de-industrialization" and almost exclusive reliance on commodity exports. State aid, with direct transfers and preferential treatment of enterprises, was extensively used to protect incumbent firms from competition. At the same time, a sustained attempt was made to create the basis for an innovation-driven knowledge economy, with massive initiatives such as the Russian Venture Company, Rosnano or Skolkovo. Whereas it may be early to evaluate the results of these policies, it is time to focus the attention of policymakers on actions that can increase the economy's growth potential. These should aim at diversifying and strengthening the economy's asset base.

<sup>25</sup> OECD: Czech Republic, Estonia, Poland, Slovak Republic, Slovenia, Australia, Canada, Chile, Netherlands, Norway, and United States; World Bank, GEP 2014: Bulgaria, Hungary, Romania, Brazil, India, China, South Africa, Azerbaijan, Botswana, Kazakhstan, Malaysia, Nigeria, and Uzbekistan, Venezuela; IMF: Russia.

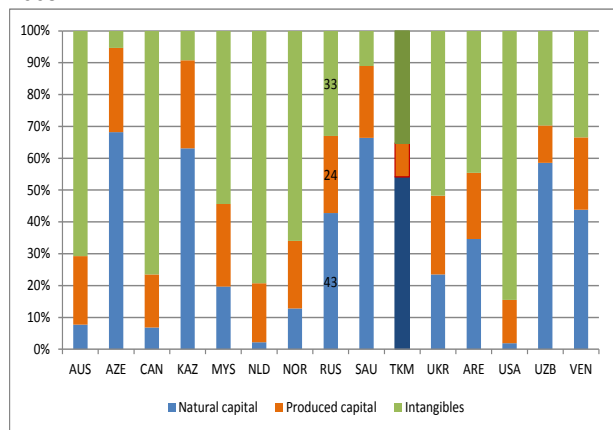
### 3.3. Russia's Current Asset Base: Abundant Natural Resources, Good Human Capital, Improving Infrastructure, But Weak Institutions

Assets can be classified into three categories: natural resources, built capital, and national institutions. Natural resources in the form of minerals, arable land, and forests are largely endowed, but technological progress and better management can radically alter their economic value. Built capital consists of both physical and human capital, in the form of adequate infrastructure and a healthy and skilled labor force. Both such assets can be measured for any country, though in the case of built capital, with more difficulty and less precision than natural resources. Finally, the most poorly measured and possibly the most important assets a country has are national institutions: the regulations and mechanisms that a country has put in place to manage resource rents, deliver public services such as roads, security, health care, and education, and regulate private enterprise.

#### Natural Resources

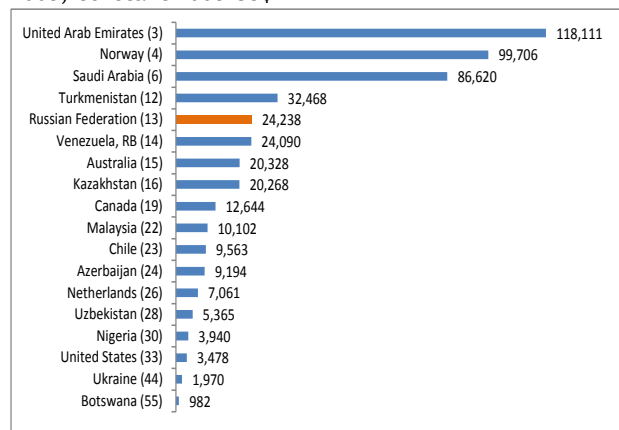
Natural capital, similarly to physical capital, is the present discounted value of the profit stream that natural resources can generate far into the future. Countries with similar initial quantities of land or subsoil assets may thus have different levels of estimated natural capital if they differ in how productively they use their land or in how effectively they exploit their subsoil assets. The period over which resources generate profit depends on whether they are renewable or exhaustible. Reserves of subsoil assets such as oil, natural gas, and minerals are typically nonrenewable and exhaustible, whereas land, forests, and rivers can potentially last forever if managed well. *The Changing Wealth of Nations* (World Bank 2011a) develops and applies a methodology that captures these dimensions. Each country's estimated total natural capital is then divided by its 2005 population to estimate per capita natural capital and its major components (subsoil capital and land capital) to permit comparisons across countries, regions, and income groups.

Figure 43: Distribution of wealth by assets, in percent, 2005



Source: World Bank (2011a) and Sugawara (2012).

Figure 44: Subsoil natural resource wealth per capita in 2005, constant 2005 US\$



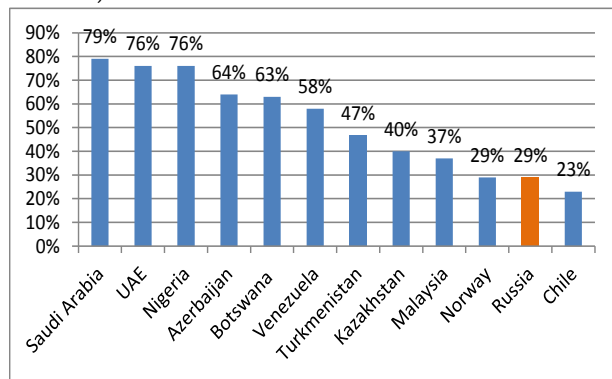
Source: World Bank (2011a).

Russia ranks 15<sup>th</sup> in the world in natural capital per capita and 13<sup>th</sup> in subsoil wealth. Russia has around 5 percent of the world's proven oil reserves and 25 percent of its proven gas reserves. In resource-rich Australia, Canada, Norway, and New Zealand, natural capital is 8-13 percent of overall wealth. The ratio in Russia is 43 percent (Figure 43 and Figure 44). Natural capital per capita rose in Russia over 2000-10, driven by a combination of growth in the production of natural gas, the expansion in reserves, and, most importantly, higher world prices. Where Russia has done less well is in exploiting its potential for agriculture.

In addition to being resource *abundant*, Russia is *dependent* on its natural resources. As of 2012, extractives (including oil, natural gas and minerals) accounted for 17.5 percent of GDP (with oil and gas at 16.2 percent). In 2013, energy exports represented about 67 percent of total exports (54 percent oil and 13 percent gas) and oil revenues contributed to 30 percent of fiscal revenue (Figure 45 and Figure 46). This dependence may result in excessive volatility of export receipts and government revenue, adding to overall economic volatility, hurting savings, investment, and economic output, straining government finances, and increasing uncertainty for households and firms. In 2013, the non-oil fiscal deficit amounted to 10 percent of GDP with an overall deficit of 0.5 percent. The difference between the two is a good measure of the government's dependence on oil and gas.

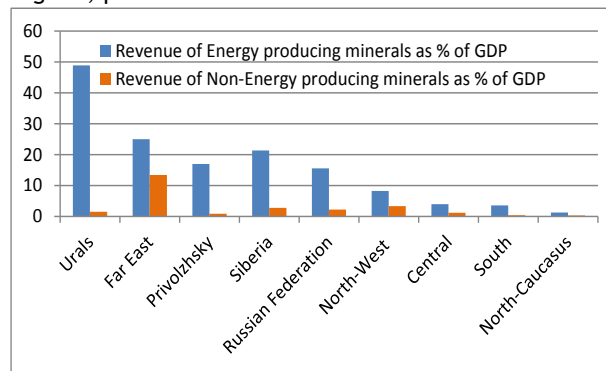


Figure 45: Resource revenue as share of total fiscal revenue, 2006-2010



Source: International Monetary Fund.

Figure 46: Revenue of energy producing minerals across regions, percent of GDP



Source: Rosstat.

Russia has sustained positive adjusted net savings since 1998, reaching 10 percent of GDP in 2008-10. Adjusted net savings (ANS) measures the true rate of savings in an economy after taking into account investment in human capital, depletion of natural resources and damage caused by pollution. With positive ANS, Russia has been adding more renewable capital—roads, railways, airports, telecommunication facilities, schools, and hospitals—than the amounts of natural resources it has been extracting and selling. Russia should maintain a positive ANS and continue avoiding reductions in total economic endowments. One reason why ANS could turn negative is high energy subsidies. In 2012, these subsidies in Russia amounted to 2.3 percent of GDP.

### Physical Capital

Table 14: Length of transport networks, km, thousands

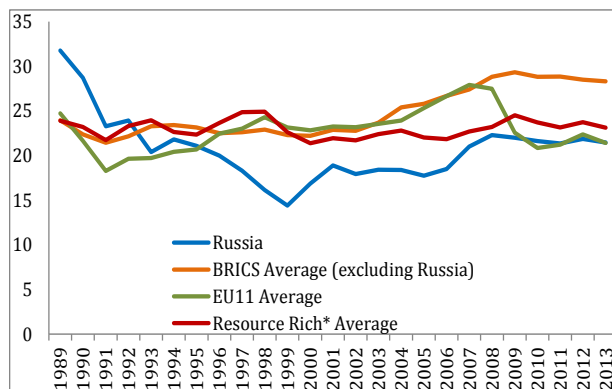
	1992	1990	2011	2010
	Russia	US	Russia	US
Highways	466	6187	903	6507
Railroad	88	240	86	204
Navigable channels	98	42	101	41
Oil pipelines	66	-	65	293
Gas pipeline	140	2032	167	2479

Source: US Department of Transportation and Rosstat.

After declining until the early 2000s, physical capital stock has begun to increase. Gross fixed capital formation has been at just over 20 percent of GDP since 2007. This is still lower than comparators, especially large emerging economies (Figure 14). Public investment has stagnated at about 3 percent of GDP since 2005. Overall, the stock of infrastructure capital is still comparatively low (Table 14).

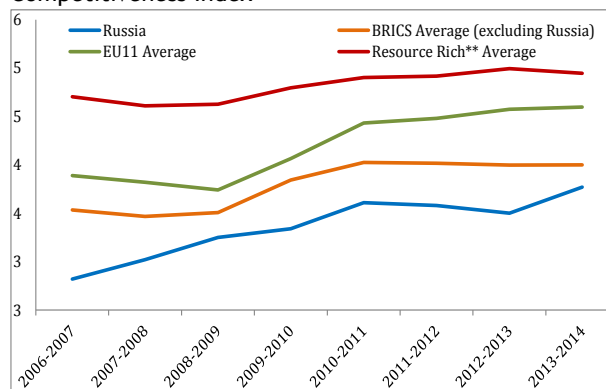
The quality of infrastructure appears to have improved since 2007. Inadequate maintenance and repairs had led to steep drops in infrastructure quality since the end of the Soviet period. Infrastructure established in cold climates proved too expensive to maintain and was allowed to degrade. Communal infrastructure similarly suffered, as artificially low prices and heavy state subsidies led to persistent underinvestment and less-frequent maintenance. The situation has improved since 2007, as indicated by a rise in perceived infrastructure quality (Figure 48).

Figure 47: Gross capital formation, percent of GDP



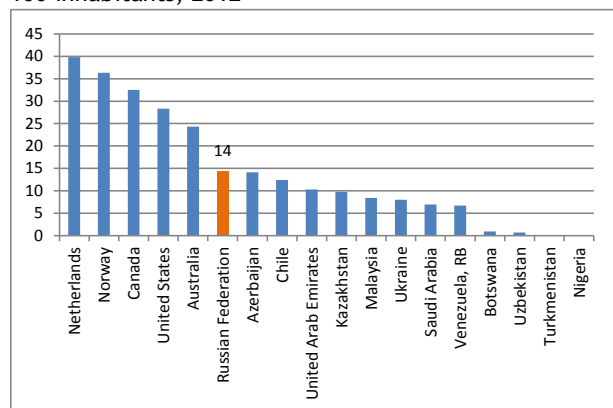
Source: World Bank, WDI 2014.

Figure 48: Quality of infrastructure, Global Competitiveness Index



Source: World Economic Forum, Executive Opinion Survey Base period 2012-13 weighted average. Score 1 (low) to 7 (high).

Figure 49: Fixed (wired-)broadband subscriptions per 100 inhabitants, 2012



Source: International Telecommunication Union.

The penetration of information and communications technology (ICT) is at very low levels compared to high income countries and this may hamper business growth going forward. In 2012, there were only 53 internet connections and only 14 fixed broadband internet subscribers per 100 people, far less than in advanced countries (Figure 49). Given its rising role in the modern economy, low ICT penetration may become an increasing problem for doing business.

### Human Capital

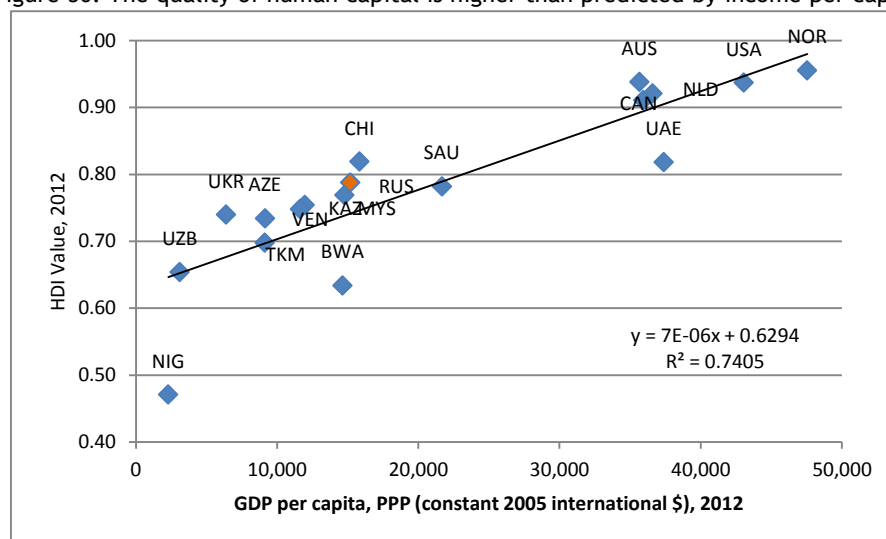
**Human capital is a vital asset for economic growth.** It is the ultimate source of innovation and productivity and one of the key mechanisms for transferring wealth across generations. Its pace of growth depends on the quantity and quality of education (in the classroom and in on-the-job training), on the quality of health care, and on the broader social environment. Education and training institutions play a key role in enhancing the productivity of capital by supplying well-trained graduates and developing innovative ideas that improve existing technologies. Workers whose skills are aligned more closely with the demands of firms are typically more productive and contribute more to the country's economic growth. In addition, they tend to command higher wages and enjoy lower levels of unemployment. By contrast, workers whose skills are misaligned with employers' needs are likely to be unemployed, underemployed, or paid less than others.

**The quality of Russia's human capital is high.** The Human Development Index (HDI), a composite statistic of life expectancy, education, and income, shows that the spectacular increase in income per capita experienced in recent years has been accompanied by improvements in health and education (Figure 50). At 9.8 years, the average years of schooling are high for Russia's income level, a legacy of the Soviet system of universal education. Russia stands out among Eurasian countries for better education attainment—quantity of schooling—at all levels but more strikingly at the tertiary level.

**Yet, there appears to be a mismatch between education achievement and employers' perceptions.** The OECD PISA assessment reveals how the quality of education in Russian schools, especially in Moscow and Saint Petersburg, is high by international standards (Table 15). Business perceptions paint a different picture, with the perceived quality of education being lower than for comparators (Figure 51). On-the-job training, albeit improving, is still perceived as inadequate (Figure 52), even though it plays an important role in building human capital (Heckman, Lochner, and Taber 1998). Employee training also affects wage growth of young or highly educated employees and training employees allows them to attain and maintain the competencies required to bring productivity in line with market wages of older and low-educated workers (OECD, 2004).

**Further investment in human capital is crucial in light of the sharp decrease in the working-age population expected in the next two decades.** Current employment rates of 60 percent and a labor force participation rate of 73 percent for the 15-64 year old population are low by international standards. Russia's working age population is expected to decline by over 5 percent by 2030 (Arias et al. 2014), implying that more (and better) investment in human capital is needed to ensure its adequate contribution to growth. Between 1999 and 2012, investments in education averaged 3.4 percent of GDP (16 percent of total investment in 2012). Health expenditures averaged 3.5 percent of GDP in the same period (17 percent of total investment in 2012). Whereas efficiency and effectiveness of public expenditures should be of paramount concern, absolute levels are low in international comparisons. In 1999-2012, high-income OECD countries spent, on average, over 5 percent of GDP on education and over 6 percent on health.

Figure 50: The quality of human capital is higher than predicted by income per capita



Source: World Bank, UNDP 2013 and Barro and Lee.

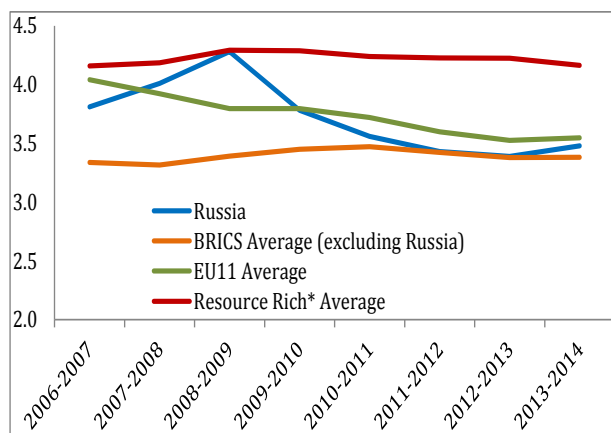
Notes: HDI = Human Development Index; PPP = purchasing power parity.

Table 15: Quality of education, OECD PISA scores, 2009

	On the overall reading scale	On the mathematics scale	On the science scale	Average
Hong Kong-China	533	555	549	546
Singapore	526	562	542	543
Korea	539	546	538	541
City of Moscow	529	541	541	537
Canada	524	527	529	527
Australia	515	514	527	519
City of Saint Petersburg	510	523	501	511
Tymen Region	503	504	501	503
OECD Average	493	496	501	497
United States	500	487	502	496
North-West FD	482	496	482	487
Urals FD	467	483	476	475
Central FD	466	479	470	472
Siberia FD	461	486	463	470
Russian Federation	459	468	478	468
Privolzhsky FD	453	471	460	461
South FD	450	462	455	456
Far East FD	432	455	455	447
Chile	449	421	447	439
North-Caucasus FD	410	455	448	438

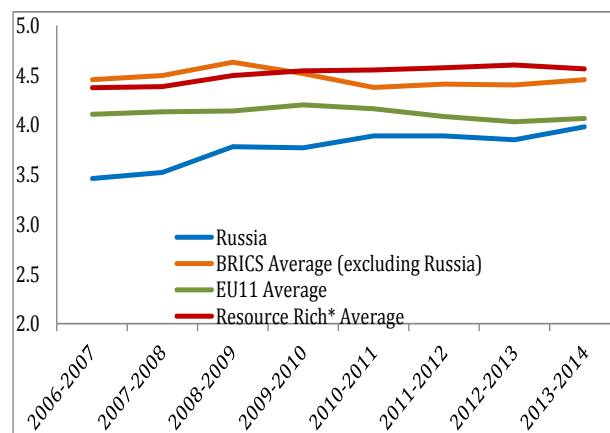
Source: OECD.

Figure 51: Quality of education, Global Competitiveness Index



Source: World Economic Forum, Executive Opinion Survey Base period 2012-13 weighted average. Score 1 (low) to 7 (high).

Figure 52: Quality of on-the-job training, Global Competitiveness Index



Source: World Economic Forum, Executive Opinion Survey Base period 2012-13 weighted average. Score 1 (low) to 7 (high).

### Institutions: Three essential functions of government

**Institutions are a fundamental asset for long-term economic development and are particularly important in resource-abundant countries.** They set the rules and norms by which economies and societies operate, shaping the incentives of governments, individuals and firms. In resource-abundant economies, institutions make the difference between success and failure in the long run. Building a sound institutional framework will ensure that natural assets are exploited responsibly and productively and that governments, individuals and firms have an incentive to invest in physical and human assets.

**Russia lags in most dimensions of governance.** Inconsistent enforcement of laws and regulations are typical symptoms of weak governance, and Russia is behind high-income resource-rich comparators in all elements of governance and transparency. The World Bank’s Worldwide Governance Indicators (WGI) indicate that rule of law, corruption, regulatory quality and accountability remain problematic, ultimately undermining the effectiveness of government policy (Table 16).

Table 16: Quality of institutions, World Governance Indicators, 1996-2012

	Average of Governance Indicators	Government Effectiveness	Control of Corruption	Political Stability and Absence of Violence	Regulatory Quality	Rule of Law	Voice and Accountability
Netherlands	1.71	1.89	2.15	1.11	1.79	1.75	1.58
Norway	1.71	1.92	2.12	1.29	1.39	1.91	1.6
Canada	1.62	1.87	2.04	1.01	1.59	1.73	1.5
Australia	1.59	1.75	1.98	0.98	1.63	1.75	1.45
United States	1.32	1.64	1.51	0.44	1.54	1.55	1.22
Chile	1.15	1.21	1.43	0.56	1.48	1.25	0.98
Botswana	0.7	0.54	0.89	0.97	0.61	0.61	0.58
United Arab Emirates	0.49	0.85	0.84	0.86	0.66	0.54	-0.81
Malaysia	0.36	1.06	0.27	0.2	0.53	0.5	-0.39
Saudi Arabia	-0.36	-0.2	-0.23	-0.29	0.03	0.16	-1.62
Ukraine	-0.58	-0.68	-0.92	-0.21	-0.53	-0.85	-0.27
Kazakhstan	-0.63	-0.6	-0.98	0.16	-0.4	-0.89	-1.06
Russian Federation	-0.73	-0.47	-0.93	-1.05	-0.33	-0.89	-0.7
Azerbaijan	-0.88	-0.8	-1.08	-0.79	-0.59	-0.88	-1.13
Venezuela, RB	-1.02	-0.98	-1.01	-1.12	-1.07	-1.33	-0.62
Nigeria	-1.14	-1.02	-1.11	-1.73	-0.89	-1.24	-0.84
Turkmenistan	-1.32	-1.47	-1.25	0.15	-1.99	-1.42	-1.94
Uzbekistan	-1.34	-1	-1.07	-1.16	-1.66	-1.27	-1.91

Source: World Bank.

**Three government functions are essential:** (i) the package of fiscal, monetary and exchange-rate policies that allow *managing the volatility* deriving from a concentrated export basket; (ii) the capacity of the public administration to effectively *deliver public services*, such as health, education and infrastructure; (iii) and the ability to effectively *regulate private enterprise* guaranteeing a competitive environment. These are especially necessary for countries that have to manage sizable resource rents, where weaknesses in accountability and corruption can become sources of instability.

### ***Managing Volatility***

**Resource-rich economies usually face the challenge of uncertainty and volatility associated with the price and/or demand fluctuations for natural resources.** Given the importance of the extractive sector for such economies, volatility of resource flows may impact broader macroeconomic parameters and lead to larger policy challenges, such as fluctuations in export performance, ups and downs of GDP growth, budget revenues, public spending/investment, employment, inflation and exchange-rate behavior.

**Russia has established an institutional framework to manage macroeconomic volatility.** International experience shows that stabilization funds are useful to ensure fiscal discipline (Sugawara, 2014). In 2004, Russia created a Stabilization Fund tasked with absorbing excessive liquidity, reducing inflationary pressure and insulating the economy from volatility of raw material export earnings. In February 2008, the US\$160 billion Stabilization Fund was split into the Reserve Fund and the National Welfare Fund, the later with the longer term purpose of bolstering the national pension scheme.

**Despite an excessively expansionary fiscal policy during the boom years, the Reserve Fund proved to be useful during the last financial crisis.** During the height of the oil-price boom after 2005, Russia's fiscal policy became increasingly expansionary and the Stabilization Fund failed to prevent rapid growth of government spending, allowing more of the oil revenue windfall to pass through to the economy. The boom in credit and in domestic demand was fed only-partial sterilization of oil revenue, the high liquidity from large capital inflows reflecting accelerated foreign borrowing by state-owned enterprises (SOEs) and the banking sector's negative real interest rates, and a tightly managed exchange rate. However, during the 2008 crisis, the Reserve Fund played a key role in smoothing out public spending. The financial sector was also stabilized when the National Welfare Fund injected about US\$30 billion into three state-owned banks.

### ***Providing Public Services***

**Institutional changes have been taking place in the delivery of public services** (World Bank, 2011b and 2001c). Some steps have been taken in the introduction of program budgeting and performance arrangements in the civil service. The system of inter-budgetary relationships has also improved, in particular as a result of the 2005 Budget Law, which led to a more clear assignment of fiscal spending and service provision responsibilities across levels of government. Ambitious national projects embracing education, health and other areas (e.g., provision of housing) have been launched, and significant public funds are spent through those programs. However, due to regional differences in the commitment and the capacity to implement the reforms, the progress has been quite uneven.

**Russia still has much scope for efficiency-enhancing reforms.** The allocation of resources can be improved by generating savings with sector reforms (for example, in health, education and transport) and strengthening the system of inter-budgetary transfers to better reflect priorities and support efficiency-enhancing reforms in the regions. The efficiency of public resource utilization could also be improved with better targeting (or reallocation) of existing resources to priority areas.

### ***Regulating Enterprise***

**The government's function in regulating private enterprise is essential.** Apart from imposing additional costs, regulation can be manipulated with the objective of creating unfair competitive advantages for some firms (not necessarily the most productive) with welfare losses for the rest of the economy. In the long run, an economy where competition is restricted by cumbersome or captured regulation or by other means will be less productive because some of its firms will face reduced incentives to be efficient and adopt new technologies (Nicoletti and Scarpetta 2003; Conway et al. 2007). The consequences may be particularly severe for economies that are far from the technological frontier, since the ability to adopt new technologies is essential to productivity growth and convergence to the levels of more developed economies (Acemoglu et al., 2006).

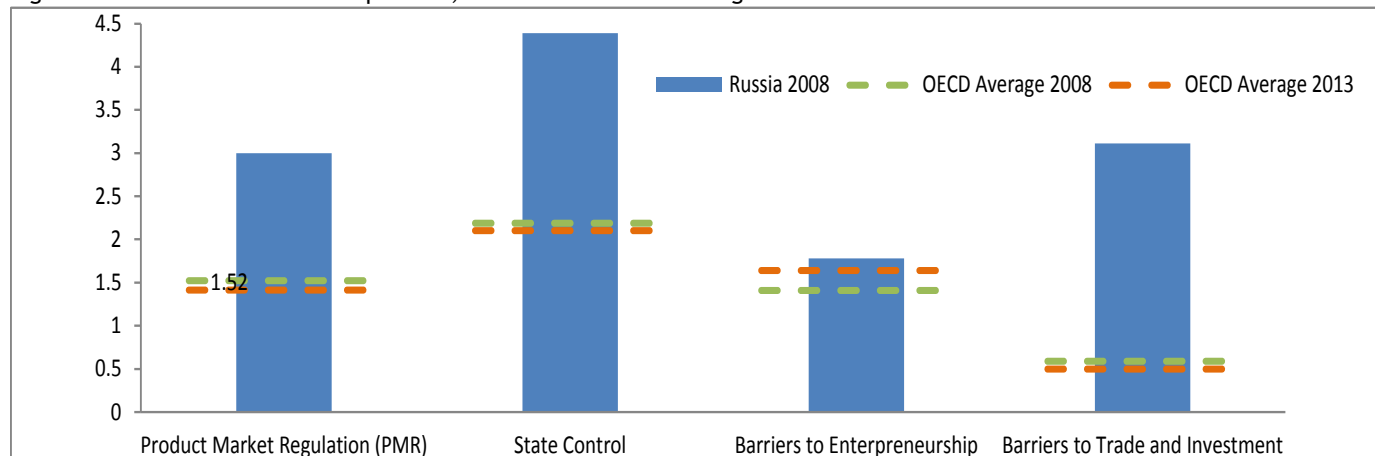
**Many spheres of corporate activity in Russia are dominated by less-productive incumbents.** These firms are likely to have privileged access to natural resources, markets, credit, and licenses. More efficient enterprises, especially small and medium firms and start-ups, cannot compete with public-sector entities and incumbent firms

on an equal footing, with the result that the best firms do not emerge or do not survive small slumps while inefficient firms remain dominant and overall productivity suffers.

**Trade and competition policy have been used to protect incumbents and have contributed to market fragmentation.** Tariffs have progressively replaced non-tariff barriers as the principal instrument for regulating foreign trade, but average tariff rates and tariff dispersion were still higher in Russia than in all OECD countries in the mid-2000s, providing some degree of isolation from international competition. Isolation from global markets may induce companies to choose less-modern technology and operate at suboptimal scale, thus reducing productivity. Around half of Russia's firms consider local markets their main sales destination—a large proportion, even relative to economies of comparable size and structure such as Brazil, where the number is about 35 percent. Two factors could potentially explain market fragmentation and uncompetitive markets: high transport costs related to limited transport infrastructure and long distances, and, in countries with some degree of regional autonomy, additional barriers created by interventions of regional governments that hamper the entry of firms from outside the region. Russian consumers and firms face prices 20 percent higher than in comparable economies, with regional price dispersion in key sectors (pharmaceuticals, communication services, and retail gasoline) exceeding what would be explained by other factors that can be assumed to affect prices, such as distance to markets and level of economic activity (World Bank, 2013).

**Russia's product market policies are more restrictive of competition.** The high degree of state control, as well as statutory and regulatory barriers to entrepreneurship and to trade and investment, all contribute to stifling the development of a productive enterprise sector (Figure 53).

Figure 53: Restrictiveness in competition, OECD Product Market Regulation Index



Source: OECD (2013), Economy-wide regulation, OECD Product Market Regulation Statistics. Note: \*Index scale: 0-6, where 6 is more restrictive. OECD average does not include U.S., Turkey, Poland, Mexico, and Luxembourg.

**State ownership in Russia is heavy by international standards.** Enterprises owned by federal or lower levels of government accounted for 19 percent of employment in 2009. SOEs occupy dominant market positions in their areas of activity, with scope for private participation, including that by foreign investors, tightly controlled.<sup>26</sup> National and subnational governments controlled at least one firm in 16 economic sectors, versus only nine in the typical OECD economy in the late 2000s (Conway et al. 2009). State ownership is markedly pronounced in infrastructure/network industries. The government has 100 percent market share in rail transport and postal services and more than 50 percent in gas, electricity, air transport, and telecommunications (World Bank, 2013).

**The current state-aid regime can distort the market and stifle emergence and survival of more efficient players.** Russia regulates the provision of state aid in its competition law and allows exceptions for various forms of state aid to specific industries, firms, or regions. Incumbent firms receive preferential treatment from federal and regional authorities in various forms including tax breaks (or arrears), investment credits, direct subsidies, guaranteed loans, access to state property, and the creation of special economic zones on the sites of specific enterprises. State support is often based on a firm's affiliation to business associations and ties dating from the Soviet era, to the detriment of new entrants. Asymmetric application of state aid rules is particularly acute at the regional level and is a source of regional variability in the broad competition regime.

<sup>26</sup> The share of foreign participation in the average Russian company was 2.7 percent in 2007 compared with 7.5 percent in the EU's new member states.

### 3.4. Rebalancing Russia's Asset Portfolio With Transparent Rules, Better Public Investment And Competition

**To sustain long-run growth, Russia needs to leverage its abundant assets and build up its less abundant ones.** The country is well endowed with natural resources and human capital. It has begun to rebuild its physical capital. The greatest weaknesses are in the institutions for the regulation of private enterprise. Relatively low and inefficient investments in physical capital, low labor force participation and weak productivity have shown the limitations of growth driven by high commodity prices and utilization of spare capacity. Russia can return to a sustainable growth path by leveraging the assets it has and by building up those that are more deficient.

**To achieve higher growth Russia needs to increase the contribution of labor and capital and remove constraints to economic efficiency.** At just over 20 percent of GDP, Russia has relatively low investment. It also faces challenging demographic conditions: an aging population, low birth rates, and imminent decreases in working-age cohorts, pointing to a limited contribution of labor to future growth. The first key to future growth lies in improvements in the quality of physical and human capital. It will be equally important to remove structural constraints to total factor productivity, the efficiency with which factors of production are employed. More responsible use of natural resources, more transparent rules for investors, better planning and monitoring of public investment, and a stronger competition framework would appear to be the priorities for the next decade.

**The ultimate reasons of low investment are institutional, rather than the proximate cause of limited fiscal space.** Resource-rich countries require much stronger institutions and political commitment than resource-poor economies. The pervasive nature of resource rents can result in lower-than-optimal government investment and large outlays on explicit and implicit subsidies and transfers. Bhattacharyya et al. (2011) use the Hall and Jones (1999) institutions index to proxy for "social infrastructure" and find that the resource curse is experienced only by countries below a certain threshold. Improving the quality of institutions is therefore essential for Russia to escape the trap of low public capital. Overall, Russia does not have to increase spending by much: increasing gross fixed capital formation to about 25 percent of GDP, as recommended by the Growth Commission, may be enough. No more than a third of this increase needs to be public investment. The rest could be private, brought about simply by improving the investment climate.

**More transparent rules for investors would enhance the contribution of natural resources to Russia's growth.** After 2004, the Russian government increased taxes and intervened more frequently in the oil industry. The growth in Russia's oil production dropped from 7 percent in 2001-2005 to about 1.5 percent in 2006-2011. The gas industry has remained a national monopoly, probably limiting efficiency and reducing the scope for the discovery and exploitation of untapped reserves. The potential for discovering additional reserves of both oil and gas would be enhanced if more risk capital and better technology could be deployed for more intensive exploration in more difficult terrain (IEA 2011).

**Better prioritization of expenditures and focus on results will strengthen the quality of public service provision.** Greater attention should be paid to planning, monitoring and evaluation of public investment expenditures in education, health and infrastructure. Russia could follow the lead of advanced OECD countries and shift to performance-oriented public sectors that emphasize efficiency and accountability. This requires systems to monitor results, including enlisting private companies, academic institutions, and nongovernmental organizations to monitor indicators of public-service delivery. The role of external performance audits will also become important in ascertaining that delivery units comply with their delivery obligations, on the basis of which they receive budget financing. This approach would require systematic reviews of public spending to identify the scope for service delivery improvements and to advance institutional reforms (World Bank, 2011c).

**Increased private participation could improve the quantity and quality of the delivery of public services.** One option widely used at international level is to establish public-private partnerships (PPPs) as an alternative to more traditional arrangements. International experience shows that different incentives, combined with an adequate legal framework, have to be in place in order to ensure sustainability of PPPs, as well as to maximize and improve the use of resources.

**Effective competition policy will increase the productivity of the business sector.** Entry and exit conditions need to allow firm churning, so that more productive firms survive and prosper and obsolete ones exit. This is what allows increases in aggregate productivity. An effective competition policy framework would enforce antitrust rules for private and state-owned firms, help reduce wasteful state aid and ensure that the benefits of competition are understood and appreciated by policymakers, firms and consumers. Specific measures that would have tangible effects in Russia could include broadening the mandate of the Federal Antimonopoly Service on state aid regulation to diminish firm- and sector-specific state aid; creating an inventory of state aid; aligning

state aid regulation with international best practices and eliminating preferential treatment to enterprises owned by states or municipalities (World Bank, 2013). Sector-specific policies in key service industries such as transport, construction, and professional services would further increase competition and reduce prices for firms and households.

### 3.5 References

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# Annex

## Main indicators

Output Indicators	2013											2014								
	2007	2008	2009	2010	2011	2012	Aug	Sep	Oct	Nov	Dec	2013	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
GDP, % change, y-o-y 1/	8.5	5.2	-7.8	4.5	4.3	3.4	-	1.2	-	-	1.3	1.3	-	-	0.9	-	-	0.8	-	-
Industrial production, % change, y-o-y	6.8	0.6	-10.7	7.3	5.0	3.4	-0.2	1.3	1.0	2.8	0.4	0.4	-0.2	2.1	1.4	2.4	2.8	0.4	1.5	0.0
Manufacturing, % change, y-o-y	10.5	0.5	-15.2	10.6	8.0	5.1	-0.7	1.1	0.6	4.8	1.7	0.5	0.0	3.4	3.5	3.9	4.4	0.3	2.4	-0.6
Extraction of mineral resources, % change, y-o-y	3.3	0.4	-2.8	3.8	1.8	1.0	1.0	1.9	1.7	1.8	2.0	1.1	0.9	0.8	0.6	1.1	0.9	0.8	0.2	0.8
Fixed capital investment, % change, y-o-y	23.8	9.5	-13.5	6.3	10.8	6.8	-1.8	-1.3	-0.1	0.4	0.6	-0.2	-7.0	-3.5	-4.3	-2.7	-2.6	0.5	-2.0	-2.7
<b>Fiscal and Monetary Indicators</b>																				
Federal government balance, % GDP 1/	5.4	4.5	-5.9	-4.1	0.8	-0.1	0.9	1.2	1.1	1.0	-0.5	-0.5	9.7	0.3	0.7	0.3	1.4	1.9	1.7	
M2, % change, p-o-p 2/	51.3	27.2	-3.5	30.6	23.3	17.9	0.2	-0.5	-0.3	2.2	7.7	15.4	-4.0	1.1	-2.2	1.2	0.3	0.6	0.3	
Inflation (CPI), % change, p-o-p	9.0	14.1	11.7	6.9	8.5	5.1	0.1	0.2	0.6	0.6	0.5	6.8	0.6	0.7	1.0	0.9	0.9	0.6	0.5	0.2
Producer price index (PPI), % change, p-o-p	25.1	-7.0	13.9	16.7	13.0	6.8	2.8	1.4	-1.2	-1.5	1.0	3.5	0.4	-0.4	2.3	0.7	0.4	0.8	1.6	
Nominal exchange rate, average, Rb/USD	25.6	24.8	31.7	30.4	29.4	31.1	33.0	32.6	32.1	32.6	32.9	31.8	33.5	35.2	36.2	35.7	34.9	34.4	34.6	36.1
Reserve Fund, bln USD e-o-p		137.1	60.5	25.4	25.2	62.1	85.4	86.4	87.2	86.9	87.4	87.4	87.1	87.5	87.5	87.9	87.1	87.3	86.6	91.7
National Wealth Fund, bln USD, e-o-p		88.0	91.6	88.4	86.8	88.6	86.8	88.0	88.7	88.1	88.6	88.6	87.4	87.3	87.5	87.6	87.3	87.9	86.5	85.3
Reserves (including gold) billion \$, end-o-p	478	427	439	479	499	538	510	523	524	516	510	510	499	493	486	472	467	478	469	465
<b>Balance of Payment Indicators</b>																				
Trade Balance, billion \$ (monthly)	123.4	177.6	113.2	147.0	196.9	191.7	14.0	15.9	12.7	16.6	15.8	181.9	18.7	12.4	19.6	19.8	18.3	14.0	17.1	
Current Account, billion \$	72.2	103.9	50.4	67.5	97.3	71.3	-	-0.7	-	-	8.0	34.1	-	-	27.1	-	-	17.1	-	-
Export of goods, billion \$	346.5	466.3	297.2	392.7	515.4	528.0	42.6	44.8	43.6	46.7	49.2	523.3	39.7	36.5	47.1	47.5	44.3	40.7	46.1	
Import of goods, billion \$	223.1	288.7	183.9	245.7	318.6	335.7	28.6	28.9	30.9	30.2	33.4	343.0	21.0	24.0	27.4	27.6	26.0	26.8	29.0	
Gross FDI, mln USD 1/	27,797	27,027	15,906	13,810	18,415	18,666	-	18,610	-	-	26,118	26,118	-	-	n/a					
<b>Financial Market Indicators</b>																				
Average weighted lending rate for enterprises, % 3/	10.8	15.5	13.7	9.1	9.3	9.4	9.3	9.5	9.2	9.0	9.4	9.4	9.2	9.4	10.3	10.5	10.6	10.7	10.7	
CBR policy rate, %, end-o-p	10.0	9.5	6.0	5.0	5.3	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	7.0	7.5	7.5	7.5	8.0	8.0
Real average rate for Ruble loans, % (deflated by PPI)	-3.4	-6.8	-0.1	-6.5	-3.2	3.9	4.5	7.5	7.1	7.3	5.5	5.5	4.3	6.0	5.0	3.1	1.6	1.7	1.6	
Stock market index (RTS, ruble term, eop)	2,291	632	1,445	1,770	1,382	1,527	1,291	1,422	1,480	1,403	1,443	1,443	1,301	1,267	1,226	1,156	1,296	1,366	1,219	1,190
<b>Income, Poverty and Labor Market</b>																				
Real disposable income, (1999 = 100%)	245.6	251.5	259.3	272.5	274.7	286.2	288.9	277.3	292.3	301.6	425.0	295.7	204.4	273.1	262.2	304.9	276.6	291.0	291.8	301.5
Average dollar wage, US \$	532	697	588	698	806	859	885	899	938	928	1,205	942	838	812	882	923	929	1,003	910	854
Share of people living below subsistence, % 1/	13.3	13.4	13.0	12.5	12.7	10.7	-	12.6	-	-	11.0	11.0	-	-	13.8	-	-	13.1	-	-
Unemployment (% , ILO definition)	6.1	7.8	8.2	7.2	6.1	5.1	5.2	5.3	5.5	5.4	5.6	5.6	5.6	5.6	5.4	5.3	4.9	4.9	4.9	

Source: Rosstat, CBR, EEG, IMF, staff estimates.

1/ Cumulative from the year beginning.

2/ Annual change is calculated for average annual M2.

3/ All terms up to 1 year.