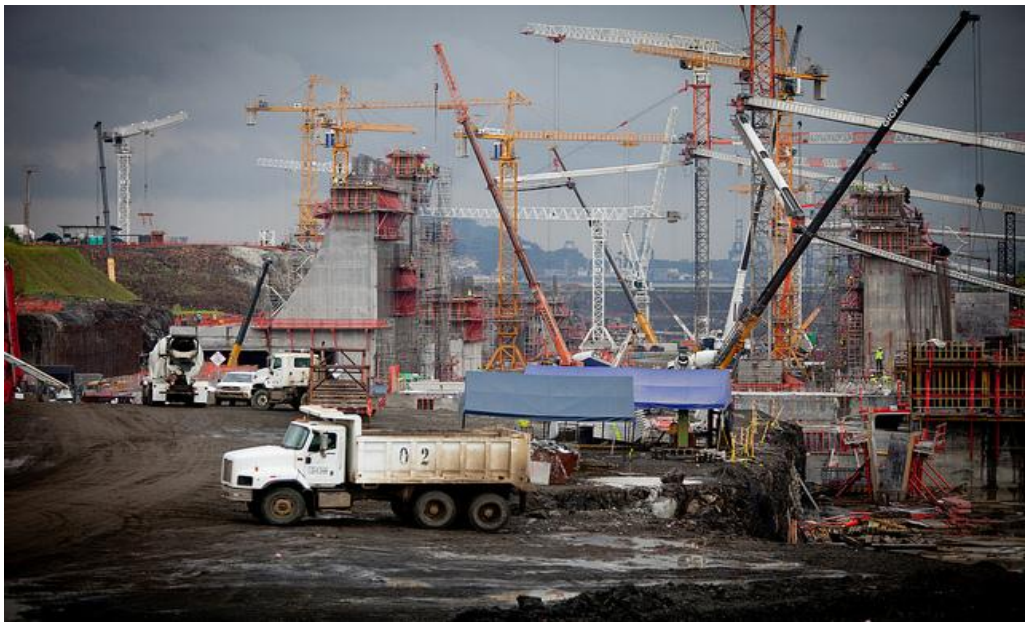
Russia Economic Report[1]

Structural Challenges To Growth Become Binding



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[1] This report is produced twice a year by World Bank economists of the Europe and Central Asia Region Poverty Reduction and Economic Management Department. The team was led by Birgit Hansl (Lead Economist and Country Sector Coordinator for Economic Policy in Russia, bhansl@worldbank.org) and consisted of the following members: Sergei Ulatov (Senior Economist), Stepan Titov (Senior Economist), Olga Emelyanova (Research Analyst), Mikhail Matytsin (Consultant), John Pollner (Lead Financial Officer), Lawrence Kay (Consultant), Tehmina Khan (Economist), John Baffes (Senior Agricultural Economist) and Irina Rostovtseva (Team Assistant). Alvaro Gonzales (Lead Economist), together with Leonardo Iacovone (Senior Economist) and Hari Subhash (Consultant) authored the focus note on volatility, firm survival and diversification in manufacturing. Peer reviewers were Wolfgang Fengler (Lead Economist), Raju Singh (Lead Economist) and Denis Medvedev (Senior Economist). The report was edited by Christopher Pala (Consultant), and the graphic design was provided by Robert Waiharo (Consultant). We are grateful for advice from discussions with Michal Rutkowski (Country Director for Russia), Roumeen Islam (Acting Director for Poverty Reduction and Economic Management in the Europe and Central Asia Region), Carolina Sanchez (Sector Manager for Russia, Ukraine, Belarus, and Moldova), Lada Strelkova (Country Program Coordinator for Russia), Zeljko Bogetic (Lead Economist in the Europe and Central Asia Region) and the IMF team for Russia, led by mission chief Antonio Spilimbergo.

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ABBREVIATIONS AND ACRONYMS

CBR	Central Bank of Russia
CI	Confidence Interval
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
NPL	Non-Performing Loan
OECD	Organization for Economic Cooperation and Development
PMI	Purchasing Managers Index
RBC	Rosstat's Business Confidence
RCC	Rosstat's Consumer Confidence
SAAR	Seasonally Adjusted Average
SMEs	Small and Medium-Size Enterprises
UNIDO	United Nations Industrial Development Organization
US	United States

Executive Summary

Russia's economy lost steam in 2013. Growth slowed to 1.4 percent in the first half (H1) of 2013, compared to 4.5 percent in H1 2012. This report will examine in its first part several aspects of the economic slowdown. It will show that it was largely the result of weaker demand, which was due to a combination of external and domestic factors, some of which are cyclical and others structural. A large part of the cyclical component is related to Russia's high dependence on oil and gas exports and with it, its exposure to commodity-price volatility. The structural challenges to the Russian economy and its growth, such as non-competitive sectors and markets, are another important factor to consider in the economic slowdown. In fact, structural issues moved recently to the forefront of policy discussions as the economy seems to operate close to its current capacity limit. This has important implications for our outlook, which will be presented in part two of the report. The special focus note in part three of this report will discuss the link between growth patterns in Russia, firm survival and diversification in manufacturing and will also highlight the impact of limited competition as a structural constraint.

Russia's external demand remained weak. Oil prices retreated and stabilized below US$ 100/bbl during the second quarter of 2013, while global trade lost momentum in recent months. The current account deteriorated as the trade surplus melted. Lower oil revenues to the federal budget already increased fiscal pressures, invigorating the domestic discussion on the fiscal buffer, in particular the optimal size of the Reserve Fund and prudent investment options for the National Welfare Fund. In addition, in anticipation of the scaling back of the US monetary stimulus, Russia experienced greater capital outflows since May. Exchange-rate volatility increased in June, forcing the Central Bank of Russia to gradually raise the bilateral currency corridor up and considerably scale up its interventions. With respect to the likely impact of a withdrawal of quantitative easing policies, we expect the resulting adjustments in capital flows to be temporary, though they might expose domestic vulnerabilities during the transition period. Although access to the capital market could be somewhat restricted, we do not expect that Russian banks and/or private companies would face major limitations.

Domestic demand continues to be subdued. Both investment and consumption trends disappointed in H1 2013. Investment activities had weakened during the 2008-2009 crisis and only exceeded these pre-crisis levels in 2012. They tapered sharply as large infrastructure projects for the Winter Olympic Games in Sochi and the *Northern Stream* pipeline neared completion. During the first quarter (Q1) 2013, the decline in investment demand was the main cause for growth deceleration. Added to this, we observed slower growth in consumption. Consumption, the main growth driver in the past, expanded at a much slower pace than a year ago, despite low unemployment levels and increases in wages and credit. Some of the slowdown in consumer demand can be attributed to the higher burden of interest payments for households as a result of the recent credit boom, along with stubbornly high inflation in the first half of 2013. It also reflects a lack of confidence rooted in lingering uncertainty on how the global economy and specifically, the Russian economy will play out. While investors were already in a wait-and-see mode for a while, consumers now appear to have joined them and the players in the Russian economy are sitting on the fence.

Russia's output gap is nearly closed. Despite the recent economic slowdown, capacity utilization stood in H1 2013 near 80 percent. This is close to the level observed when the economy was expanding rapidly in the pre-crisis period at 8 percent annually. At the same time, the labor market remains tight, with unemployment hovering around 5.5 percent. Weaker growth potential is also reflected in the sector composition of growth. In H1 2013, growth in major non-tradable sectors such as construction, financial services, transport and communication slowed dramatically. In the past years, strong growth in these sectors compensated for the gradually deteriorating industrial performance and the manufacturing of tradables in particular, but is does not so anymore. This would suggest that the recent growth model, which was largely based on growth in consumption and in non-tradables, has reached its limits. It would also imply that policies to stimulate the economy would need to be reviewed and, perhaps, incorporate acknowledgement that an annual growth rate of 6-7 percent is not feasible under current conditions. In our view, a lower growth trajectory is more likely in the absence of more substantial reforms. That means for Russia structural challenges are becoming now binding constraints for its growth and would need to be addressed to lift the economy's growth potential.

The World Bank's outlook for Russia changed. These factors together led to downward revision of our growth projection for Russia to 1.8 percent in 2013. Nevertheless, in 2014, we project the Russian economy to accelerate to 3.1 percent growth. Global recovery could result in an increase in Russian exports starting in Q4 2013, while the World Bank projects oil prices to remain stable. Next year's growth prospects will largely depend on the recovery in Russia's most important economic partner, the Euro Area, and the increased investment activities associated with the recently announced large state investment projects to be financed off-budget. This moderately positive outlook is in our view subject to downside risks. Russian exports could remain depressed if the recovery in global demand is further delayed. The tapering of quantitative easing policies, notably in the US, could temporarily negatively impact Russia's economy through lower oil prices, restricted access to international capital markets and capital outflows. We also note higher vulnerability to increasing risks in regard to the quality of the credit portfolio given continuously high credit growth.

Part I. Recent Economic Developments

The global economy is moving into a new phase marked by stronger activity in high-income economies and a gradual adjustment to tighter financial conditions in developing and emerging economies. The Russian economy decelerated to an estimated 1.4 percent in H1 2013 from 4.5 percent in H1 2012 due to a slowdown in consumption, stalled investment demand and a continuing weak external environment. Nevertheless, the economy appears to grow close to its capacity, constrained by feeble investment activities and a tight labor market. As a result of the economic slowdown during H1 2013, the labor market relaxed slightly. Growth in real wages decelerated, but continued to outpace productivity growth. Poverty rates stopped their recent decline as income dynamics became less favorable. The weaker export performance in H1 2013 reflects a subdued global economic activity that brought about sluggish external demand and a deteriorating current account. Capital outflows increased since May as a result of some reallocation of global assets portfolios away from emerging economies, in anticipation of the scaling back of the US monetary stimulus. Inflation moderated towards the end of Q2 2013 largely due to slower-rising food prices. Starting in June, exchange-rate volatility intensified markedly and the Ruble came under increasing pressure. The rate of credit growth remains high and risks involving market access and portfolio quality are on the rise. Fiscal policy switched from expansionary to consolidation mode as lower oil prices cut revenues in early 2013. Yet, fiscal buffers remained well below pre-crisis levels while sub-national fiscal trends exert increasing pressure on the consolidated budget.

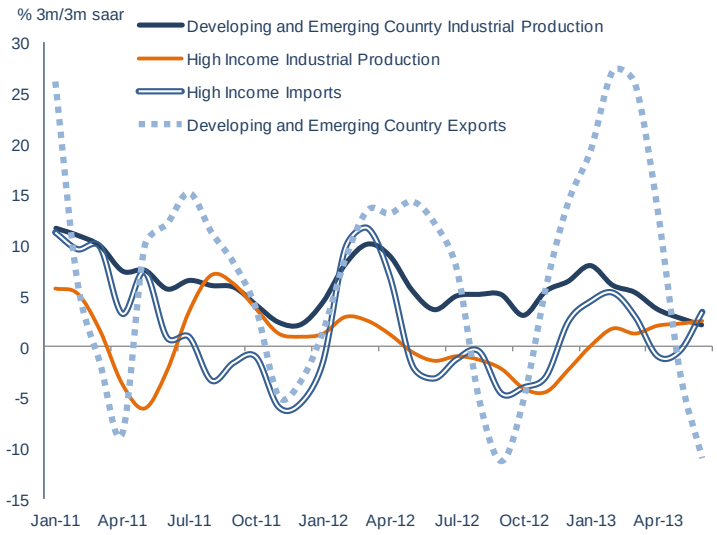
Global Trends — Uncertainty and Volatility Prevail

The global economy is moving into a new phase marked by stronger activity in high-income economies and a gradual adjustment to tighter financial conditions in developing and emerging economies.

The global economy is continuing to recover, led by strengthening high-income economies. Growth in the US has firmed since the start of the year, in line with business and consumer confidence. The US economy grew faster than the anticipated 2.5 percent (q/q saar) in the second quarter. Growth remained robust at 2.6 percent in Japan, supported by aggressive monetary easing. Growth also turned positive in the Euro Area, led by strong growth in France and Germany, with more recent activity and sentiment data pointing to stabilization in the troubled periphery of the Euro Area economies. However, tight credit remains a drag while unemployment rates are uncomfortably high and investment and output levels are well below their pre-crisis levels. Growth in developing and emerging countries has slowed, but is still expanding at a reasonable pace. Barring disappointing outturns in India, Mexico and Thailand in the second quarter, developing and emerging countries are mostly growing at a satisfactory pace, in line with their potential. Growth has actually strengthened in several major economies, including South Africa, Malaysia, and the Philippines. China's growth also stabilized in the second quarter, following several relatively weak quarters, with recent industrial production data showing activity rates firming to 7.0 percent annualized in the three months to July. Timelier business-sentiment data from August indicate expanding output in developing and emerging countries during the course of the third quarter.

Global trade, which has lost momentum in recent months, shows signs of rebounding. Global exports contracted at an annualized pace of about 1 percent in the second quarter after expanding at a 10 percent rate in the first quarter, led by sharp contraction of over 11 percent in developing and emerging countries' exports (mostly China). However, high-income countries' trade registered increased imports and exports (by around 3.5 percent annualized), and a further recovery should help support improving developing and emerging countries' exports.

Figure 1: Global industrial production and trade

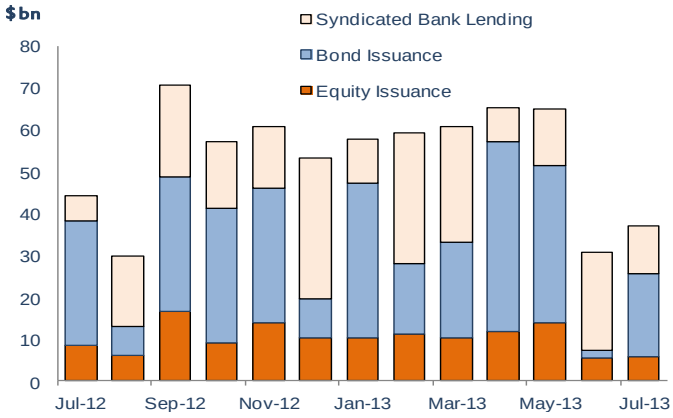


Source: Datastream and World Bank Prospects

Financial conditions tightened since May in developing and emerging economies in anticipation of the scaling back of the US monetary stimulus, in turn triggering a reallocation of global asset portfolios away from emerging economies and towards high-income ones. Developing and emerging-country stock markets have lost about 7 percent since mid-May, while sovereign bond yields and Credit Default Swaps spreads have increased about 146 and 60 basis points respectively over the same period. Currencies have also come under pressure, although losses on a trade-weighted basis have been less severe, while gross capital flows, which had dropped in June, partially recovered in July (Figure 2).

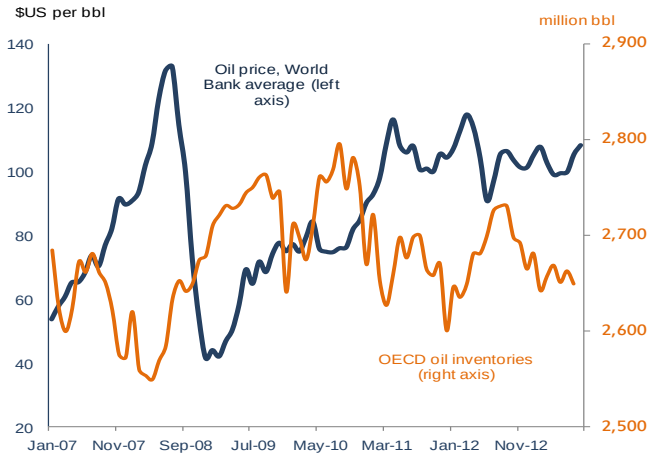
After reaching a high of US$108/barrel (bbl) in February, oil prices retreated and stabilized below US$ 100/bbl during the second quarter (Figure 3). However, geopolitical concerns in Egypt and Syria, supply disruptions in Libya, a rocky relationship between Belarus and Russia, high refinery runs in the US and better-than-expected news on global demand pushed oil above US$105/bbl in July (up 5.5 percent from June) and US$108/bbl in August and early September. Brent retreated slightly in mid-September as an agreement regarding Syria's chemical weapons program is gradually gaining traction.[2]

Figure 2: Gross capital flows to developing and emerging countries



Source: Datastream and World Bank Prospects

Figure 3: Oil prices and OECD inventories



Source: Datastream and World Bank Prospects

Growth — Moderation to a New Trajectory

The Russian economy decelerated to an estimated 1.4 percent in H1 2013 from 4.5 percent in H1 2012 due to a slowdown in consumption, stalled investment demand and a continuing weak external environment. Nevertheless, the economy appears to be growing close to its capacity, constrained by feeble investment activities and a tight labor market.

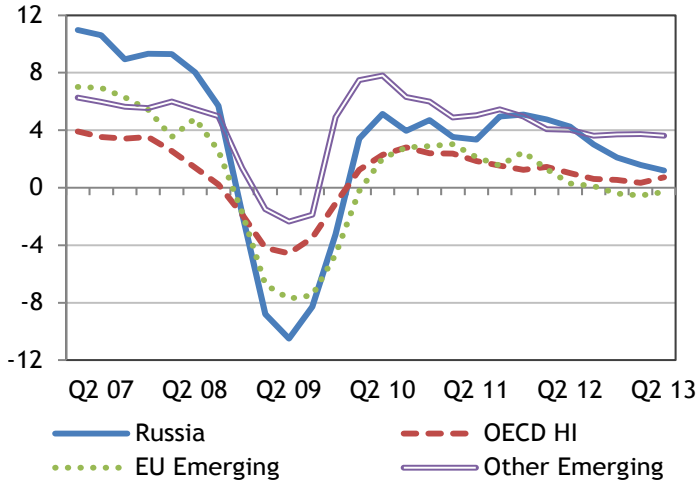
Economic growth slowed significantly during the first half of 2013, but fared well compared to both high-income economies and EU emerging ones (Figure 4). But while these appear to be in a recovery mode, this appears not yet to be the case for Russia. Also, Russia's growth path started to divert significantly from that of other emerging economies in mid-2012, with their gap continuing to increase due to Russia's persistent growth decline. Russia's 2013 first quarter growth slowed to 1.6 percent from 4.8 percent in the same period a year ago, and in Q2 2013, growth further declined to 1.2 percent (Figure 5). In Russia, the slowdown came as a result of weaker demand due to combination of external and domestic factors, some of which are cyclical and some are of structural nature. A large part of the cyclical component is related to Russia's high dependence on oil and gas exports and with it its exposure to commodity price volatility. Structural challenges to the Russian economy and its growth, such as non-competitive sectors and markets, have recently come to the forefront of policy discussions as the economy seems to operate close to its current capacity limit. Our special focus note links the discussion of growth patterns in this section to firm-level analysis, on firm survival and diversification in manufacturing. It will highlight limited competition as a structural constraint.

Weakness in domestic demand was reflected in subdued investment and consumption activities. Consumption, the main growth driver in the past, expanded at a much slower pace than a year ago. Official statistics on contribution to aggregate growth during Q1 2013 exhibit a significant decrease from all demand components of GDP: consumption, investment and net export, compared to the same period in 2012 (Figure 11). The lower growth in Q1 2013 can partly be attributed to a base effect of last year's fast growth. What is most noteworthy is

[2] The Brent-WTI spread, which exceeded US$ 20/bbl earlier in the year, kept shrinking throughout the summer to reach almost US$ 2/bbl in early August, following a rally in WTI prices (a reflection of sharp increases in US refining runs and a decline in crude stocks, especially in the Midwest). Yet, the spread was back up to US$ 7/bbl by early September. During July-August Urals traded at a US$ 0.65/bbl discount over Brent. Typically, when oil from the Urals is in surplus it will trade at a discount. When exports to the Mediterranean are low, then it will trade closer to parity with Brent.

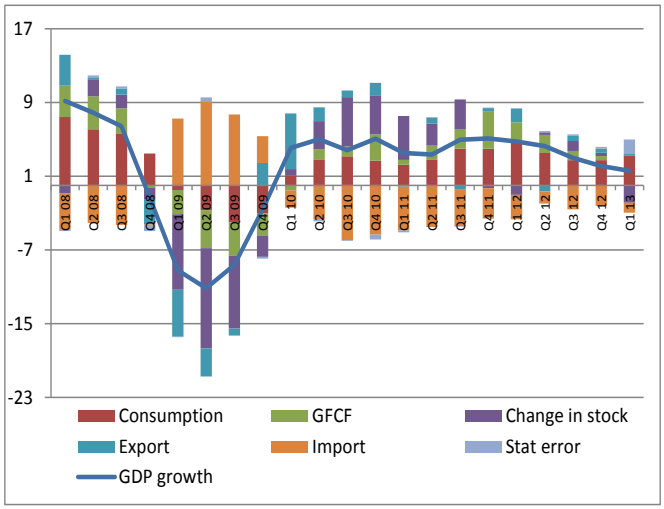
that despite record low unemployment, continuing credit and real-wages growth, consumption grew slower at 4.4 percent in Q1 2013 compared with 6.5 percent a year ago. Its contribution to aggregate growth fell to 3.4 percent from 4.8 (Figure 11). The contribution of consumption to growth leveled out in H2 2012 and Q1 2013. Although the demand composition of GDP growth is not yet available for Q2 2013, high-frequency indicators suggest that domestic demand remained weak and below last year's average. We believe this is also reflecting pessimistic consumer sentiments related to high global and domestic uncertainty about future growth prospects (Box 1).

Figure 4: World 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.

Figure 5: Year-on-year growth composition (percent)



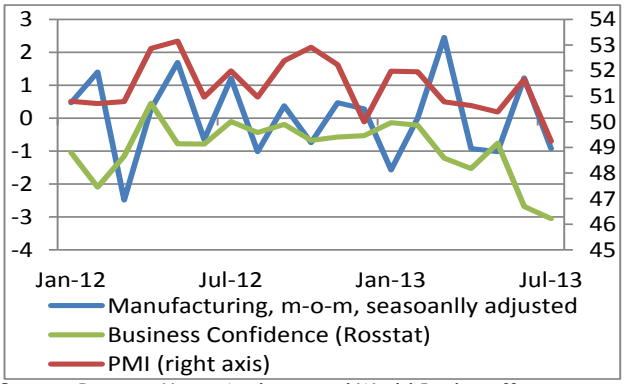
Source: Rosstat and World Bank staff estimates

Box 1. Russian Business and Consumer Confidence Surveys

Business and consumer surveys are traditionally used as predictors of short-term dynamics of high frequency indicators. There are two main indicators of Russian business activity in the manufacturing sector: the Purchasing Manufacturing Index (PMI) conducted by Markit Economics and HSBC and the Rosstat's Business Confidence (RBC) survey. On the consumption side, there is the Rosstat's Consumer Confidence (RCC) survey. These indicators should be used carefully, considering their specific features. For Russia, we observed:

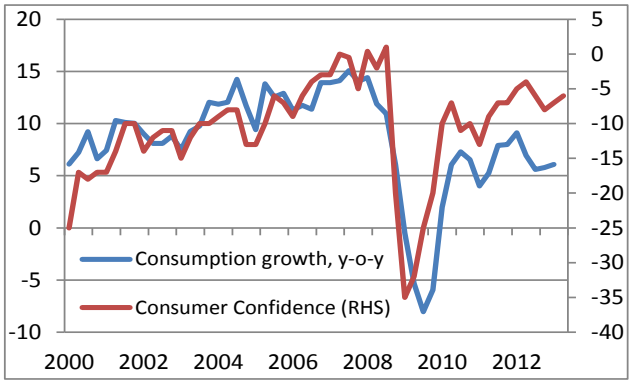
- The PMI is a relatively good predictor of direction of change in manufacturing growth, but not of its level as it appears to be biased upwards
- The RBC indicator predicts the level of manufacturing growth well, but does not reflect all fluctuations
- In recent months, both indexes demonstrated the increased volatility of industrial production growth rates
- The RCC is downward-biased to consumption dynamics, despite becoming more optimistic after the 2008 crisis, making it overall a weak consumption predictor.

Figure 6: Manufacturing and business surveys



Source: Rosstat, Haver Analytics and World Bank staff estimates

Figure 7: Consumption and consumer confidence

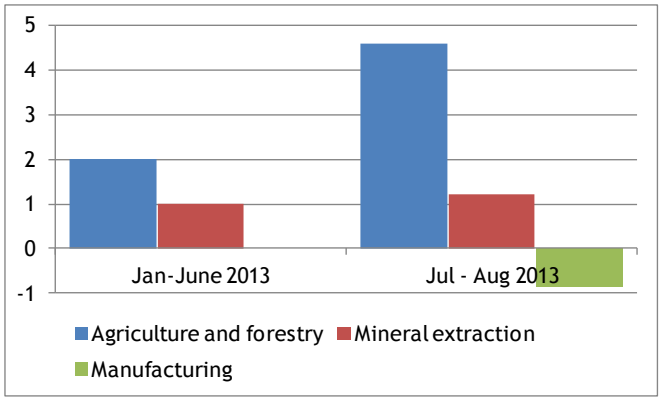


Source: Rosstat and World Bank staff estimates

Box 2. Growth trends in the first two months of Q3 2013

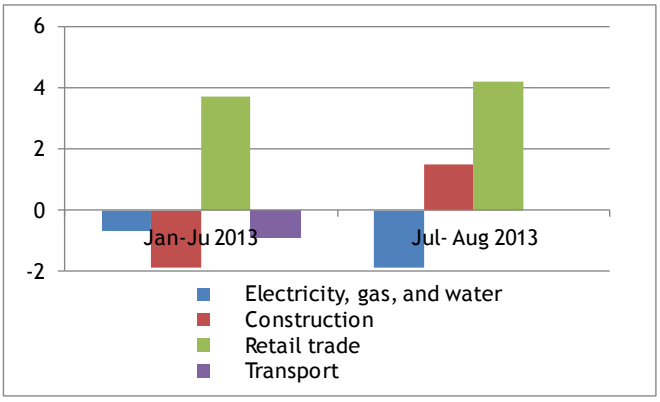
High-frequency indicators for the first two months of Q3 2013 point to still-weak industrial performance while retail, construction picked up. Aggregate industrial production contracted by 0.3 percent in July-August (simple average, y-o-y) after being almost flat in June. As a result, cumulative industrial growth for the first eight months of 2013 fell to zero, compared to a 3.1-percent in the same period of 2012. Apart for the negative impact of the calendar factor (August 2013 had one working day less than August 2012) the observed contraction was driven largely by manufacturing industries (negative 0.9 percent, y-o-y), and, in particular, machine building (negative 8.2 percent), transport (negative 5.6 percent) and metal production (negative 3.2 percent). Yet, economic activity in some of services sub-sectors displayed some improvements in July-August. Construction grew at 1.5 percent (y-o-y) compared with a decline of 1.9 percent in the first half of the year (Figure 9). Retail trade also reported higher growth of 4.2 percent in July-August (y-o-y) compared to 3.8 percent in the first half of the year but still remains considerably below the last year average of 6.3 percent. Investment activity, however, displayed rather uneven dynamics, growing 2.5 percent in July and contracting 3.9 percent in August.

Figure 8: Tradable sector growth (percent, y-o-y)



Source: Rosstat and World Bank staff estimates

Figure 9: Non-tradable sector growth (percent, y-o-y)



Source: Rosstat and World Bank staff estimates

Investment activities dropped sharply as a result of the near completion of large infrastructure projects. During Q1 2013, the decline in investment demand was the main cause for economic slowdown. Investment demand essentially stalled with fixed-capital investment edging up by just 0.1 percent in Q1 2013, compared to a 15.5 percent growth in the same period last year. Thus, its contribution to aggregate growth fell to zero in Q1 2013 from 2.1 percent in Q1 2012 (Figure 11). Companies also continued inventory destocking which almost doubled investment's demand negative contribution to growth. The observed slowdown in investment activities could be partly explained by the ending of large infrastructure projects for the Winter Olympic Games in Sochi and the *Northern Stream* pipeline and partly by skeptical business sentiments (Box 1), which lowered investment demand.

Meanwhile, external demand remained sluggish. Trade in global markets did not provide the expected relief while oil prices retreated, stabilizing below US$ 100/bbl during the second quarter of 2013. Weak export performance was an important factor for lower growth in Q1 2013. Its contribution to aggregate growth fell to just 0.2 percent in Q1 2013 from 2.5 percent in Q1 2012 (Figure 11). We note, however, that first estimates of GDP in Q1 2013 incorporate a relatively large discrepancy (about 1 percentage point). This implies that the reported relative contributions of the GDP's demand components could be overestimated.

Recent consumer and business confidence indexes point to deteriorating sentiments. While investors were already for some time in a wait-and-see mode for some time, consumers now appear to have joined them and the Russian economy is sitting on the fence. According to Rosstat, consumers' confidence deteriorated in H1 2013 relative to the same period of 2012, yet the index remained stable in the first two quarters of the year (Figure 7). PMIs moved quite erratically and remained below their levels of last year, while the Producers' confidence index by Rosstat deteriorated, based on seasonally adjusted trends (Figure 6). The deterioration is especially visible in the manufacturing sectors, which reflects current sluggish output dynamics for that sector. Recent readings of both indices show no improvement, which we interpret as lack of confidence rooted in lingering uncertainty where the global economy and specifically, the Russian economy will come out.

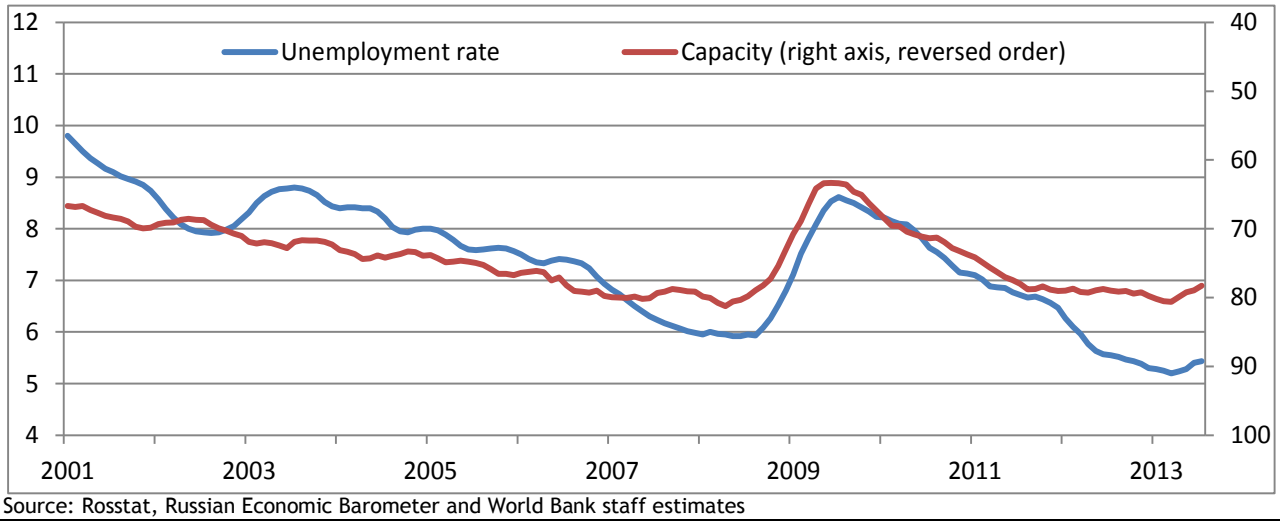
Capacity utilization remains near the upper limit, indicating that the economy is close to its current growth potential (Box 3). Despite the observed broad-based slowdown in the economy, most recent estimates show that

capacity utilization remained in H1 2013 close to 80 percent (Figure 10). That is comparable with rates observed in 2006 and 2007, when the economy was expanding at 8 percent annually. A similar level of capacity utilization was registered in H1 2012, when the economy grew at 4.5 percent. Given the still-tight labor market and the depressed investment activities of the last 4 quarters, it appears that the economy could be running very close to its maximum capacity. This has implications for the efficacy of growth-supporting policies.

Box 3. Is Russia reaching its current growth potential?

Key indicators that could confirm if the Russian economy is operating near its potential are the unemployment rate and capacity utilization. Capacity utilization returned to pre-crisis level and stabilized there, while the unemployment rate is now significantly below the level from 5 years ago. This can partly be attributed to changes in Russia's demographics as the working age population started to decline, translating into a shrinking labor force. Under these conditions the labor market adjusted in Russia and the unemployment rate decreased.

Figure 10: Unemployment rate and capacity utilization, 6 months moving average



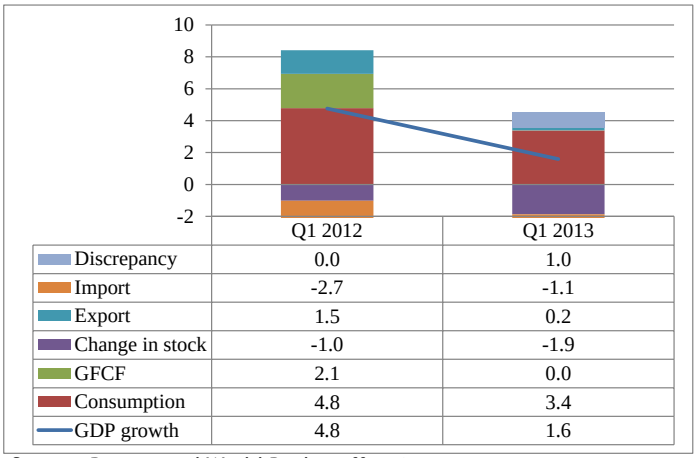
Source: Rosstat, Russian Economic Barometer and World Bank staff estimates

Weaker growth potential is also reflected in the sector composition of growth. We observe that in H1 2013, growth in non-tradable sectors slowed dramatically. In the past years, strong growth in the non-tradable sectors compensated for the gradually deteriorating industrial performance, and the manufacturing of tradables in particular. In H1 2013, growth in major non-tradable sectors such as construction, financial services, transport and communication slowed. Trade performance (retail and wholesale, 20 percent of value of total value added) has been especially disappointing, with the value added in the sector increasing only 1.5 percent in Q1 2013, compared to 8.4 percent in Q1 2013. As a result, the aggregate contribution of non-tradable sectors fell to an estimated 1.7 percent in Q1 2013 from 3.6 percent in Q1 2012 (Figure 12). At the same time, industries involved in extraction and manufacturing[3] either contracted by 4.9 percent in Q1 2012 (y-o-y), compared to a 1.5 percent growth in Q1 2012, or slowed to 1.3 percent from 6.2 percent. As a result, aggregate contribution of tradable sectors contracted to an estimated 0.3 percent in Q1 2013 from 1.2 percent in Q1 2012. This report's special focus note on firm survival and diversification in manufacturing investigates obstacles to growth in this tradable sub-sector.

Considering these observations, overcoming structural challenges to the Russian economy and its growth would need to constitute an important aspect of growth-stimulating policies. For Russia, this would constitute a shift from the growth model followed in the past, which focused at stimulating domestic demand. As structural challenges become binding, constraints such as non-competitive sectors and markets, would need to be addressed to lift Russia's growth potential. This will be also highlighted in the special focus note of this report.

[3] Extraction industries account for 10.9 percent in total value added and manufacturing 15.2 percent.

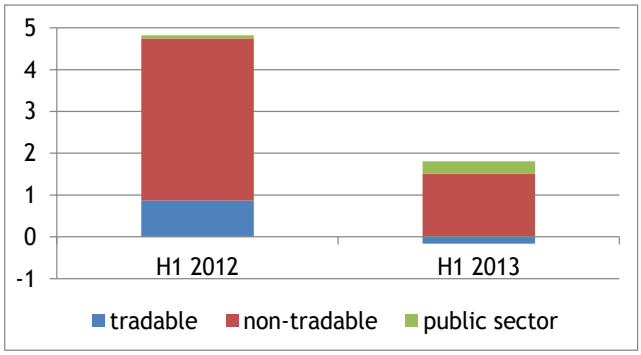
Figure 11: Quarterly year-on-year growth composition (percent)



	Q1 2012	Q1 2013
Discrepancy	0.0	1.0
Import	-2.7	-1.1
Export	1.5	0.2
Change in stock	-1.0	-1.9
GFCF	2.1	0.0
Consumption	4.8	3.4
GDP growth	4.8	1.6

Source: Rosstat and World Bank staff estimates

Figure 12: GDP growth composition (percent, y-o-y)



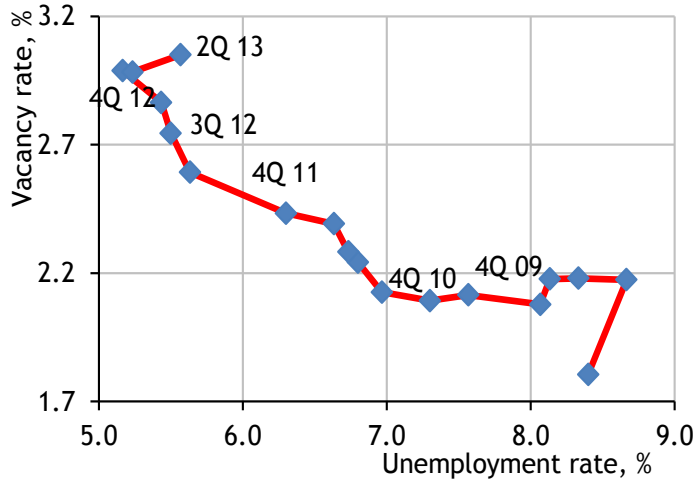
Source: Rosstat and World Bank staff estimates

Labor Market – A Widening Productivity Gap

As a result of the economic slowdown during H1 2013, the labor market relaxed slightly. Growth in real wages decelerated, but continued to outpace productivity growth. Poverty rates stopped their recent decline as income dynamics became less favorable.

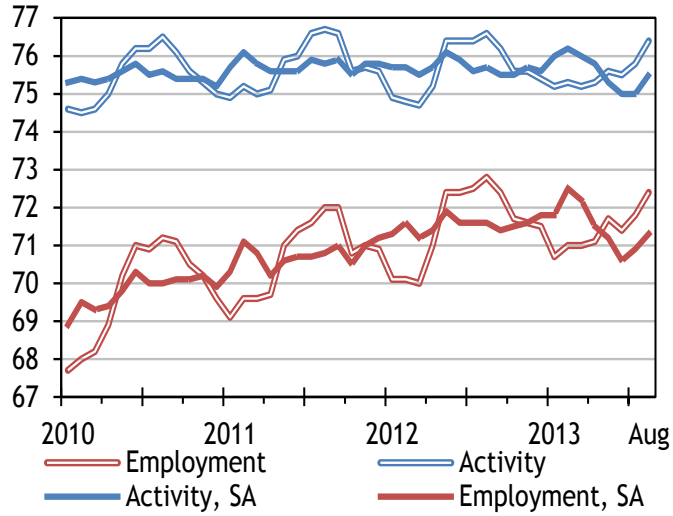
The demand for labor stabilized, reflecting the slowdown in the real sector (Figure 13**).** The vacancy rate[4] in H1 2013 was essentially the same as in H2 2012 when seasonally adjusted. Labor-market supply is now less of a binding constraint than at end of 2012. The seasonally adjusted unemployment rate averaged 5.6 percent in May-August 2013, compared with 5.3 percent in H2 2012. Since the beginning of 2013, the market also saw a decline in the number of employed and economically active people (in seasonally adjusted terms) with some minor pick-up in July-August (Figure 14). Unemployment dynamics across different population groups (male and female, urban and rural) were homogenous. Trends at the regional level, although unequal, reflect national dynamics (Figure 15). The average number of hours worked remains high, though dropping slightly from 38.2 hours per week in Q1 2013 to 38.0 in Q2 2013.

Figure 13: Beveridge curve, %



Source: Rosstat and World Bank staff estimates

Figure 14: Number of employed and economically active population, million people

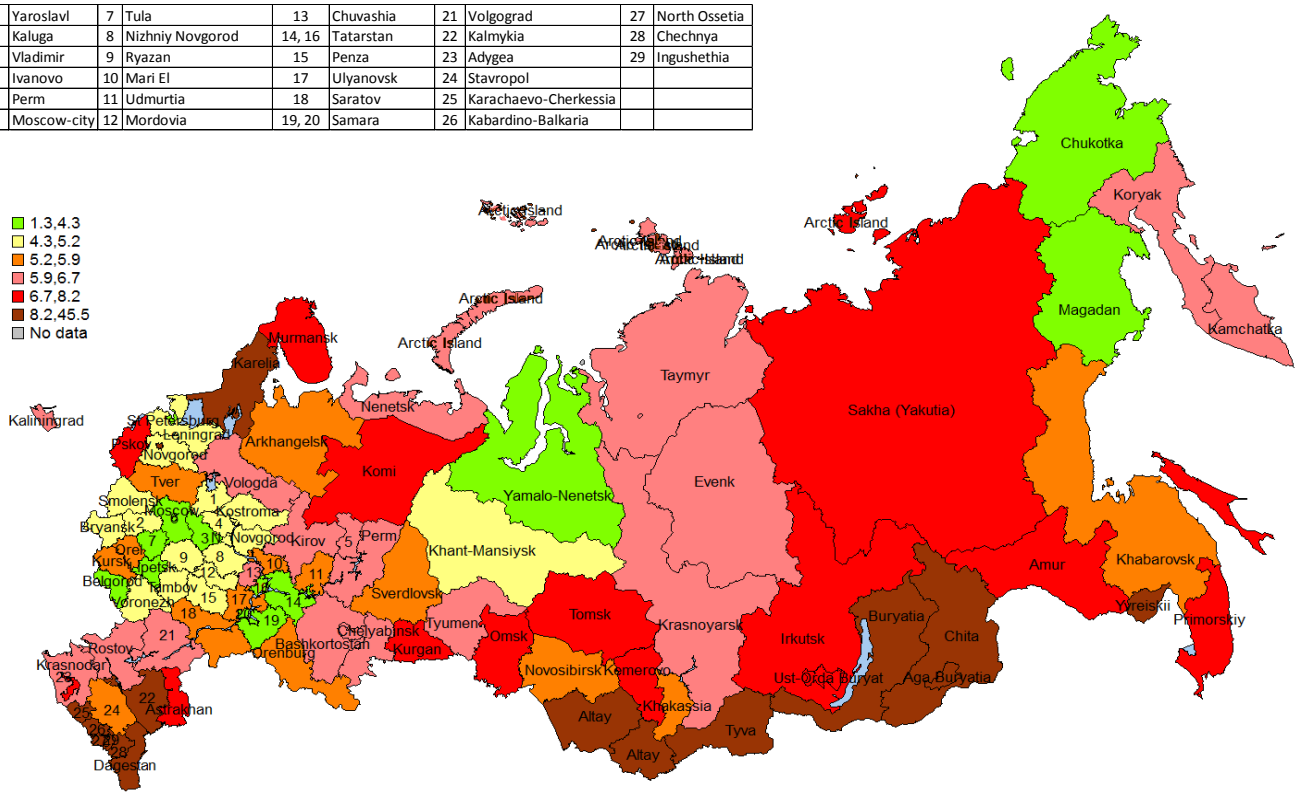


Source: Rosstat and World Bank staff estimates

[4] Definition: Number of vacancies as a share of total number of jobs.

Figure 15: Unemployment rate by regions in H1 2013, percent

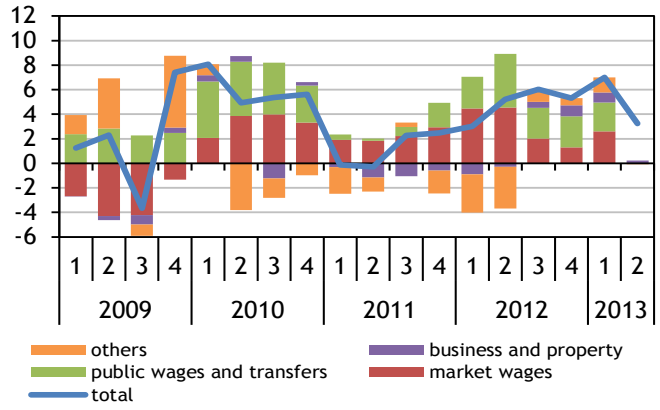
1	Yaroslavl	7	Tula	13	Chuvashia	21	Volgograd	27	North Ossetia
2	Kaluga	8	Nizhniy Novgorod	14, 16	Tatarstan	22	Kalmykia	28	Chechnya
3	Vladimir	9	Ryazan	15	Penza	23	Adygea	29	Ingushethia
4	Ivanovo	10	Mari El	17	Ulyanovsk	24	Stavropol		
5	Perm	11	Udmurtia	18	Saratov	25	Karachaevo-Cherkessia		
6	Moscow-city	12	Mordovia	19, 20	Samara	26	Kabardino-Balkaria		



Source: Rosstat and World Bank staff estimates

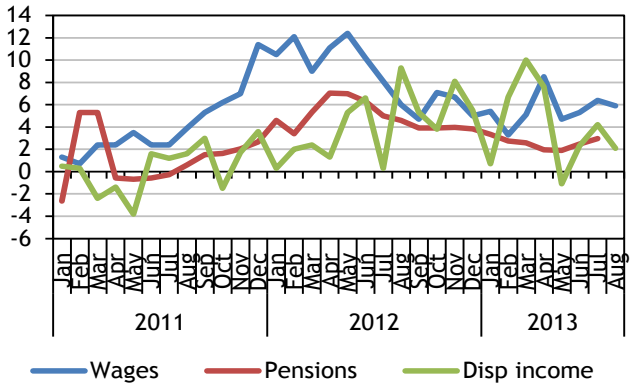
As the labor market softened, household-income and expenditure dynamics decelerated. Income dynamics were weaker, despite wages continuing to be the main driver of disposable income growth in H1 2013 (Figure 16), because other income sources, such as pensions (and other transfers), dividends and entrepreneurial income either stagnated or decelerated (Figure 17). Wage growth in the non-market (i.e., public) sector continues to be faster than in the private sector, contributing to its already higher share in total wage growth (Figure 16). An important factor for recent household consumption growth was the high average growth of stock (35-40 percent, y-o-y) in consumer and other household credits, despite some slow-down since mid-2012. This credit expansion resulted in an increase in total household indebtedness to 25 percent of total disposable income in the first 5 months of 2013, from 17 percent in 2011 and 19 percent in 2012. This increasing debt burden puts pressure on consumption, as interest payments have now reached 5 percent, a significant share of the average household's income (footnote 11). The weak consumption trend observed in the previous section is directly correlated to the increase in households' debt burden, rather than an increase in savings: the net savings rate did not grow in the past months, fluctuating marginally around 15-16 percent.

Figure 16: Contribution to income growth, % y-o-y



Source: Rosstat and World Bank staff estimates

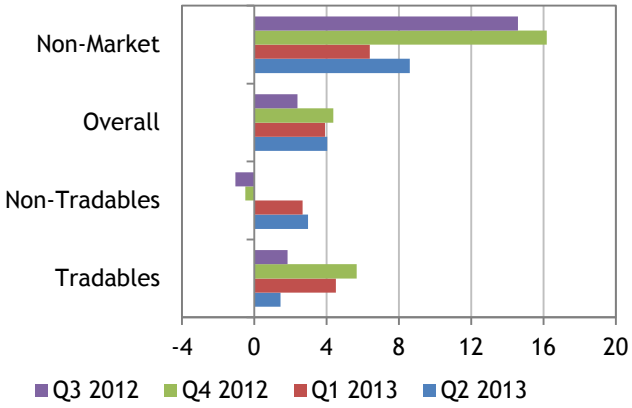
Figure 17: Real income dynamics, y-o-y growth



Source: Rosstat and World Bank staff estimates

The gap between productivity and wages continued to grow (Figure 18). Productivity (per worker and per hour) started to decline in early 2013, as employment growth outpaced GDP growth. Public sector employment especially is back at record level, constituting 24.5 percent of all employment (Box 4).[5] At the same time, real-wage growth in the public (or non-market) sector remained high. Real wage growth accelerated in the non-tradables sector.

Figure 18: Gap between real wages and productivity growth by sectors, y-o-y growth

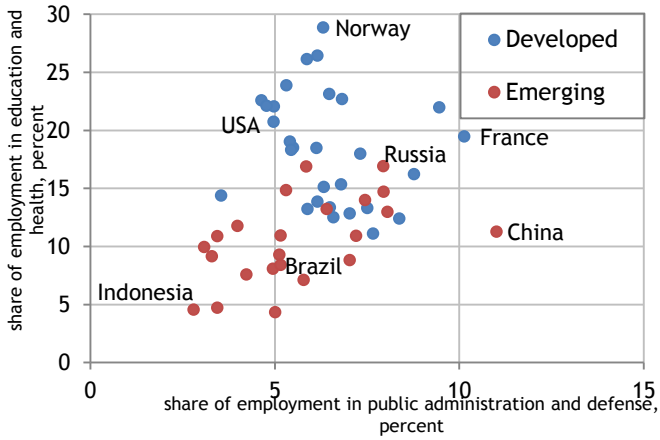


Source: Rosstat and World Bank staff estimates

Box 4. Cross-country comparison of public sector employment

In Russia the average total share of employment in the public (or non-market) sector during 2008-2010 was higher than compared to other developed countries and emerging countries[6], such as Brazil, South Korea, Turkey, or the Ukraine. Among the emerging countries, the only exception is China, which has a very high share of employment in public administration and defense. Compared to developed countries Russia has a higher-than-average share of employment in public administration and defense and education, but a lower share in health and social services.

Figure 19: Share of employment in the public sector



Source: ILO and World Bank staff estimates

Poverty trends were recently flat and accompanied by level-inequality dynamics. The World Bank estimates that poverty in Russia remained almost flat during 2012 at 11-11.5 percent, with seasonal adjustment. According to Rosstat data, all quintile groups had almost the same rate of income growth in 2012. Rosstat also reported a slight increase in the poverty rate in Q1 2013 (Table 1), perhaps due to continuously high food inflation of 13.8 percent compared to 13.5 year ago. However, due to the strong seasonality of poverty and incomes dynamics we would refrain to put much emphasis on developments within a year and focus on multi-annual data.

[5] Such a high share of public sector employment (i.e., public administration and defense, health, social services and education) was only seen in 2009 when it reached a comparable high level of 25.5 percent.

[6] Emerging countries are defined following the IMF definition of July 2012. They include: Argentina, Brazil, Bulgaria, Chile, China, Estonia, Hungary, India, Indonesia, Latvia, Lithuania, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Romania, Russia, South Africa, Thailand, Turkey, Ukraine, Venezuela

Table 1: Poverty rates in Russia, percent

Period	*2010*	*2011*	*2012 (average)*	*Q1 2012*	*Q2 2012*	*Q3 2012*	*Q4 2012*	*Q1 2013*
Poverty rate, percent	12.5	12.7	11	13.5	11.5	11.6	8.8	13.8

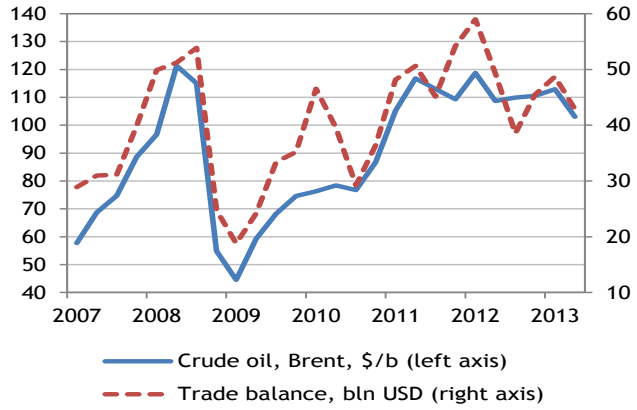
Source: Rosstat, World Bank staff estimates

Balance of Payments — Deterioration as Exports Weaken

The weaker export performance in H1 2013 reflects a subdued global economic activity that brought about sluggish external demand and a deteriorating current account. Capital outflows increased since May as a result of some reallocation of global assets portfolios away from emerging economies, in anticipation of the scaling back of the US monetary stimulus.

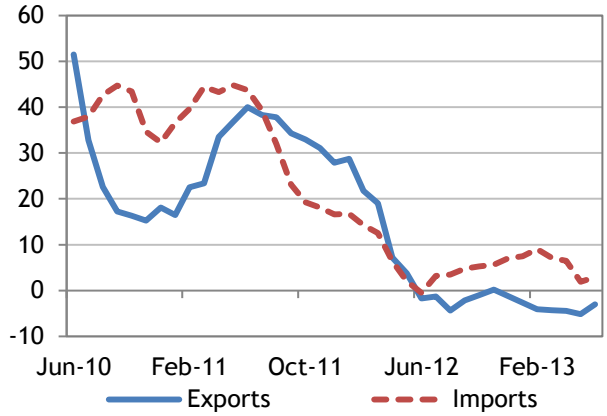
The current account deteriorated as the trade surplus melted. The current account surplus decreased to US$32 billion in the first half of 2013, from US$55.5 billion in the same period last year. Falling exports and lower resources prices were the main cause for the decline of trade surplus to US$91.6 billion (9.1 percent of GDP) in H1 2013, from US$108.3 billion (11.5 percent of GDP) in H1 2012 (Figure 20, Figure 21). The weakening of the current account is also attributed to a deteriorated balance of services, in which the deficit increased to US$23.4 billion in H1 2013 from US$18.5 billion in H1 2012. In spite of a still-substantial current-account surplus, the non-oil deficit of the current account reached US$134.7 billion, or 13.4 percent of GDP in the first half of 2013, compared to US$119 billion, or 12.6 percent in the same period last year (Table 2).

Figure 20: Trade balance and oil prices



Source: CBR; and World Bank staff estimates

Figure 21: Export and imports (growth yoy, 3mma US$)



Source: Rosstat and World Bank staff estimates

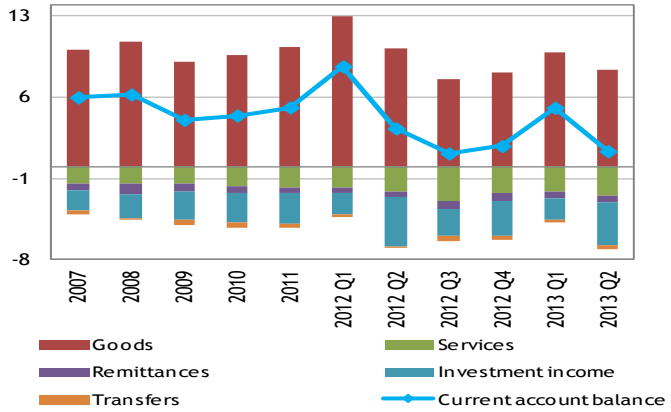
The capital account improved marginally but it experienced volatility due to some erratic investors' behavior in anticipation of the winding up of quantitative easing in the US. While capital outflows increased since the announcement of the Fed in May, overall, net capital outflows from the private sector declined marginally during the first half of 2013, compared to the period a year ago totaling US$38.4 billion in H1 2013, compared to US$40.1 billion in H1 2012 (Table 3). The financial account remained practically unchanged. According to preliminary estimates, the deficit amounted to US$21.7 billion, or 2.2 percent of GDP in the first half of 2013, compared to US$22.32 billion, or 2.4 percent of GDP in the first half of 2012 (Figure 23).

Table 2: Balance of Payments, 2007-2013, US$ billions

	2007	2008	2009	2010	2011	2012	Q1 2012	Q2 2012	Q3 2012	Q4 2012	Q1 2013*	Q2 2013*	H1 2012	H1 2013*
Current account balance	72.2	103.9	50.4	67.5	97.3	71.4	39.5	16.0	5.9	10.0	25.1	6.9	55.5	32.0
Trade balance	*123.4*	*177.6*	*113.2*	*147.0*	*196.9*	*192.3*	*59.0*	*49.3*	*38.5*	*45.5*	*48.7*	*42.9*	*108.3*	*91.6*
Non-oil current account balance	-146.4	-206.2	-140.3	-186.6	-244.5	-265.8	-51.6	-67.4	-74.5	-72.3	-60.4	-74.3	-119.0	-134.7
Capital and financial account	86.4	-139.8	-40.6	-21.6	-72.5	-31.2	-28.8	1.7	-4.3	0.1	-14.0	-7.8	-27.0	-21.8
Errors and omissions	*-9.7*	*-3.1*	*-6.4*	*-9.1*	*-12.1*	*-10.2*	*-6.1*	*-2.8*	*-0.1*	*-1.2*	*-6.2*	*-3.6*	*-8.9*	*-9.8*
Change in reserves (- = increase)	-148.9	38.9	-3.4	-36.8	-12.6	-30.0	-4.6	-15.0	-1.5	-8.9	-4.9	4.4	-19.6	-0.5
Memo: average oil price (Brent, US$/barrel)	72.5	96.9	61.5	79.7	111.1	112.0	118.7	108.7	109.9	110.5	112.9	103.0	113.7	108.0

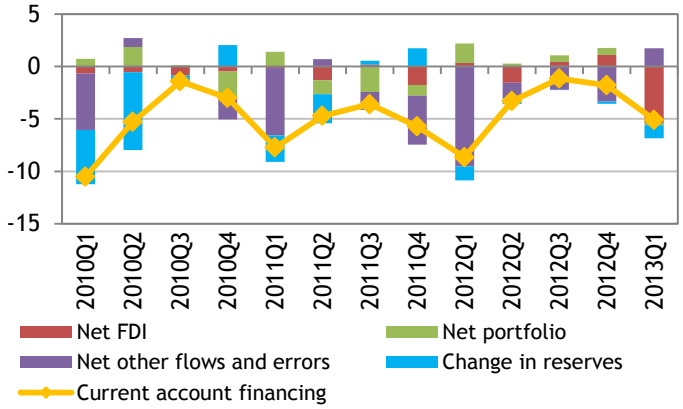
Source: CBR * Preliminary estimates

Figure 22: Current account balance (percent of GDP)



Source: CBR, Rosstat, World Bank staff calculations

Figure 23: Current account financing (percent of GDP)



Source: CBR, Rosstat, World Bank staff calculations

Table 3: Net Capital Flows, 2007-2013 (US$ billions)

	2007	2008	2009	2010	2011	2012	Q1 2012	Q2 2012	Q3 2012	Q4 2012	Q1 2013*	Q2 2013*	H1 2012	H1 2013*
Total net capital inflows to the private sector	87.8	-133.6	-57.5	-30.8	-84.8	-53.8	-34.7	-5.4	-7.9	-5.9	-28.4	-10	-40.1	-38.4
Net capital inflows to the banking sector	*45.8*	*-55.2*	*-32.2*	*15.9*	*-23.9*	*18.5*	*-9.7*	*11.6*	*7.7*	*8.9*	-17.2	-2.2	1.9	-19.4
Net capital inflows to the non-banking sector	42	-78.3	-25.3	-46.7	-60.9	-72.3	-24.9	-17.0	-15.6	-14.8	-11.2	-7.7	-41.9	-18.9

Source: CBR * Preliminary estimates

Russia's external liabilities increased in H1 2013 with state-owned or state-controlled non-financial corporations and banks continuing to increase their borrowing abroad in spite of volatile global market conditions. Russia's external debt increased to US$704 billion (33.2 percent of GDP) by end June 2013 from US$638 billion (31.7 percent of GDP) at end December 2012 (Table 4). The increase was driven by the corporate sector, with the exposure of non-financial corporations increasing most (by US$52 billion) while the external debt of the banking sector increased by just US$9 billion. It is important to note that in H1 2013, most of the new external debt was accumulated by state or quasi-state companies and banks. The exposure of private-sector firms remained practically unchanged, and it decreased for private-sector banks. There are large external debt payments by the corporate sector coming due in the second half of 2013. CBR projected bank's external debt payments in H1 2013 of about US$ 29 billion and those ofnon-financial corporations at almost US$62 billion, with US$52 due in the last quarter of the year (Table 5). Although access to the capital market could be somewhat restricted for emerging economies because of the reevaluation of risks associated with potential tapering of the quantitative easing, it is not expected that banks and/or private companies will face restrictions with rolling over their external liabilities. To a large extent, this is due to the fact that a large share of external liabilities is held by state or quasi-state companies and banks, which have implicit Government guarantee that the market takes into account.

Table 4: Russia's External Debt, US$ billions

	1-Jan-10	1-Jul-10	1-Jan-11	1-Jul-11	1-Oct-11	1-Jan-12	1-Apr-12	1-Jul-12	1-Oct-12	1-Jan-13	1-Apr-13	1-Jul-13
Total debt	**467.2**	**457.4**	**488.9**	**538.9**	**527.8**	**541.9**	**561.7**	**574.8**	**600.6**	**637.8**	**691.1**	**703.9**
Corporate	**421.3**	**410.1**	**442.4**	**491.0**	**482.6**	**492.6**	**509.1**	**517.1**	**538.8**	**567.8**	**614.1**	**628.4**
Banks	***127.2***	***122.1***	***144.2***	***159.0***	***157.3***	***162.8***	***169.2***	***175.4***	***189.9***	***201.6***	***205.8***	***210.7***
of which Private Banks	*77.0*	*71.4*	*80.8*	*89.1*	*86.8*	*89.5*	*90.6*	*78.7*	*84.1*	*86.2*	*81.0*	
Non-financial corporations	***294.1***	***287.9***	***298.2***	***332.0***	***325.3***	***329.8***	***339.8***	***341.7***	***348.9***	***366.2***	***408.3***	***417.7***
of which Private Non-fin. Corporations	208.9	204.1	208.3	236.3	228.9	227.8	236.0	234.2	237.7	252.6	255.1	

Source: CBR, World Bank staff calculations

Table 5: Projected debt payments in 2013-2014 (principal + interest)

	Q2 2013	Q3 2013	Q4 2013	2014
Government	7.9	2.0	1.1	12.1
Banks	18.8	11.9	17.2	47.8
Other sectors	28.5	26.6	35.2	91.7
Total	**55.2**	**40.6**	**53.5**	**151.6**

Source: CBR, World Bank staff calculations

Box 5. Russia-Ukraine Trade Relations

On August 14, 2013, Russian customs started in an unannounced unilateral move to apply stricter rules for checking of Ukrainian goods. This caused substantial delays for many Ukrainian exporting companies. On August 20, Russian customs switched back to regular checking procedures of imports from the Ukraine.

According to Russian officials, customs used the more strict procedures so it could estimate what changes in customs procedures Russia would need to introduce if Ukraine signed the Agreement of Association with the EU at the end of November, 2013. Russia says that if Ukraine signs the Agreement of Association, it will be ineligible to join the Eurasian Customs Union and Common Economic Space. In order to the prevent transshipment of goods from the EU through Ukraine, Russian authorities plan to introduce stricter customs procedures when these goods enter Russia. In addition, if Ukraine signs EU agreement, Russia will introduce import tariffs for goods. Ukraine has declared its interest in signing a customs agreement with Russia that would not contradict the Agreement of Association with the EU. The two countries are in the process of negotiating conditions for their future trade cooperation.

Since September 2012, Russia and the Ukraine have been acting under the CIS free-trade zone agreement, with tariff-free access to markets (with a small number of exceptions) and simplified customs checks. Russia is a key trade partner for the Ukraine. In 2012, Ukrainian exports to Russia comprised US$18 billion, 23.7 percent of total Ukrainian exports. It exported mainly ferrous metals, railcars, nuclear equipment and food products (Table 6). Export of Russia to Ukraine totaled US$27.2 billion or just 4.9 percent of Russia export, with fuel products (mainly gas) comprising more than 60 percent of the total. The integration links that existed between Russian and Ukrainian companies during Soviet times are much weaker now. It appears that for Russia, the majority of the imports from the Ukraine could be easily sourced elsewhere, except for nuclear parts. The immediate economic impact of worsening trade relations with Ukraine would be quite limited for Russia.

Table 6: Export of goods, percent

Ukrainian export of goods to Russia, by main components, percent		*Russian export of goods to Ukraine, by main components, percent*	
Ferrous metals and metal goods	19.6	Mineral fuel products	63.8
Railcars	14.8	Nuclear reactors, boilers, etc.	4.7
Nuclear reactors, boilers, etc.	12.8	Non-organic chemical products	3.9
Food and agricultural raw materials	11.6	Ferrous metals	3.8
Electric machines and equipment	6.7		
Mineral fuel products	4.9		
Non-organic chemical products	4.3		

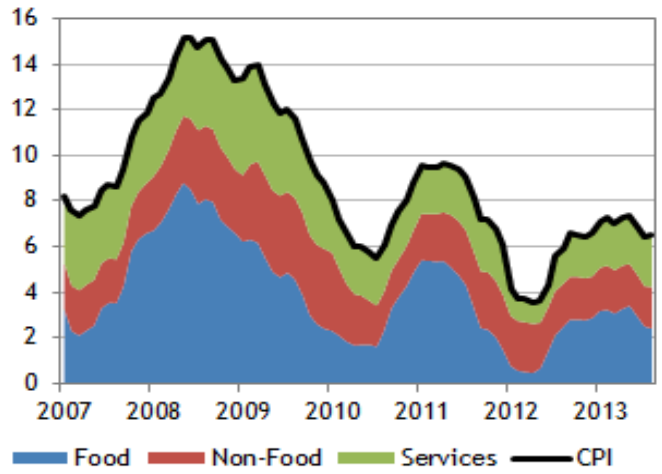
Source: Customs statistics

Monetary Policy and Financial Sector — Increased Currency and Credit Risks

Inflation moderated towards the end of Q2 2013 largely due to slower-rising food prices. Starting in June, exchange-rate volatility intensified markedly and the Ruble came under increasing pressure. The rate of credit growth remains high and risks involving market access and portfolio quality are on the rise.

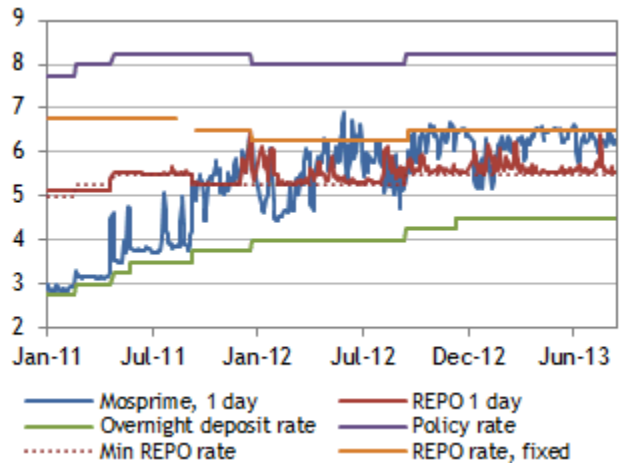
Inflation pressures subsided by mid-year. The consumer price index (CPI) had been stubbornly high during most of H1 2013, staying above 7 percent during the first five months of 2013 due to higher-than-expected prices on food (8.7 percent) and services (8.0 percent). Headline CPI inflation started to retreat only in June and leveled out by August at 6.5 percent (Figure 24). This slightly exceeds the end-year inflation range targeted by CBR (5 to 6 percent), while core inflation, which excludes food and gasoline, remained in the targeted range at 5.5 percent in August. In June, lower inflation risk and sluggish economic performance raised speculative talk of monetary loosening. However, the central bank resisted growing public and political pressures to change its main policy rates. This signaled to market participants that it remains fully committed to inflation targeting, even if on balance, risks have switched from inflation to growth. CBR's policy choice is reasonable in an economy where the labor market remains tight and inflation still exceeds money-market rates (Figure 25). The policy also appears consistent with the remaining challenge for the CBR: to anchor the expected rising inflation in Q3 due to seasonal increases in administrated utility prices.

Figure 24: CPI inflation by component (percent, yoy)



Source: Rosstat and World Bank staff estimates

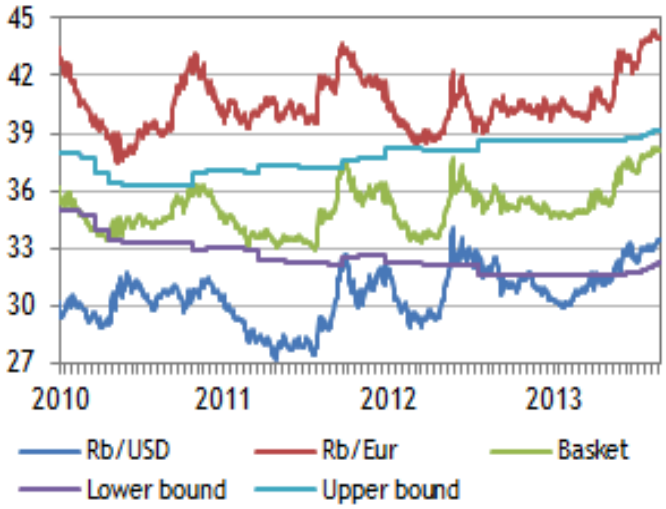
Figure 25: Interest rates (percent)



Source: CBR and World Bank staff estimates

Exchange-rate volatility increased in June-August 2013, forcing CBR to gradually move the bilateral currency corridor up (Figure 26) and to considerably scale up its interventions. The increased pressure on the Ruble was triggered by a sharp seasonal deterioration of the current account and sizable capital outflows. However, at present quantitative easing tapering effects appear to be limited. CBR sold US$2.7 billion in June and US$4.2 billion in July to support the Ruble. In June-August 2013, the Russian currency depreciated by 4.6 percent against the US$ and 5.4 percent against the bilateral currency basket (compared with a depreciation of 3.8 and 3.7 percent, respectively, in the first five months of 2013). However, according to the CBR, only US$1.6 billion were untargeted interventions, which the regulator uses to smooth excessive volatility of the exchange rate not related to fundamental changes in the balance of payment.[7] Compared to US$13 billion in 2011 and US$25 billion in 2010, the amount of untargeted interventions this year is rather limited, which indicates that the CBR remains fully committed to transitioning to a flexible exchange-rate management.

Figure 26: Exchange rate and its bilateral band



Source: CBR, World Bank staff calculations

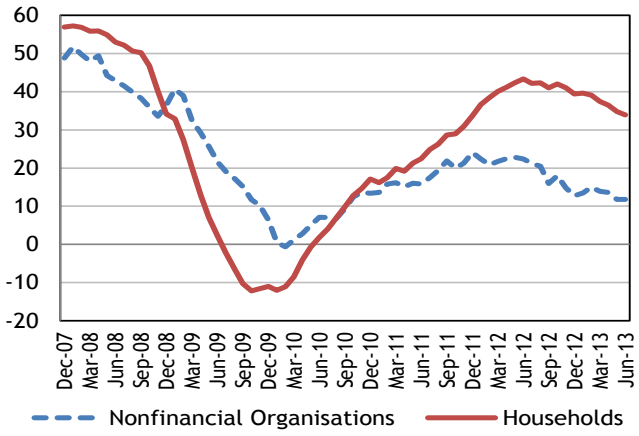
[7] One of the sources for speculative attack on the Ruble in June appeared to be an announcement by the Ministry of Finance of the potential purchase of foreign exchange on the market to replenish the Reserve fund. Initially the amount was estimated at around Rub150 billion (USD 4.5 billion) and later reduced to Rub 30-50 billion. Recently, the Ministry of Finance has indicated that the amount could be even lower due to lower-than-projected revenue collection. Thus, even if the Ministry of Finance makes trial purchases of US$ on the market, it is unlikely to add significantly to market volatility.

In Russia, greater capital outflows since May appear to have been caused by a reallocation in financial assets triggered by expected narrowing yield differentials with the advanced economies, supported by a perception that the new Governor of CBR will take a dovish stance towards interest rates. The equity and bond markets have been volatile and, while lower bond rates may lead to capital gains, these might also presage a future of lower yields once positions are unwound. However, given that a higher interest rate environment would be more beneficial for the policy framework, sharp changes in the bond market are likely to be short-lived. It is likely that large firms currently are parking more assets abroad. This is a rational approach to investing, albeit one that is detrimental to Russia. In any case, large Russian firms often issue debt abroad as the financing costs (net of exchange-rate risks) are usually lower than at home. Future tapering of quantitative easing could lessen demand for such debt but does not, as yet, appear to have done so in recent months.

Box 6. Recent Trends in Credit Growth and Market Access

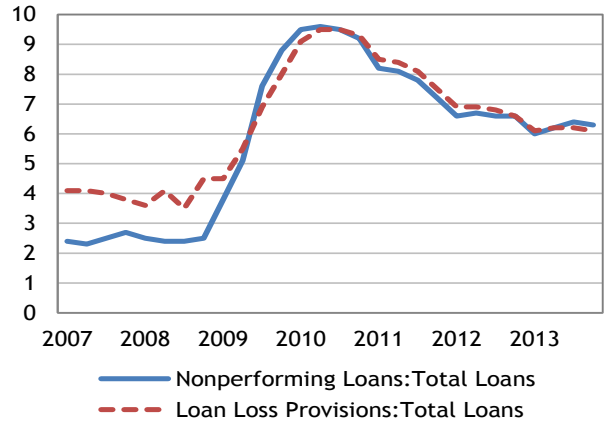
The rate of credit growth is high, and capital adequacy ratios of 13.5 percent, while meeting regulatory requirements, are not enviable and below the region's average. In the 12 months to July 2013, the volume of new ruble loans increased by 12.9 percent, on top of a 42.6 percent rise between 2010 and 2011. Moreover, new foreign exchange loans increased by 52.0 percent from January-July 2013, after a small contractions in the previous two years. This suggests that it is more cost effective for banks to borrow abroad than to attract domestic deposits. These funds are then lent to bank customers. Consistent with this, new bond issuance by banks is rising. There is a similar pattern in new lending to small- and medium-sized firms (SMEs), where new loans in rubles increased by 12.9 percent versus by 26.1 percent in foreign currencies. This likely reflects opportunistic interest-rate pricing and may lead to higher effective rates if, as expected, the ruble depreciates. However, interest rates on loans to SMEs of one-year-or-higher maturity have been falling, a likely consequence of using foreign exchange loans that carry the risk of a rise in effective rates. Foreign-exchange loans account for only 10 percent of all new lending, although the share is growing. This suggests that banks currently do have appropriate access to foreign exchange and concern over such access is not the cause of current capital outflows.

Figure 27: Credit growth (percent, yoy)



Source: CBR, World Bank staff calculations

Figure 28: Nonperforming loans and loan loss provisions (percent of total loans)



Source: CBR, World Bank staff calculations

Credit expansion slowed, but risks of maintaining credit quality and access to markets increased (Box 6). Credit growth to households slowed for seven consecutive months to 33.8 percent in July 2013 from a peak of 42.7 percent in October 2012. Yet, the stock of private credit increased to 44.7 percent of GDP at the end of July 2013, compared to 44.2 percent at the end of December 2012.[8] There are also some concerns about links between the banks and state-owned enterprises, and about the stock of refinanced and restructured loans in the system. Non-performing loans (NPLs) correspond to 6.3 percent of loans in the banking system, around the same level as in the previous year. Continued high growth in lending may lead to more NPLs, which could also, in time, induce a reduction in bank lending.[9] The effect of this, coupled with a possible decline in funding to banks, would restrict

[8] Mortgage interest rates were higher by around 0.5 percent in July 2013, y-o-y. The volume of new mortgage loans increased by 24.8 percent over the same period, although that rate was down from the 52.6 percent rise in the previous 12 months. The distribution of maturities has remained roughly the same.

[9] Household credit growth picked up last year from a very low base and compared to other eastern European countries the level of household debt is still low. In addition, the depth of financial intermediation is still very low in Russia with only about 25 percent of the population

access to credit, especially for SMEs. In the event of less access to foreign funding, for example as an effect of quantitative easing tapering, it is likely that CBR and Government funds would act as a stop-gap replacement.[10] This might soften the impact but nevertheless stress the system and restrict normal credit. However, structural reforms would be much healthier for the financial system than back-stop financing from the state. Hence, a prudent policy would be to increase banks' capital levels (an initiative already being undertaken by CBR) and implement higher provisioning against potential loan losses while taking a conservative stance against easy loan re-scheduling. Such an approach would develop a capital cushion that would soften the impact of any future international funding problems.

Government Budget – Consolidation as Fiscal Revenues Plummet

Fiscal policy switched from expansionary to consolidation mode as lower oil prices cut revenues in early 2013. Yet, fiscal buffers remained well below pre-crisis levels while su-bnational fiscal trends exert increasing pressure on the consolidated budget.

The Federal Government exercised higher control over budget spending during the first seven months of 2013. Over this time period, oil revenue declined from 11.2 percent of GDP to 9.8 percent. To compensate for this decline, federal expenditures were reduced from 20.9 percent to 19.1 percent of GDP. The non-oil fiscal deficit dropped to 9.2 percent of GDP as compared with 10.4 percent in January-July 2012 (Table 7). While 2012 ended with a marginal federal budget deficit of 0.1 percent of GDP, during January-July 2012 it was still in surplus at 0.9 percent of GDP. Preliminary numbers for January-July 2013 show that the fiscal outturn during the same period this year worsened moderately by 0.3 percent of GDP, but remained in surplus at 0.6 percent of GDP. Despite the global oil price moderation in H1 2013, the average oil price during January-July 2013 remained above the prices envisaged in the 2013-2015 budget law (US$97 per barrel for 2013). Most recently[11], the Ministry of Finance forecast in its new medium-term budget document of July 2013 (Box 7) a lower federal budget deficit for the year end of 0.5 percent of GDP, while the 2013 Budget Law projected 0.8 percent of GDP.

Table 7: Federal Budget 2011-2013, % of GDP

	2011	2012	Jan - Aug 2012	Jan - Aug 2013	2013	2013
	Actual	Actual	Actual	Actual	Budget Law	Estimate
Expenditures	20.1	20.6	20.9	19.1	20.1	19.8
Revenues	20.9	20.5	21.8	19.8	19.3	19.3
Balance	0.8	-0.1	0.9	0.6	-0.8	-0.5
Oil Revenues	10.4	10.3	11.2	9.8	8.9	9.0
Non-Oil Balance	-9.6	-10.4	-10.4	-9.2	-9.7	-9.6
Urals oil price, US$/barrel	109.3	110.4	110.4	106.8	97.0	105.0

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

Increased fiscal pressures on the consolidated budget primarily originate from a weaker sub-national public finance situation. Consolidated budget revenues declined as a result of lower sub-national revenues (Table 8). The main reason was lower corporate profits due to the economic slowdown, especially in manufacturing. This cut corporate profit tax proceeds at sub-national level from 3.9 percent of GDP in H1 2012 to 2.6 percent of GDP in H1 2013. Total sub-national revenues decreased by 1.7 percent of GDP in H1 2013 as compared to H1 2012, while sub-national budget expenditure declined only moderately by 0.3 percent of GDP over the same period, turning a sizable surplus of the sub-national budget into a zero budget balance. Consolidated budget revenues dropped in H1 2013 from 38.5 percent of GDP to 36.4 percent in H1 2012. But contrary to the situation at the federal level, this decline was not accompanied by an adjustment on the expenditure side. Consolidated expenditures stayed

currently using formal financial services. Nevertheless, we expect relatively fast credit growth in the medium term which could increase credit risks. Currently, these risks appear to be contained and the CBR does not see any systemic risk according to the results of their stress testing.

[10] In July Moody's lowered the ratings of long-term senior debt and deposits for four major state banks, including Sberbank and VTB, by one notch. Lower capacity of the state to step in with systemic support in case of a crisis was the main reason for the downgrade. Such capacity has been negatively affected by growing contingent liabilities associated with the financing of state corporations and regions, as well as with lower levels of the Reserve and National Welfare Funds, standing now at 8.5 percent of GDP compared to 16.1 percent before the 2008 crisis.

[11] In its new medium term budget document of July 2013.

almost at the 2012 level, 34.7 percent of GDP. As a result, the consolidated budget balance deteriorated during the first half of 2013 by 2.3 percent of GDP compared to previous year, from 4.0 percent of GDP to 1.7 percent of GDP.

Table 8: Consolidated Budget and Consolidated Subnational Budget in 2012-2013, % of GDP

	2012	2012 H1	2013 H1	2013
	Actual	Actual	Actual	Forecast
Consolidated Budget				
Expenditures	36.6	34.6	34.7	37.6
Revenues	37.0	38.5	36.4	36.9
Balance	0.4	4.0	1.7	-0.7
Consolidated Subnational Budget				
Expenditures	13.3	12.1	11.8	13.0
Revenues	12.9	13.5	11.8	12.7
Balance	-0.4	1.4	0.0	-0.3

Source: Ministry of Finance, World Bank staff calculations

Box 7. The New Medium-Term Budget Policy Document

Key directions of the budget policy for 2014 and for the planning period of 2015 and 2016 was published by the Ministry of Finance in July. The document contains a preliminary, medium-term budget forecast and, for the first time, preliminary long-term budget parameters for the years 2020, 2025, and 2030. Overall, a gradual fiscal consolidation is envisaged, with the key assumption that a reduction in the non-oil federal budget deficit will occur over time: decreasing from 9.6 percent of GDP in 2013 to 7.8 percent of GDP in 2016, and to 6.0 percent of GDP in 2030. The consolidated budget deficit is expected to shrink from 0.7 percent of GDP in 2013 to 0.5 percent in 2016, with revenues and expenditures declining by 2.5 percent of GDP and 2.7 percent of GDP respectively (Table 9).

By 2020, the consolidated budget deficit is projected to be executed with a moderate deficit (0.1 percent of GDP). In 2025 a balanced budget is forecast and for the outer year of the projection, 2030, a 0.3 percent deficit is foreseen. A more prominent principle of the new framework is to increase the sustainability of the federal budget by decreasing its dependence on external factors in the long run. Notably, it also envisions that for new expenditure commitments, efficiency analyses are performed and program-budgeting principles are applied by 2016 for about 90 percent of all federal budget expenditures. Planned measures to reduce budgetary dependence on external factors include: (i) the adherence to the recently installed fiscal rule, (ii) a gradual reduction in the non-oil budget deficit during 2014-2016, (iii) capping Federal debt (to not more than 20 percent of GDP), and (iv) continuing to accumulate extra oil revenues in the Reserve Fund.

Table 9: Medium-Term Projections and Long-Term Government Budget Forecast For 2014-2016 and Up To 2030, % of GDP

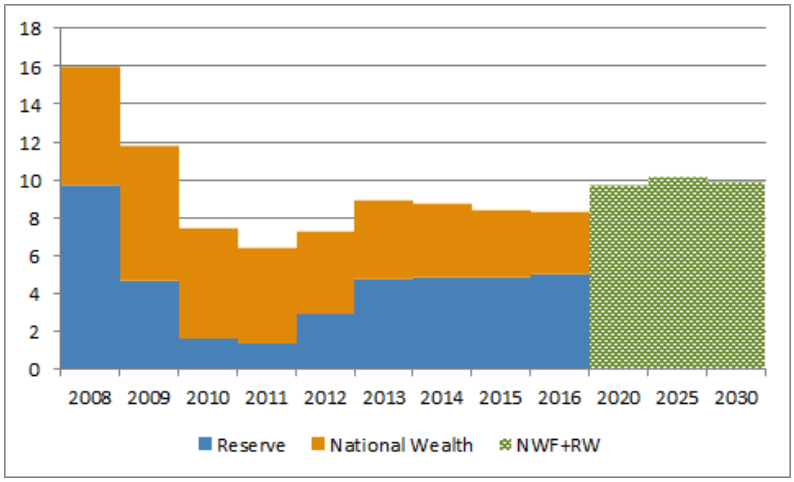
	Estimate	Preliminary draft budget			Preliminary forecast		
	2013	2014	2015	2016	2020	2025	2030
Consolidated Budget							
Expenditures	37.6	35.8	35.4	34.9	34.7	33.6	33.0
Revenues	36.9	35.1	34.9	34.4	34.6	33.6	32.7
Balance	-0.7	-0.7	-0.5	-0.5	-0.1	0.0	-0.3
Federal Budget							
Expenditures	19.8	18.7	18.6	18.0	17.0	15.7	14.5
Revenues	19.3	18.2	18.0	17.4	16.6	15.4	14.2
Balance	-0.5	-0.5	-0.6	-0.6	-0.4	-0.3	-0.3
Non-Oil Balance	-9.6	-8.5	-8.4	-7.8	-7.8	-7.0	-6.0
Urals crude oil price, US$/barrel	105.0	101.0	100.0	100.0	NA	NA	NA

Source: Ministry of Finance

No significant changes to Russia's fiscal buffers are being planned. Both the Reserve Fund and the National Welfare Fund (NWF) are projected to remain well below 2009 pre-crisis levels (of 9.8 percent of GDP and 6.3 percent of GDP, respectively) and their new medium-term targets are quite modest. According to preliminary projections, the Reserve Fund, which was replenished in early 2013 to about 4 percent of GDP, is expected to

increase to about 4.4 percent of GDP by 2016. The NWF (currently at about 4.3 percent of GDP) is forecasted to decline to about 3.2 percent of GDP by 2016 (Figure 29). The possibility that the NWF could invest up to 450 billion rubles into domestic stock and bonds associated with new priority infrastructure projects is being publicly discussed. Such projects include the construction of a high-speed railroad between Moscow and Kazan, a new Central Ring Road in Moscow and upgrades to the Trans-Siberian railway. As a result of this strategy, by 2016 about 29 percent of NWF would be invested into domestic assets. In the long run, both funds together are projected to reach 9.8 percent of GDP in 2020 and 9.9 percent of GDP in 2030. Thus there is an implicit assumption that the Reserve Fund could reach its target level of 7.0 percent of GDP in the long run.

Figure 29: Reserve and National Welfare Funds in 2008-2030, % of GDP



Source: Ministry of Finance, World Bank staff calculations

Part II. Economic Outlook

The World Bank expects global growth to gradually recover and oil prices to stabilize at current levels. Although risks to the global outlook are less pronounced and more balanced compared to a year ago, new risks are gaining prominence. For 2013, we lowered our May projection of Russia's GDP growth to 1.8 percent from 2.3 percent. Economic activity is expected to remain fragile in Q3 2013, with the overdue global recovery delaying the earlier projected increases in Russian exports towards the end of 2013. In Q4, we expect the economy to regain some dynamism as investment activities start to pick up. For the remaining two quarters of this year, we also expect positive effects from agriculture. The World Bank projection for Russia's growth in 2014 is positive at 3.1 percent, but with downside risks. We project a moderate uptick in growth as the pace of expansion will be, in our view, fundamentally held back by the economy operating near its current capacity. Next year's growth prospects will largely depend on an increase in external demand and the recovery Russia's most important economic partners in the Euro Area. Domestic demand is expected to accelerate somewhat, if Government's recently announced investment projects (to be financed off-budget) will commence. Risks to the outlook refer largely to external factors and a lower-than-expected recovery in domestic demand.

Global outlook

Global GDP is projected to expand by 2.4 percent in 2013 and 3.2 percent in 2014 (Table 10). Growth in high-income countries is assumed to remain relatively weak at 1.3 percent in 2013, but is projected to reach 2.1 percent in 2014. The US economy in particular is expected to gather momentum, buoyed by improving conditions in the labor market and in domestic demand, with growth projected at 2.8 percent in 2014, up from 1.8 percent this year. Developing and emerging-country growth projections are broadly in line with underlying potential. Growth here is expected to accelerate to 5.5 percent in 2014 from 4.9 percent this year, supported by a gradual recovery in external demand from high-income economies.

Table 10: Global Growth Assumptions – Real GDP Growth (percent)

	2008	2009	2010	2011	2012	2013f	2014f
World	1.4	-2.2	3.9	2.8	2.5	2.4	3.2
High Income	0.1	-3.5	2.8	1.7	1.6	1.3	2.1
Developing and Emerging Countries	5.8	1.9	7.3	5.9	4.8	4.9	5.5
Euro Area	0.3	-4.3	1.9	1.5	-0.6	-0.5	0.9

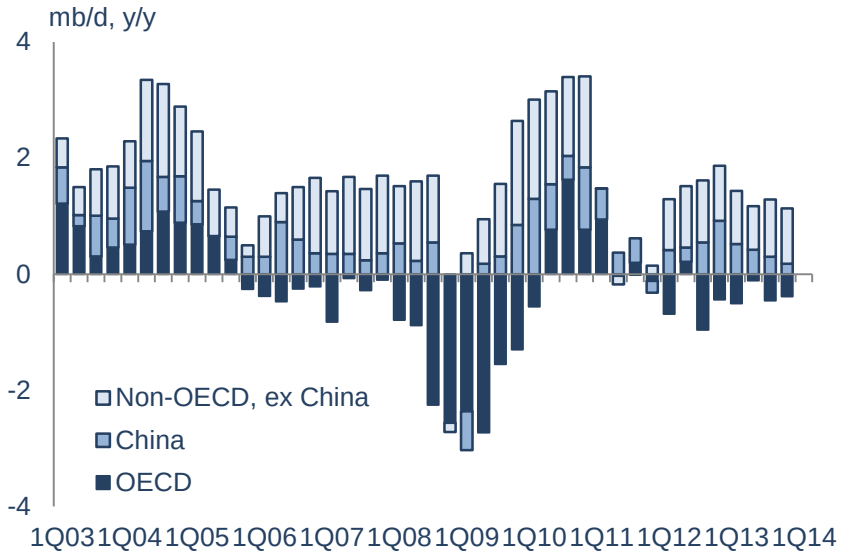
Source: World Bank Global Economic Prospects Group staff estimates

Improving growth prospects in high-income economies increase the likelihood that quantitative easing policies, notably in the US, will be withdrawn soon. The adjustment in capital flows should prove temporary. However, recent volatility in developing country financial markets and sustained pressure on some currencies, indicate the potential for domestic vulnerabilities to be exposed during the transition period.

Global oil demand is expected to rise in 2014 by 1.1 mb/d, up from an increase of 0.9 mb/d in 2013, with consumption likely to exceed 92 mb/d in 2014, according to the August update of the International Energy Agency (IEA). As in the recent past, all of the growth in demand will originate in non-OECD countries. Most of it is expected to come from China, which for the past decade has increased its consumption at almost 0.5 mb/d a year (Figure 30). Demand by OECD economies contracted (albeit marginally) during Q2 2013 (by 0.11 %), for a fourth consecutive quarter, with IEA expectations of further contraction in the next 2 quarters as well.

OPEC oil supply is expected to decline and non-OPEC oil production to increase. Most of the non-OPEC growth comes from unconventional production in the United States, which in 2013 will exceed 10 mb/d and is expected to reach around 11 mb/d in 2014. Altogether non-OPEC oil production is projected to each almost 56 mb/d in 2014. OPEC supplies, on the contrary, are expected to decline slightly, from 31.3 mb/d in 2012 to 30.5 mb/d in 2013. The key concern appears to be Libya, where civil unrest cut exports to their lowest level since the 2011 civil war. During July and August, Libya lost 0.5 mb/d, with more losses expected in September. In Iraq, pipeline damaged by attacks dragged the country's output below 3 mb/d for the first time in six months, while exports are expected to drop to 0.5 mb/d in September. Events in Syria have been drawing much attention recently and may have been responsible for the uptick in oil prices. Although Syria is not a key player either on the demand or the supply side, there are concerns that the conflict may spill over to key producing countries and the likelihood of disruption of oil supplies from the Gulf.

Figure 30: Growth of world oil demand by quarter 2003-2014 (% change, y-o-y)



Source: World Bank; IEA

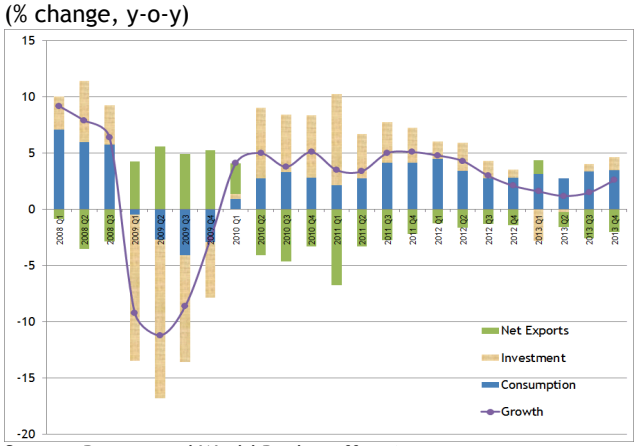
The World Bank expects oil prices to average US$ 105/bbl in 2013 and to decline marginally in 2014. At the moment, most of the risks are on the upside, especially if the conflict in the Middle East spills over to key producing countries, or if there is an unexpected disruption in the Strait of Hormuz. Over the longer term, oil prices are expected to increase moderately in nominal terms but fall slightly in real terms due to growing supplies of unconventional oil combined with efficiency gains and (to a limited extent) substitutions away from oil. The assumption behind such projections reflect the high upper-cost of developing additional oil capacity, notably from the oil sands in Canada, currently assessed by the industry at about US$80/bbl in 2013 constant terms. OPEC, which is expected to limit supplies in order to sustain prices, may also decline to let prices rise too high for fear of speeding up technological innovations that eventually could reduce demand and prices.

The Outlook for Russia

For 2013, we lowered our May projection of Russia's GDP growth to 1.8 percent from 2.3 percent (Table 11**).** Specifically, we revised down our previous Q3 projection (from 2.5 to 1.5 percent), but kept our Q4 projection of 2.6 percent (Figure 32). According to our baseline scenario, economic activity is expected to remain fragile in Q3 2013. This reflects the following trends. First, in respect to external demand, we expect that the overdue global recovery will delay the earlier projected increases in Russian exports towards the end of 2013, as compared to our earlier forecast. Second, on the domestic demand side, we expect consumption to remain sluggish, with limited growth potential for the remainder of the year. In Q4, we expect the economy to regain some dynamism as investment activities start to pick up. Additionally, a low base for Q4 2012 will contribute to higher growth in that quarter in 2013. For the remaining two quarters of this year, we also expect positive effects from agriculture, which is projected to benefit from a good harvest and a large positive base effect due to last year's drought.

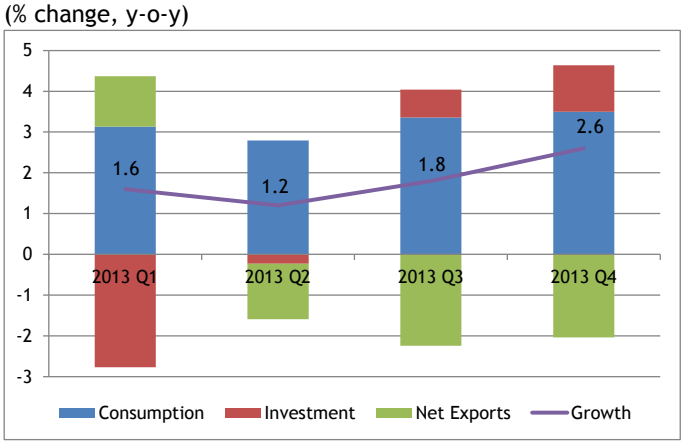
In 2014, the World Bank projects the Russian economy to accelerate to 3.1 percent growth. The revision reflects a positive outlook, but with higher downward risks. Also, compared to the World Bank's growth projection published in the June edition of the World Bank Global Economic Prospects, this still represents a slight downward revision from our previous forecast of 3.6 for in 2014. The World Bank projects a moderate uptick in growth as the pace of expansion will be, in our view, fundamentally held back by the economy operating near its capacity. Next year's growth prospects will largely depend on an increase in external demand and the recovery of Russia's most important economic partners in the Euro Area. Domestic demand is expected to accelerate somewhat, if Government's recently announced investment projects (to be financed off-budget) will commence. In addition, we foresee some growth in private consumption, but at a moderate pace, as we expect lower growth in disposable income and weak consumer confidence. Wages in the public sector, which were the main contributor to disposable income growth in the recent past, are not expected to increase given projected oil-price trends and Government's consolidation commitments made in the current medium-term budget framework.

Figure 31: Demand Sources of Growth by Quarter 2008-2013 (% change, y-o-y)



Source: Rosstat and World Bank staff estimates

Figure 32: Projected Sources of Growth by Quarter 2008-2013 (% change, y-o-y)



Source: CBR and World Bank staff estimates

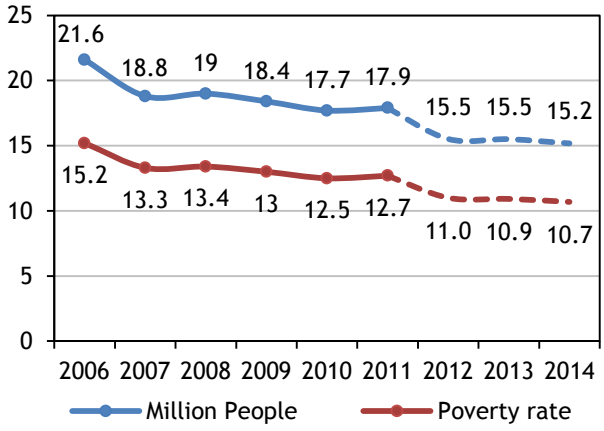
Given the current monetary stance, we expect inflation pressure to subside toward year-end. A good agricultural harvest and stricter control for administrated prices will help to bring CPI inflation down in the remainder of 2013. Provided the CBR keeps its monetary stance unchanged, the World Bank expects with high probability that CBR will meet its target of 5 to 6 percent CPI inflation. With modest potential for growth, we anticipate that a tight labor market is likely to continue exerting some upward pressure on prices this year and next, suggesting that the CBR has limited room for monetary loosening if it wants to stimulate economic growth. Such a loose-money policy would probably have a marginal impact on growth, but it could undermine the quality and credibility of the CBR and limit its recent success in anchoring inflation expectations.

Table 11: Main economic indicators (baseline projection) (percent)

	2012	2013	2014
GDP growth (%)	3.5	1.8	3.1
Consolidated government balance (%)	0.4	0.2	1.9
Current account (US$ billions)	74.8	60.5	39.4
Percentage of GDP	3.7	2.9	1.8
Capital account (US$ billions)	-41.0	-62.9	-50.0
Percentage of GDP	-1.8	-3.0	-2.3
Oil price assumption (US$ per barrel)	105.0	105.0	104.0

Source: Rosstat and World Bank staff estimates

Figure 33: Poverty rate forecast



Source: CBR and World Bank staff estimates

We expect the Balance of Payments position to weaken slightly in 2013 and 2014. Given the stable outlook for oil prices, the current-account surplus is expected to decline to US$63 billion in 2013 and further to US$39 billion 2014. The capital account deficit is projected to deteriorate slightly to about US$63 billion (3.0 percent of GDP) in 2013. Volatility of capital flows is likely to remain high and might even increase towards the end of the year amidst heightened uncertainty regarding an impact of the potential quantitative easing withdrawal on the capital market, especially in emerging markets. This could create additional pressure on the Ruble, given the projected deterioration in the current-account balance. In 2014, the capital account is projected to improve to US$50 billion as capital returns to emerging markets. The CBR appears to have sufficient resources and an effective mix of instruments to fight off potential speculative attacks while continuing the transition to flexible exchange-rate management.

The World Bank projects a modest reduction in poverty in 2013 and 2014. The share of the population with incomes below the national poverty line is estimated to drop from 11.0 percent in 2012 to percent 10.9 percent in 2013 (Figure 33). Due to the moderate pace of the expansion of the economy, poverty reduction is estimated to slow down despite low unemployment. For 2014, we project a poverty rate of 10.7 percent. This would translate into a decline in the number of poor people from 15.6 million in 2012 to 15.2 million in 2014.

Risks to the Outlook

Although risks to the global outlook are less pronounced and more balanced compared to a year ago, new risks are gaining prominence. Continued balance-sheet adjustments in the Euro Area, the potential for higher market-driven interest rates and rising debt ceiling-related uncertainty in the US could all set back private spending and confidence, although these risks are offset by the possibility of stronger growth should confidence improve more quickly than anticipated. Other risks include rising geo-political and commodity risks stemming from events in the Middle East. Furthermore, while a progressive decline in China's unusually high investment rate is expected over the medium-term, a disorderly unwinding could have significant consequences, particularly for developing-country and emerging commodity exporters. Finally, when quantitative easing policies are withdrawn, rising interest rates should increase debt-servicing costs and raise the cost of capital in developing and emerging economies. Risks also grow if the adjustment to these rates is too abrupt or they expose domestic vulnerabilities in developing and emerging economies with large external funding needs and difficult domestic policy and growth environments.

The World Bank sees mostly downside risks to the baseline scenario for Russia, the first major risk being related to external factors. Russian exports could remain depressed if the recovery in global demand is further delayed. The tapering of quantitative easing policies, notably in the US, could temporarily negatively impact Russia's economy through lower oil prices, restricted access to international capital markets and capital outflows.

Second, there is a risk that the main drivers of consumption could weaken. If Government's recently announced investment projects will not come through or will be delayed, labor-market relaxation is likely to continue and we would expect private-sector wages to decelerate. As mentioned, the public sector, which was the main contributor to disposable income growth in the recent past, is unlikely to expand further. We also note vulnerability to increasing risks in regard to the quality of the credit portfolio given the continuously high credit growth, which could dampen domestic demand.

Part III. Volatility in Russia: Obstacle to Firm Survival and Diversification in Manufacturing[12]

The need for economic diversification receives a great deal of attention in Russia. This note looks at a way to improve it that is essential, but largely ignored: how to help diversifying firms better survive economic cycles. By definition, economic diversification means doing new things in new sectors and/or in new markets. The fate of emerging firms, therefore, should be of great concern to policy makers. This note indicates that the ups and downs—the volatility—of Russian economic growth are key to that fate. Volatility of manufacturing growth is higher in Russia than in comparable economies because its slumps are both longer and deeper. They go beyond the cleansing effects of eliminating the least efficient firms; relatively efficient ones get swept away as well. In fact, an incumbency advantage improves a firm's chances of weathering the ups and downs of the economy, regardless of its relative efficiency. Finally, firms in sectors where competition is less intense are less likely to exit the market, regardless of their relative efficiency. Two policy conclusions emerge from these findings. First, strengthening competition and other factors that support the survival of new, emerging and efficient firms will promote economic diversification. Second, efforts to help small and medium enterprises may be better spent on removing the obstacles that young, infant firms face as they attempt to enter, survive and grow.

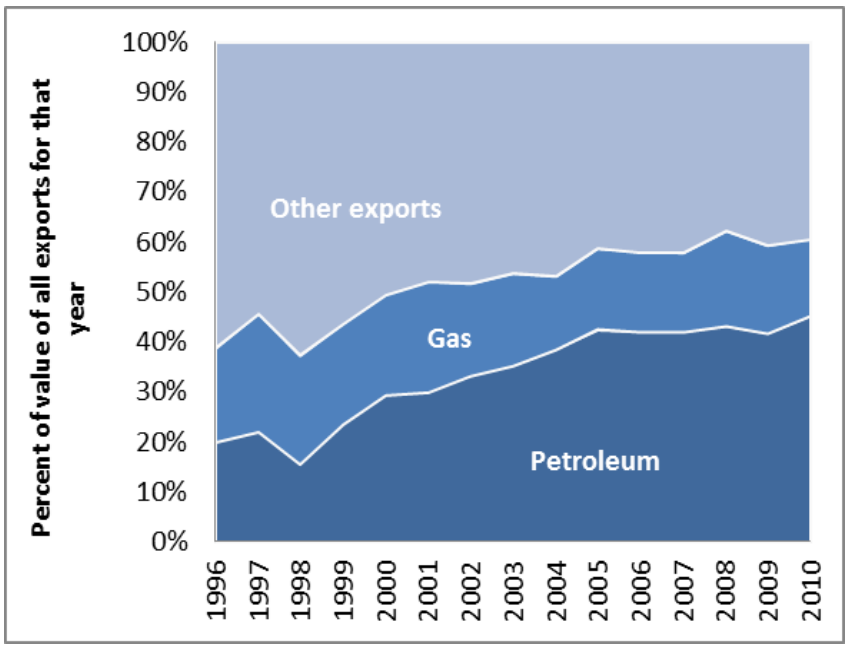
[12] *This special focus note on diversification is part of a larger research agenda on diversification currently followed by the European and Central Asia region of the World Bank. Its main messages and material are aligned with other forthcoming regional reports. This specific note is based on material from the World Bank Policy Research Working Paper No. 6605, September, 2013, Russian volatility :Obstacle to firm survival and diversification,*

Introduction

Russia is much less diversified today than it was during the Soviet Era (EBRD, 2012).[13] Post-2000 economic growth in Russia has been reliant on natural resources, especially hydrocarbons, and this is a trend that is likely to persist. Exports data tell the same story: Figure 34 highlights the increasing reliance on natural gas and petroleum exports. The oil-and-gas sector has experienced double-digit annual export growth in the last decade and accounted for nearly 69 percent of the value of Russia's exports in 2010. Such strength originating from so few sectors may already be a risk in the economy.

The export story is repeated for the rest of the economy; namely, while there is growth in the Russian economy, there are concerns that it has been limited to too few sectors. The economy does not appear to be diversifying as expected despite favorable economic conditions. Why?

Figure 34: Petroleum and gas increasingly dominate Russia's exports



This note looks at the role of growth volatility as a possible explanation. It examines the role of surges and slumps in manufacturing output and its microeconomic implications in the dynamics of emergence and sustainability of nascent economic activities. The dynamics of the industrial output of the economy as whole, between 1993 and 2009, are the focus of this study.

Volatility in Russian manufacturing output goes beyond the ups and downs of regular business cycles.[14] This note examines the downturns that magnify and accelerate the cleansing effects to the economy in forcing inefficient firms to exit, as well as the upturns that set the foundations of economic diversification by giving new economic activities the opportunity to emerge.

Finding evidence that businesses are created in times of economic expansion is important because much of the policy debate about diversification is based on the assertion that few do emerge. Russia does not seem to produce much beyond what it has produced in the recent past. This claim is used to support direct intervention to help new economic activities emerge. But one of this study's hypotheses is that emergence may not be the problem; rather, sustainability is. Therefore, improving sustainability may be the central economic issue for diversification: it means creating the conditions that will let the efficient firms that emerge in booms survive the downturns. One way to improve their chances of survival is to reduce volatility in economic output.

Comparative analysis of the concentration of Russian industrial production and its potential consequences

There are high levels of concentration of output in a few manufacturing sector in Russia.[15] The bottom quartile of sectors, ranked in order of their size in terms of operating revenue, contribute 0.6 percent of the total manufacturing output in Russia. In comparison, the top quartile contributes 80 percent.[16]

[13] http://www.ebrd.com/downloads/research/economics/publications/specials/diversifying-russia.pdf
[14] Nickell, S., D. Nicolitsas and M. Patterson (2001) "Does doing badly encourage management Innovation?", Oxford Bulletin of Economics and Statistics, Department of Economics, University of Oxford, vol. 63(1), pages 5-28, February.
[15] The characteristics of the dataset used for the descriptive statistics presented here are further explained in the Annex of the *World Bank Policy Research Working Paper No. 6605, September, 2013, Russian volatility: Obstacle to firm survival and diversification*.

The concentration of output within sector (between firms) in Russia is even more noteworthy. The average share of output for the bottom quartile of firms (in terms of operating revenue) in a manufacturing sector[17] is 0.06 percent. The share of the top quartile is 94.7 percent.[18]

These relatively high levels of output concentrated in either a few sectors or in a handful of firms may lead to more volatility. High economic concentration makes an economy vulnerable to the fate of fewer economic events, such as changes in the price of the most prevalent commodity sold or goods produced. For example, some highly concentrated economies expand and contract in response to rises and dips in the price of the output that dominates total national economic output. In addition, these types of economies are more likely to produce spillover volatility from dominant fluctuating sectors to other sectors that are not directly affected by external events. Evidence shown here supports this characterization of growth volatility in Russia.

In turn, volatility may exacerbate the concentration of economic output. This study also suggests that volatility in growth may increase the likelihood of (premature) exit of new, emerging firms. This means that the structural change that new, emerging firms bring is stunted by high levels of economic volatility. As a result, the economy can experiences a vicious cycle of comparatively higher "premature death" of new firms due to economic volatility, and increased volatility driven by an economic structure that remains undiversified or even more concentrated as a result of the high exit rate of new firms.

The reinforcing dynamics between volatility and concentration of output is also a possible explanaition of Russia's relatively larger manufacturing firms. As the four graphs in Figure 35 indicate, the average Russian manufacturing firm, whether measured by annual operating revenue or by its labor force, is larger than the average manufacturing firm in the rest of world or in Russia's closest neighboring economies in Europe and Central Asia[19].[20] A relatively high mortality rate of young Russian firms likely explains the size distribution, since it eliminates smaller firms from the average-size estimation (the left-hand side tail of the distribution). Young firms tend to be small. In Russia, those younger and smaller manufacturing firms tend to have a high mortality rate (not unusual in any economy) irrespective of their level of efficiency (a relatively less common finding). This is a cause for concern. In addition, as discussed later in more detail, this relatively high mortality rate is associated with the deep and long downturns that characterize some cycles in the short history of the modern Russian economy.

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[16] See Annex of the *World Bank Policy Research Working Paper No. 6605, September, 2013, Russian volatility: Obstacle to firm survival and diversification*).for a yearly breadown.

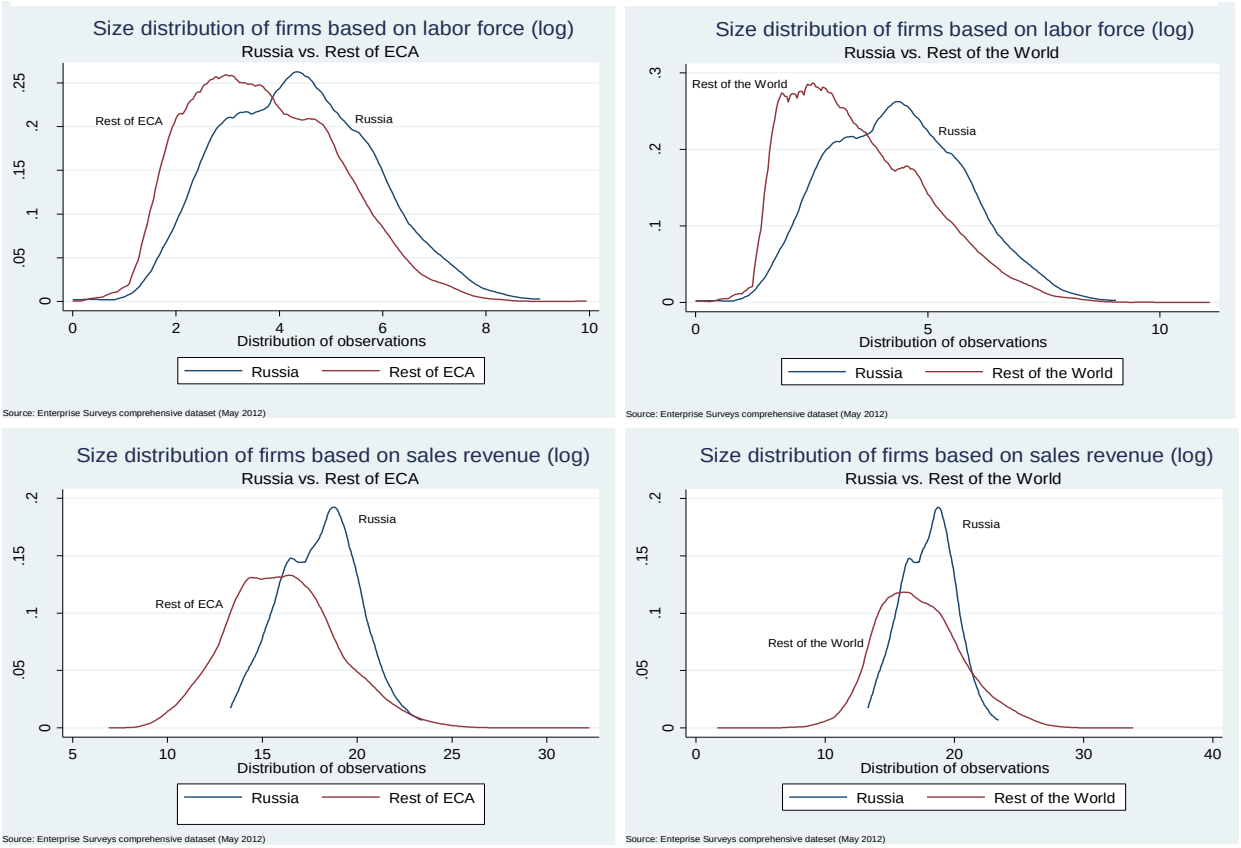
[17] When referring to sectors, these are defined by 4-digit NACE 1.1. The higher the digit, the more disagregated the sector data will be.

[18] See Table in the Annex of *World Bank Policy Research Working Paper No. 6605, September, 2013, Russian volatility: Obstacle to firm survival and diversification*.

[19] The 28 economies included in the Europe and Central Asia (ECA) region (in alphabetical order): Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kosovo, Kyrgyz Republic, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Poland, Romania, Serbia, Slovak Republic, Slovenia, Tajikistan, Turkey, Ukraine, Uzbekistan. Turkmenistan is not included.

[20] This size comparison controls for differences in the composition of manufacturing sectors across these economies.

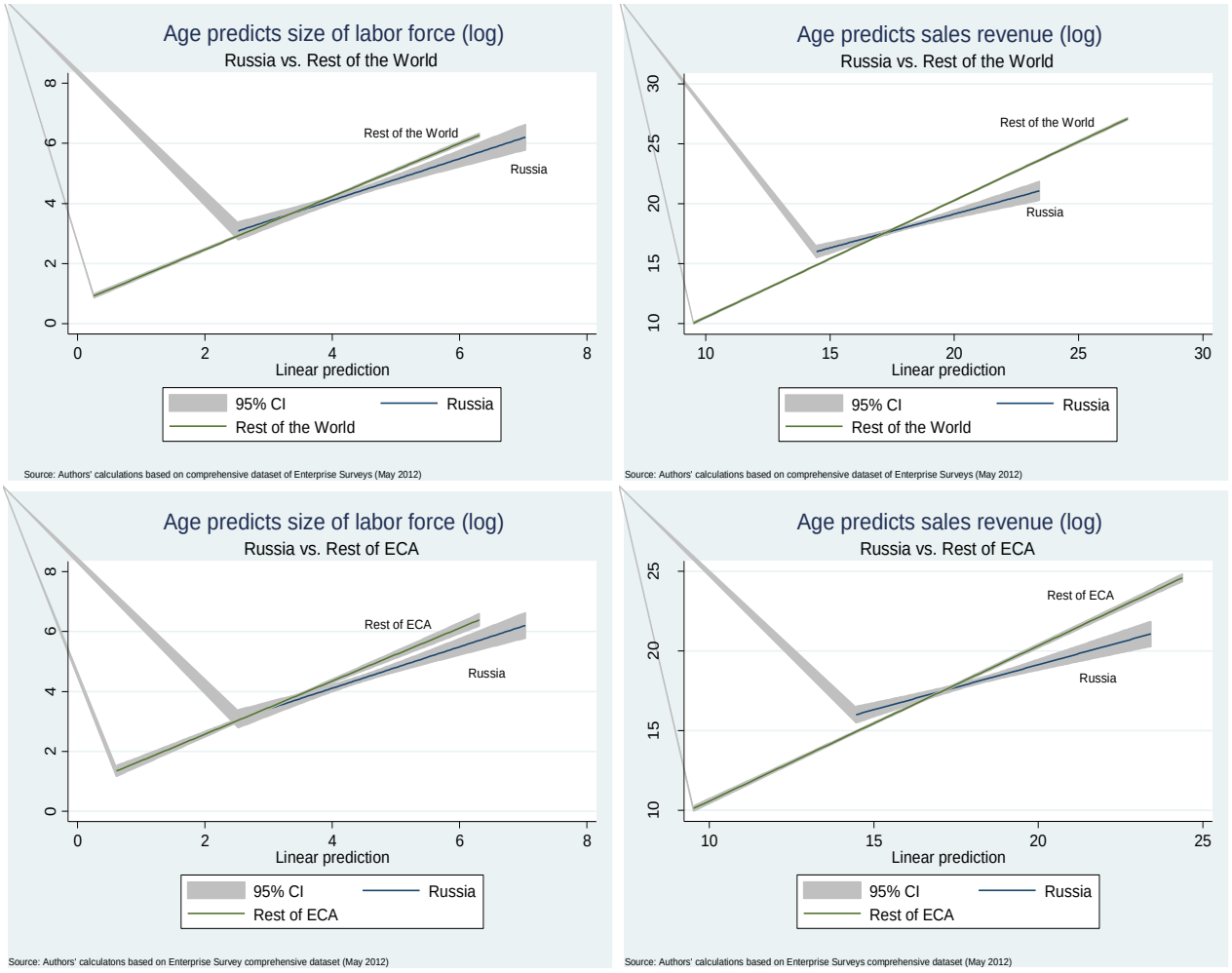
Figure 35: The Russian economy is dominated by larger firms



Of equal concern is that the biggest firms (the right-hand side of the size distribution of manufacturing firms) do not grow to be as big in Russia as in other parts of the world. This finding calls into question whether even efficient firms get the resources they require to grow in the Russian economy. In well-functioning economies, markets efficiently allocate resources to the most productive firms irrespective of their size and age (Hsieh and Klenow 2009).[21] This implies that holding for all other explanatory factors (location, sector and economic activity, for example), firms of the same age across different economies should employ a similar number of people and make about the same sales revenue if economies are all equally efficient in allocating resources to the most productive firms. If some economies are not allocating the resources that firms need to grow, they exhibit what is known in economic terminology as allocative inefficiencies.

[21] Hsieh, Chaing-Tai, and Peter J. Klenow. "Misallocation and manufacturing TFP in China and India. “The Quarterly Journal of Economics: 124.4 (2009): 1404-447. Print.

Figure 36: Older firms in Russia employ fewer workers and earn less sales revenue than similar firms in other economies



One way to determine the relative allocative efficiency of economies is to compare firm-size and age data across economies. As firms get older and grow, they employ more workers and increase their sales revenue. For that reason, there should be a positive relation between firm size and age and this relation should demonstrate a statistical regularity across economies (Figure 36). The size of a manufacturing firm is measured either by annual sales revenue or number of employees. Indeed, the space between the two forty-five degree line in Figure 36, indicates that firm growth is relatively stunted in Russia compared to other economies. If all firms grew in size at about the same rate in Russia as in other economies, the lines in this figure would be on top of each other. They are not; the size-age line trajectories cross and separate at a certain point. The Russian trajectory falls below that of comparator economies. Moreover, the figure indicates that the differences in trajectory are statistically significant to a 95-percent confidence interval. The grey shading around these lines depicts that band of confidence. Where these grey bands do not cross, the reader can conclude that the estimates are statistically significantly different from each other. After a certain age, the size of firms in Russia slows. Based on these data, Russia is seems relatively less allocatively efficient than many of the economies to which it was compared.

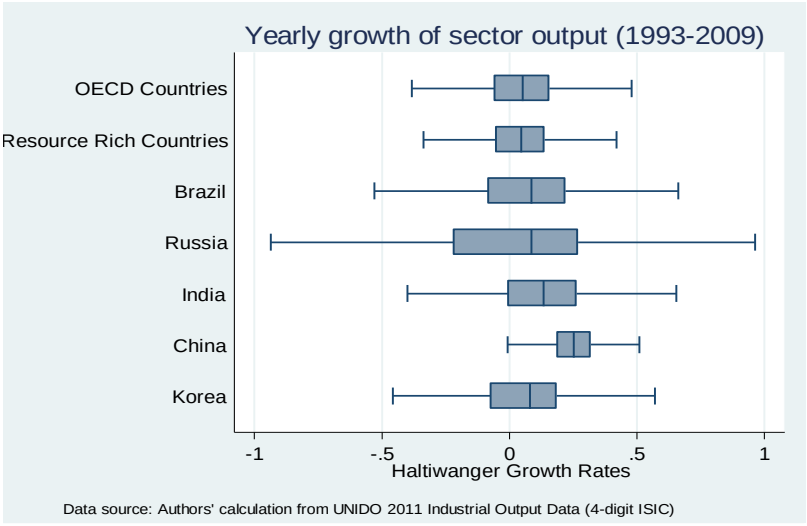
At this point, findings on the relatively lower levels of allocative efficiency in the Russian economy are indicative, not conclusive, but nonetheless important. They point to an additional factor that may hamper growth and diversification of the economy: that the staying power of inefficient firms that are stunted in growth but do not exit the market may be a problem. In relation to how they affect the entrance of new firms, these stunted firms that stay put hold on to productive resources (labor and finance) that newer, possibly more productive firms in emerging sectors could make use of to survive and grow. The staying power of these stunted firms also calls into question how fierce competition may be, since the forces of economic rivalry do not seem to be enough to escort them to the exits. Research is just starting to provide support for the relationship between allocative efficiency, firm entry and competition in other economies.

Volatility of Russia's Sector-level output relative to other economies

The first question to answer is whether Russia's economy is more volatile than others. The study does this by comparing year-to-year changes in sector-level[22] manufacturing output of the Russian economy, between 1993 and 2009, to that of other economies.[23] To determine if the Russian economy is relatively more volatile than other economies, the variance of the average sector-level growth rate across several years is the statistic of import—a high variance means high volatility.

A box and whisker plot (Figure 37) allows the reader to visually determine whether the average annual manufacturing growth at the sector level in Russia indicates higher variances across time than that of other economies. The vertical line inside the grey box represents the median growth for each country between 1993 and 2009. The right and left boundaries of the grey rectangles represent the middle half of the data; they define the 25thpercentile to the 75th percentile of annual rate of sector-level industrial output growth per economy or group of economies. The lines or whiskers, outside of these boxes, delineate the most extreme values.

Figure 37: The annual growth in output of Russian sectors exhibit relatively higher variances—more volatility.



Data source: Authors' calculation from UNIDO 2011 Industrial Output Data (4-digit ISIC)

As can be easily seen, both the grey rectangles and the whiskers in the figure are markedly more extended for Russia than for any other comparator. This means that the variance of average annual industrial growth in Russia is statistically larger than that of other economies, meaning that Russian sector-level growth has higher variances and is more volatile.

Having established that the variance of average annual industrial growth for the period of time examined here is higher than that of comparator economies, the question is whether this volatility is the result of fluctuations in annual growth between sectors or between years. In other words, is the variance of annual growth explained by fluctuations in the growth of some sectors that in certain years grow fast then slow or is it that all sectors, year by year, generally grow fast or slow?

This is an important question because it may point to spillover or to macro-economic drivers of volatility. In other words, if fluctuations are explained by yearly or temporal fluctuations, where generally all sectors are in slumps or surges at the same time, that may indicate that these industrial sectors are linked in such a way that they are all pulled down or up together or there are macroeconomic factors that affect all of them. Alternatively, if a few sectors are continually in flux while others grow at a steady, even pace throughout the years, this suggests that there are comparatively few spillovers and relatively little linkage between sectors.

[22] For the sector analysis, a shortened panel that included the period between 1993 and 2009 was used. UNIDO data for Russia start in 1994. In addition, outlier observations – identified as output growth outside 3 standard deviations above or below the mean growth rate for each sector in each country – were removed. Doing this resulted in dropping about 45 percent of the observations in the dataset (See Annex of the *World Bank Policy Research Working Paper No. 6605, September, 2013,* *Russian volatility: Obstacle to firm survival and diversification* for a detailed breakdown of the dataset pre and post sample selection).

[23] For the sector-level comparative analysis across economies, the following groups of economies and countries are considered: Brazil, India and China, which along with Russia comprise country grouping called BRICs; Australia, Canada, Chile, and New Zealand are high growth countries that like Russia have an abundance of natural resources but, unlike Russia, have largely diversified economies and these are grouped together under Resource Rich Countries; and finally Korea and the set of economies grouped under the Organization of Economic Cooperation and Development (OECD) are compared to Russia because of their relatively long periods of steady and positive growth that serves as reference of long-term economic performance. Of course, there are overlaps between these groups and some of these economies. For example, Australia, Canada, Chile, Korea and New Zealand are all members of the OECD.

The analysis of variances presented in the table below indicates that sector-level growth rates in Russia are highly correlated to each other, year to year. This conclusion is based on the relatively higher coefficient for the yearly variable as compared to other economies and as compared to the sector variable coefficient as well. These results imply that nearly the entire set of Russian industrial sectors experience fluctuations in growth rates in tandem. This lends support to the spillover hypothesis; namely, that the relatively high levels of concentration of economic output, both across firms and sectors, contributes to volatility.

The reader will note that the empirical results for the analysis of variances are presented for two separate periods: 1993-1999 and 2000-2009. The first represents the period following the economic collapse of the Soviet Union, between 1993 and 1999. The second covers the years of economic recovery where higher growth (2000-2009) took hold. While these are two dramatically different periods in recent Russian economic history, the empirical results on the possible explanation for the patterns of economic output volatility are remarkably similar. In both, the year-to-year fluctuations in sector-level annual industrial output explain more of the variation in growth rates than the composition of sectors that contribute to output growth. This similarity in results demonstrates the persistence in the nature and sources of volatility of the Russian economy. While this temporal effect is seemingly less prominent in the latter period, the data indicate that in Russia, changes in sectors output generally move in tandem across the years.

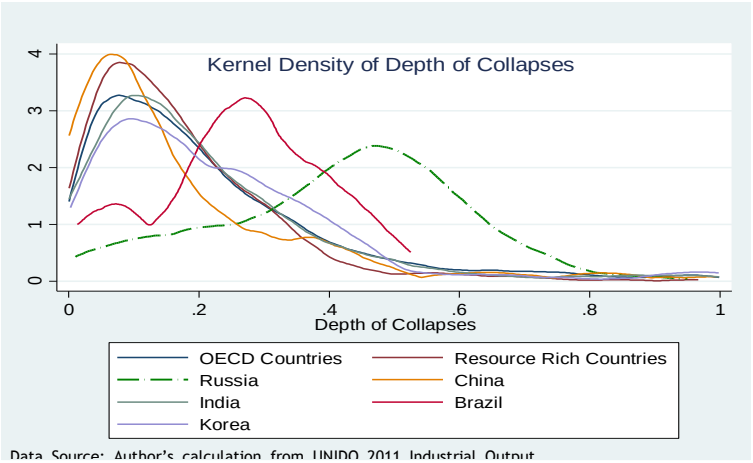
Table 12: ANOVA Partial Sum of Squares

	ANOVA FOR 1993-1999					ANOVA FOR 2000-2009				
	Russia	**Brazil**	**India**	**China**	**Korea**	**Russia**	**Brazil**	**India**	**China**	**Korea**
Model	28.35	1.27	14.02	NA	29.24	16.32	4.96	6.68	3.86	7.88
Sector	4.72	0.21	8.15	NA	7.62	2.25	0.54	1.75	1.27	3.33
Year	23.63	1.05	5.86	NA	21.62	13.70	4.44	4.92	2.58	4.53
Residual	21.35	0.95	44.85	NA	37.80	23.15	3.99	25.12	2.54	16.31
Total	49.70	2.22	58.87	NA	67.03	39.47	8.95	31.80	6.40	24.19

Source: Author's calculation from UNIDO 2011 Industrial Output Data (4-digit NACE)

The nature of Volatility compared with other economies

Figure 38: The average slump in Russia is deeper than in other economies



Data Source: Author's calculation from UNIDO 2011 Industrial Output

Recent sector-level growth rates in Russia exhibit more volatility than in other economies. All volatility is made up of booms, referred to here as surges, and busts, referred to here as slumps. These two can be examined separately since they are quite different—surges foster firm entry while slumps cause firm exits. But before getting to the dynamics of firm entry and exit, the next task is to understand the characteristics of slumps and surges in the Russian economy.

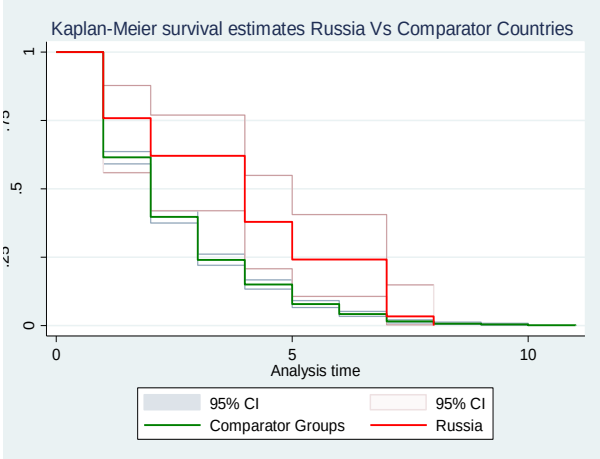
Slumps and surges have two characteristics: depth and endurance. In the case of slumps, the depth is characterized by how much the economy shrinks. Similarly, to determine the endurance of a slump, the task is to determine from beginning to end how long a slump lasted without being interrupted by at least one period of positive growth. With respect to the data, to ascertain the depth of slumps, one looks at period in which a slump takes place and one asks how

often these slumps are characterized by rates of 0, -1, -2, or -3 percent average annual negative growth, for example. To get a picture of how long slumps last, one records how long (how many years) each slump remained in negative territory once the slump began.

To illustrate the depth of Russian slumps and compare these to that of other economies, a kernel density estimator[24] is used. Figure 38 (above) is a kernel density plot where the horizontal axis, from left to right, indicates progressively deeper slumps (higher negative growth rates). The vertical axis, from bottom to top, records how often a particular negative growth rate is recorded. The data lines record how often a negative growth rate is recorded for all the slumps that took place in these economies between 1993 and 2009. The top of each hill marks the most common negative rate of growth registered in slumps for each economy.

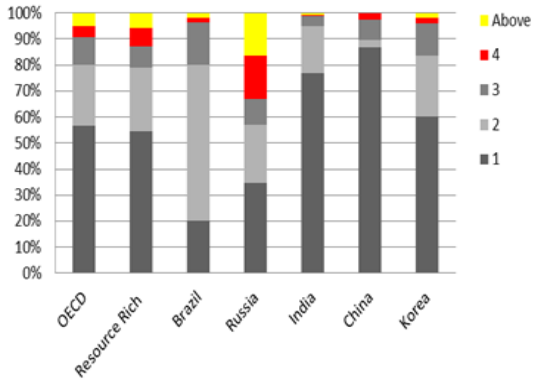
This graph confirms that for Russia—because the top of the hill is to the right of all other comparator economies—the common slump is characterized by higher negative growth than that found in any of the economies to which it is compared.

Figure 39: The average slumps last longer in Russia



Source: Author's calculation from UNIDO 2011 Industrial Output Data (4-digit ISIC)

Figure 40: A greater proportion of slumps last longer in Russia (years)



Source: Author's calculation from UNIDO 2011 Industrial Output Data (4 digit ISIC)

To compare and contrast differences in the duration of slumps across economies, a survival analysis with simple comparisons of the proportion of slumps that lasted 1, 2, 3 or more periods are used. The same time-series data of sector-level output that were used to calculate the volatility of output comparators are used to determine whether the length of slumps in Russia differ significantly from those of other economies. It was found that they do: they are generally longer.

Figure 39, above, is a graphic depiction of how data answer the following question: given that a slump has started, what is the likelihood that it will last at least one year? Given that the slump has lasted one year, what is the likelihood that it will last an additional year? And so on. This graphical depiction of the endurance of slumps (Figure 39) indicates that slumps are likely to last longer in Russia than in other economies. This conclusion is based on the fact that for slumps of less than 6 years (the horizontal axis), the probability (the vertical axis) of a slump persisting for another period is higher in Russia (the step-like line is above that of the other economies) than in the comparator group.[25] Finally, to check these results, a simple proportions analysis is provided. This analysis simply answers the following question: for all of the slumps recorded during the period of these data, how many of them last 1, 2, 3, etc. periods? Figure 39 clearly indicates that a disproportionately higher number of slumps are 4 or more years in duration. In sum, Russian slumps also last longer than those of comparable economies.[26]

[24] Smoothing the duration of slumps data with a kernel density estimator can be more effective than using a histogram to identify features that might be obscured by the choice of histogram bins or sampling variation.

[25] Since these probabilities are estimates, a 95 percent confidence interval is also estimated to make sure that the probability estimates are indeed significantly different across economies. The grey lines above and beyond Russia's and the other economies' step-like probability estimates delineate these confidence intervals. Where these intervals do not overlap (up to 5 periods), the differences in probability that a slump will last longer in Russia than in other economies can be safely assumed to be significant.

[26] See Figure A2 in the Annex of the *World Bank Policy Research Working Paper No. 6605, September, 2013,* [*Russian volatility: Obstacle to firm survival and diversification*]).

A similar analysis on the duration of economic surges in Russia and comparator economies was performed as well. Interestingly, that analysis showed that Russia is no different in terms of height or duration of surges than that of other economies. In sum, Russian slumps, not Russian surges, distinguishes its growth dynamics from other economies examined.

Determinants for Firm Survival in Russia

The comparative analysis of slumps and surges using the UNIDO dataset indicate that the Russian economy exhibits significantly deeper and longer slumps than other economies. But should these features of the Russian economy be of concern? One answer is that these macroeconomic features of the economy may have specific microeconomic consequences. Slumps may slow or halt firm growth, may force the exit of relatively efficient, newer firms and hinder the allocation of resources from less efficient firms to more efficient ones. To see if these concerns are warranted, this section focuses on identifying and describing the link between firm exits and surges and slumps, sector-level competition the role firm-level productivity plays into firm mortality.

Given the pattern of deep and long slumps discovered in the previous analysis, there is particular emphasis on these results to identify and explain the implications of these slumps on firm mortality. For that reason, only the following findings, out of many, are highlighted and discussed here:[27]

1. The more productive firms are less likely to exit than the less productive ones. Productivity is more of a factor in improved firm mortality during surges than slumps;

2. Older firms are relatively less likely to exit than younger ones. The age of the firm is also more of a factor in improved firm mortality during surges than slumps; and

3. In sectors where competition is less intense, unproductive firms are less likely to exit than in sectors where competition is more intense.

On average, a firm's likelihood of surviving the ups and downs of the Russian economy improves if it's more productive than others, holding for all other factors.[28] The data however also provide a slight nuance to this result. Being more productive improves the odds of survival during surges than during slumps. This finding supports the conjecture that during a surge started by an expansion of demand for goods, the intra-sectoral reallocation of resources between firms will favor those that are more productive. To respond to increased demand, firms expand the purchase of their inputs to increase production. Increased demand for inputs raises their prices. In this situation, the least productive firms, which by definition are already burdened with higher costs of production, are unable to stay in the market as higher input prices further raise their costs and these cannot be recovered with higher prices. This forces uncompetitive firms to exit even during economic booms. [29] This finding is good news for the Russian economy. If during surges, emerging and more-efficient firms enter to present new products to new markets, this helps economic diversification. However, issues arise during the long and deep Russian economic slumps that were described in previous sections.

Slumps, however, temper this positive news. Productivity is expected to be equally important in the survival of firms during both slumps and surges. However, the Russian data indicate that this is not the case.[30] Part of the explanation may be that the dynamics of slumps are dissimilar to those of surges. The empirical results may just

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[27] The econometric results are displayed in Tables A17, A18 and A19 of in the Annex of the *World Bank Policy Research Working Paper No. 6605, September, 2013, Russian volatility: Obstacle to firm survival and diversification*.

[28] See Tables A17, A18 and A19 in the Annex of *World Bank Policy Research Working Paper No. 6605, September, 2013, Russian volatility: Obstacle to firm survival and diversification* where the variable **ln(value added per worker)** serves as a productivity measure. In all cases, the coefficient for this variable is negative and statistically significant at the 99 percent level.

[29] This is consistent with a heterogeneous firm-model of Melitz (2003).

[30] The reader can see in Tables A17, A18 and A19, in the Annex of *World Bank Policy Research Working Paper No. 6605, September, 2013, Russian volatility: Obstacle to firm survival and diversification*, that the coefficient for the interaction term between productivity and slump or surge (**surge/slump × ln(value added per worker**) is always negative and statistically significant at the 99 percent confidence level. Since a surge is coded as value=1, the coefficient of this interaction term indicates that during surges, being more productive is more important than during slumps (coded as value=0). If productivity had been as equally important to firm survival during slumps as in surges, the coefficient for this interaction would have been zero.

be a reflection of that fact.[31] Nevertheless, while the dynamics may be different, in healthy, competitive economies, productivity is equally important to the survival of a firm in the ups and in the downs. In Russia, during the long and deep slumps, other factors are important in determining the survival of firm.

The age of the firm plays a more significant role during slumps than in surges. Older firms are less likely to exit the market.[32] Regardless of their relative productivity, older, incumbent firms will remain in the market.[33] This finding, when coupled with the discovery that Russian slumps are more frequent, longer and deeper, raises the question of whether this premium on incumbency and age is an adaptation, albeit not a very healthy one, to the nature of Russian slumps. Incumbents are often not the champions of change and innovation that form the basis of economic diversification.

The last finding also suggests that firms in less competitive sectors are more likely to survive than would otherwise be the case. This result reinforces the incumbency premium and has implications for the allocative efficiency of the economy. The staying power of relatively inefficient firms in uncompetitive sectors is a problem. Indirectly, these incumbents affect the entrance of new firms by holding on to the resources that young, possibly more productive firms could employ to grow.

Based on the benchmark of health of Russian economic dynamics, namely, whether relatively productive firms stay in the market and grow while inefficient ones exit, there is some room for both optimism and for pessimism. Economic surges reward productivity. On the other hand, the staying power of inefficient, incumbent firms in slumps hints at a problem.

Conclusion

This note has three main findings. First, Russian manufacturing output growth is characterized by a higher volatility than other comparator countries. Second, this volatility is mostly driven by more numerous, deeper and longer slumps and is mostly associated with aggregate slumps that have yearly effects. When the Russian economy slumps or surges, few sectors can escape the gravity of the downward or upward pull. Third, while the economic surges increase the probability that productive firms remain in the market, the same is not true of economic slumps—older firms, not necessarily more productive ones, are more likely to survive the downturn. Furthermore, in sectors in which competition is less fierce, firms have a higher likelihood of weathering a slump.

The econometric results on the relationship between firm exit and competition have important policy implications. First, at the microeconomic level, promoting competition would help addressing them. More specifically, policymakers may want to provide new support for emerging firms, rather than large ones, to address the fact that some of the efficient firms that exit the market are young. Possibly, in a less volatile and more competitive economy, these young firms would remain in the market, grow and pave the way for the economic diversification so many Russian policymakers want. However, Russia, like most governments around the world, is focused on SMEs (small and medium enterprises) as a target for policy aid. The findings here indicate that it may be time to change focus to seeing what ails YIFs (young and infant firms) emerging in the Russian market.

The economic ramifications of these findings to the Russian economy are what matter. In that sense, the evidence presented indicates that slumps affect the nature of firm mortality and allocative efficiency. Russia's policymakers may want to worry more about the economic costs of these sharp ups and downs of the economy. If Russia is going to rely on new firms doing new things in new markets as a source of economic diversification, there will be a need to address volatility, competition and a too-heavy public policy and programmatic focus on small and medium-sized enterprises rather than on young, infant and productive firms.

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[31] Unlike in surges, in slumps demand falls and so do prices; the most efficient firms can meet these prices cuts because they are lower-cost producers and so they can survive the slump. During slumps, within-sector resource allocation may not be as important in survival as it is in surges. Through slumps, firms are releasing resources as demand shrinks and this would likely force input prices to drop as well.

[32] See Tables A17, A18 and A19 in the Annex of *World Bank Policy Research Working Paper No. 6605, September, 2013, Russian volatility: Obstacle to firm survival and diversification* where the coefficient for the variable **age**, in all cases, is negative and statistically significant at the 99 percent level.

[33] The reader will note that the coefficients for the size categories (**small, medium and large**) are statistically significant and negative. However, to determine the complete effect of size on the likelihood of survival, the coefficients to all of the interaction terms with age must be considered. Once all coefficients are summed for each size category, they add up to zero, indicating that while there are benefits to being small, medium or large in comparison to a microenterprise (the omitted category absorbed by the constant), there is no statistical difference between being small, medium or large.

Annex

Main indicators

						2012													2013							
Output Indicators	**2007**	**2008**	**2009**	**2010**	**2011**	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**	**2012**	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**
GDP, % change, y-o-y 1/	**8.5**	**5.2**	**-7.8**	**4.5**	**4.3**	-	-	4.8	-	-	4.5	-	-	4.0	-	-	3.4	**3.4**	-	-	1.6	-	-	1.4	-	-
Industrial production, % change, y-o-y	**6.8**	**0.6**	**-9.3**	**8.2**	**4.7**	3.8	6.5	2.0	1.3	3.7	1.9	3.4	2.1	2.0	1.8	1.9	1.4	**2.6**	-0.8	-2.1	2.6	2.3	-1.4	0.1	-0.7	0.1
Manufacturing, % change, y-o-y	**10.5**	**0.5**	**-15.2**	**11.8**	**6.5**	4.8	6.3	2.4	3.6	7.0	3.4	5.7	4.1	3.3	3.0	4.0	1.5	**4.1**	-0.3	-0.1	3.4	1.2	-4.4	-1.2	-1.5	-0.2
Extraction of mineral resources, % change, y-o-y	**3.3**	**0.4**	**-0.6**	**3.6**	**1.9**	1.4	3.7	0.8	1.2	-0.3	0.2	0.9	0.8	1.8	2.1	0.3	0.2	**1.1**	-1.2	-2.2	0.6	2.6	2.3	3.1	0.4	2.0
Fixed capital investment, % change, y-o-y	**21.1**	**9.8**	**-16.2**	**6.0**	**8.3**	16.6	16.3	16.6	8.5	13.7	9.2	9.5	7.8	-0.3	6.2	2.5	-0.4	**6.7**	1.1	0.3	-0.8	-0.7	0.4	-3.7	2.5	-3.9
Fiscal and Monetary Indicators																										
Federal government balance, % GDP 1/	**5.4**	**4.1**	**-5.9**	**-4.1**	**0.8**	0.7	-2.4	-0.5	-0.4	0.6	1.0	0.9	1.4	1.5	1.5	1.4	-0.1	**-0.1**	-0.3	-1.8	-0.4	0.0	0.7	1.2	0.8	0.9
Consolidated budget balance, % GDP 1/	**6.1**	**4.8**	**-6.2**	**-3.6**	**1.6**	10.6	2.7	4.0	3.6	4.7	4.1	4.3	4.2	3.6	3.6	3.2	0.4	**0.4**	6.4	1.0	2.0	2.0	2.2	1.7	2.0	
M2, % change, p-o-p 2/	**51.3**	**27.2**	**-3.5**	**30.6**	**23.3**	-3.5	0.7	0.8	0.8	0.8	1.3	-0.5	0.0	0.3	0.3	1.4	9.3	**17.9**	-2.4	1.6	1.1	1.4	0.9	1.5	0.8	
Inflation (CPI), % change, p-o-p	**11.9**	**13.3**	**8.8**	**8.8**	**6.1**	0.5	0.4	0.5	0.4	0.2	0.4	0.5	0.6	0.7	0.6	0.5	0.4	**5.1**	0.5	0.4	0.4	0.4	0.3	0.3	0.3	0.5
GDP deflator 1/	**13.8**	**18.0**	**2.0**	**14.2**	**15.5**	-	-	10.5	-	-	9.1	-	-	8.8	-	-	8.5	**8.5**	-	-	6.9	-	-	6.4	-	-
Producer price index (PPI), % change, p-o-p	**25.1**	**-7.0**	**13.9**	**16.7**	**13.0**	-0.2	1.1	2.2	0.7	-2.4	-0.8	-1.1	5.1	4.8	-1.6	-1.2	-1.1	**6.8**	-0.4	0.8	0.5	-1.2	-1.0	0.4	2.0	2.8
Nominal exchange rate, average, Rb/USD	**25.6**	**24.8**	**31.7**	**30.4**	**29.4**	31.5	29.9	29.4	29.5	30.7	32.9	32.5	32.0	31.5	31.1	31.4	30.8	**31.1**	30.3	30.2	30.8	31.3	31.2	32.3	32.7	33.0
Reserve Fund, bln USD e-o-p		**137.1**	**60.5**	**25.4**	**25.2**	61.4	62.4	62.3	62.2	60.2	60.5	59.9	60.5	61.5	61.4	61.4	62.1	**62.1**	86.2	84.7	83.9	84.9	84.4	84.7	85.4	85.4
National Wealth Fund, bln USD, e-o-p		**88.0**	**91.6**	**88.4**	**86.8**	88.3	89.8	89.5	89.2	85.5	85.6	85.2	85.9	87.6	87.2	87.5	88.6	**88.6**	89.2	87.6	86.8	87.3	86.7	86.5	86.9	86.8
Reserves (including gold) billion $, end-o-p	**478**	**427**	**439**	**479**	**499**	505	514	513	524	510	514	511	515	530	527	528	538	**538**	532	526	528	533	518	514	513	
Balance of Payment Indicators																										
Trade Balance, billion $ (monthly)	**130.9**	**179.7**	**112.1**	**151.4**	**198.2**	20.4	20.3	18.3	18.1	17.3	13.9	11.5	11.3	15.7	14.4	14.7	16.4	**192.3**	17.2	15.4	16.0	14.2	15.0	13.6	13.3	0.0
Share of energy resources in export of goods, %	**61.5**	**65.9**	**62.8**	**63.5**	**65.5**	-	-	68.7	-	-	65.0	-	-	64.7	-	-	64.3	**65.7**	-	-	68.2	-	-	66.0	-	-
Current Account, billion $	**76.6**	**102.4**	**48.9**	**70.3**	**98.8**	-	-	39.5	-	-	16.0	-	-	5.9	-	-	10.0	**71.4**	-	-	25.1	-	-	6.9	-	-
Export of goods, billion $	**354.4**	**471.6**	**304.0**	**400.1**	**522.0**	39.5	45.0	46.7	44.9	45.5	40.8	41.2	41.2	43.1	46.5	45.3	48.3	**528.0**	38.9	42.0	44.6	44.0	41.4	41.6	43.5	0.0
Import of goods, billion $	**223.5**	**291.9**	**191.9**	**248.7**	**323.8**	19.1	24.7	28.4	26.8	28.2	27.0	29.7	29.9	27.4	32.2	30.6	31.9	**335.7**	21.7	26.5	28.6	29.8	26.4	27.9	30.1	0.0
Gross FDI, mln USD 1/	**27,797**	**27,027**	**15,906**	**13,810**	**18,415**	-	-	3,863	-	-	7,598	-	-	11,333	-	-	18,666	**18,666**	-	-	6,384	-	-	12,139	-	-
Average export price of Russia's oil, $/bbl	**64.4**	**91.2**	**56.2**	**74.6**	**103.9**	102.5	108.1	112.7	111.7	106.6	94.5	93.6	100.4	104.3	104.6	103.2	101.1	**103.6**	102.8	105.3	102.9	97.6	94.4	95.5		
Financial Market Indicators																										
Average weighted lending rate for enterprises, % 3/	**10.8**	**15.5**	**13.7**	**9.1**	**9.3**	8.8	8.9	9.2	9.0	8.9	9.3	9.5	9.1	8.9	9.1	9.1	9.4	**9.4**	8.8	9.6	10.0	10.2	9.9	9.5	9.2	
CBR refinancing rate, %, end-o-p	**10.0**	**13.0**	**8.8**	**7.8**	**8.3**	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.25	8.25	8.25	8.25	**8.3**	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3
Real average rate for Ruble loans, % (deflated by PPI)	**-3.4**	**-6.8**	**-0.1**	**-6.5**	**-3.2**	-1.5	0.8	0.2	1.3	4.8	3.6	3.9	1.7	-2.6	0.0	2.3	3.9	**3.9**	3.5	4.6	6.8	9.0	7.2	5.5	2.0	
Stock market index (RTS, ruble term, eop)	**2,291**	**632**	**1,445**	**1,770**	**1,382**	1,577	1,735	1,638	1,594	1,242	1,351	1,377	1,390	1,476	1,436	1,437	1,527	**1,527**	1,622	1,534	1,460	1,407	1,331	1,275	1,313	1,291
Enterprises Finances																										
Share of loss-making companies 1/	**23.4**	**25.2**	**30.1**	**27.8**	**28.1**	34.0	33.2	35.0	32.9	31.4	31.0	29.3	28.2	28.3	27.0	26.3	25.9	**25.9**	34.9	34.3	36.5	34.8	33.5	32.3		
Share of credits in capital investment 1/	**15.5**	**17.6**	**20.1**	**14.3**	**12.8**	-	-	13.4	-	-	13.7	-	-	13.8	-	-	13.3	**13.3**	-	-	17.1	-	-	17.2		
Income, Poverty and Labor Market																										
Real disposable income, (1999 = 100%)	**245.6**	**251.5**	**259.3**	**272.5**	**274.7**	203.4	253.4	253.4	274.5	258.8	290.1	270.7	281.5	278.7	277.6	295.3	415.9	**286.2**	205.0	270.8	279.2	296.0	256.6	297.4	282.8	
Average dollar wage, US $	**532**	**697**	**588**	**698**	**806**	754	804	868	875	861	835	821	804	824.7	862.1	873.9	1185.4	**859**	887	883	932	958	951	960	923	
Share of people living below subsistence, % 1/	**13.3**	**13.4**	**13.0**	**12.5**	**12.7**	-	-	13.5	-	-	12.5	-	-	12.1	-	-	11.0	**11.0**	-	-	13.8	-	-			
Unemployment (%, ILO definition)	**6.1**	**7.8**	**8.2**	**7.2**	**6.1**	6.3	6.2	6.3	5.6	5.2	5.2	5.2	5.0	5.0	5.1	5.2	5.1	**5.1**	6.0	5.8	5.7	5.6	5.2	5.4	5.3	5.2

Source: Goskomstat, 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.