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The Dawn of a New Economic Era?

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Russia Economic Report

The Dawn of a New Economic Era?

This report is produced twice a year by World Bank economists of the Macroeconomics and Fiscal Management Global Practice. The team for this issue, led by Birgit Hansl (Lead Economist and Program Leader for Macroeconomics and Fiscal Management, Governance and Social Policy in Russia, bhansl@worldbank.org), consisted of Sergei Ulatov (Senior Economist), Stepan Titov (Senior Economist), Olga Emelyanova (Research Analyst), Mikhail Matytsin (Consultant), John Pollner (Lead Financial Officer), Mizuho Kida (Economist), Ekaterine Vashkmadze (Senior Economist), Damir Cosic (Economist), John Baffes (Senior Economist), Hanspeter Wyss (Senior Economist), Seyed Reza Yousefi (Consultant) and Irina Rostovtseva (Team Assistant). Birgit Hansl, Nancy Benjamin (Senior Economist), and Julie Saty Lohi (Consultant) produced the focus note on the economic impact of sanctions with contributions from Michael Ferrantino (Lead Economist) and Karlygash Dairabayeva (Consultant). Peer reviewers were Vinaya Swaroop (Lead Economist), Souleymane Coulibaly (Lead Economist), Fritzi Koehler-Geib (Senior Economist) and Karlis Smits (Senior Economist). The report was edited by Anne Grant (Consultant), and the graphic designer was Robert Waiharo (Consultant). The team is grateful for advice received from Laura Tuck (Vice President of the Europe and Central Asia Region), Hans Timmer (Chief Economist of the Europe and Central Asia Region), Michal Rutkowski (Country Director for Russia), Miria Pigato (Practice Manager, Macroeconomics and Fiscal Management Global Practice), Peter Tabak from the European Bank for Development and Reconstruction, and the IMF team for Russia, led by mission chief Ernesto Rigo Ramirez.

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ABBREVIATIONS AND ACRONYMS

BoP	Balance of Payments
CA	Current Account
CBR	Central Bank of Russia
CDS	Credit Default Swap
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
EBF	Extra-Budgetary Fund
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IMF	International Monetary Fund
NPL	Non-Performing Loan
NWF	National Welfare Fund
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of the Petroleum Exporting Countries
PPP	Purchasing Power Parity
RDIF	Russian Direct Investment Fund
REER	Real Effective Exchange Rate
USITC	United States International Trade Commission
VAT	Value-added Tax
VTB	Vneshtorgbank
WTO	World Trade Organization

EXECUTIVE SUMMARY

Russia's economy experienced two shocks in 2014. On top of the structural crisis that began in 2012, Russia had to deal with cyclical and idiosyncratic challenges to the economy. One of the new shocks illustrates Russia's integration into the world economy through its natural resource exports—and thus its dependence on the global commodity cycle: oil prices more than halved between July and December 2014, giving Russia a terms-of-trade shock. The ruble lost 46 percent of its value against the US dollar, which worsened already eroded business and consumer confidence. The monetary tightening in response made credit expensive, further dampening domestic demand. The other, more idiosyncratic, shock was related to the geopolitical tensions that began in March 2014 and led to economic sanctions. The tensions not only heightened perceptions that Russian investments had become riskier, they also dramatically increased the costs of external borrowing for Russian banks and firms. Spreads on Russian credit default swaps peaked in December at 578 basis points, compared to 159 a year ago. Together with the financial sanctions imposed on Russia in late July, which have restricted the access of Russia's largest state-connected banks and firms to Western international finance markets, this all but extinguished investment.

Despite the economic turmoil, Russia has so far avoided recession. In 2014, growth was moderate at 0.6 percent, due to the carry-over effect from 2013 growth of 1.3 percent. Two reasons contributed to this result: (i) The government and the Central Bank moved swiftly; policy responses to both shocks were adequate. The economy was stabilized successfully: The planned switch to a free float of the ruble was advanced to November and other measures to support financial stability were introduced promptly, including the recapitalization of banks in December; (ii) The oil price slump and stricter sanctions came late in 2014, so that their impact began to affect the economy only in the final quarter of 2014—the effects are likely to be more profound this year and in 2016. Other supportive circumstances relate to the balancing effect that imports, lowered by the geopolitical tensions and sanctions, had in softening the impact of the oil terms-of-trade shock. Finally, the much weaker ruble and trade restrictions gave a slight positive boost to the manufacturing sector.

Growth prospects for 2015-2016 are negative. It is likely that when the full effects of the two shocks become evident in 2015, they will push the Russian economy into recession. The World Bank baseline scenario sees a contraction of 3.8 percent in 2015 and a modest decline of 0.3 percent in 2016. The growth spectrum presented has two alternative scenarios that largely reflect differences in how oil prices are expected to affect the main macro variables. A lower-bound oil price scenario projects a larger contraction of 4.6 percent in 2015 and a second recession year in 2016 with a 1.0 percent contraction. The upper-bound oil price scenario projects a contraction in real GDP of 2.9 percent in 2015 followed by recovery to 0.1 percent growth in 2016. The main assumptions of the baseline growth outlook for both years are that consumer demand is likely to be eroded by weak confidence, still-high household debt, and slowing income growth. In 2015, high inflation resulting from the recent steep devaluation of the ruble would further depress incomes and wages. Investment is projected to contract in 2015, though with external and credit conditions expected to improve somewhat in 2016, it should recover marginally. The only bright spot is that the weak ruble could create incentives for expansion in some tradable industries. However, high level of capacity utilization, structural rigidities, and the surging cost of imported investment goods and credit may dampen these benefits.

A major medium-term risk for the economy lies in the continued dearth of investment. Low investment demand hints at the deeper structural problems of the Russian economy and has already initiated a new era of potentially small growth. Presently, higher interest rates are exerting pressure on Russian banks as their costs of funding rise, credit levels decline, and more loans default. Given the slowdown of the economy, the result could be a vicious cycle of a shortage of project credit, rising lending rates, and a tightening of access to credit. But there are more fundamental factors that could limit investment demand: The uncertainty related to geopolitical tensions and sanctions is still holding investors back and it is likely to take some time until their confidence is restored. The economy continues to grapple with serious inefficiencies in factor allocation, reflected, e.g., in limited labor mobility, and also with the weakness of the institutions that regulate markets, which leads to significant variation in how the rules of law are applied. Private investment would need to be assured of a level playing field, with more opportunities for competition and fewer for corruption. Systematically lower investment rates will ultimately lower Russia's prospects for higher growth in the next few years and limit the already modest potential for growth.

The impact of sanctions is likely to linger for a long time. As lessons from international experience demonstrate, sanctions could well alter the structure of the Russian economy and the ways in which Russia integrates with the rest of the world. Early glimpses of changes in the Russian economy are already visible, notably a shift in orientation away from Europe and the West and efforts at closer integration with East Asia, Latin America, and former Soviet Union republics. Other changes take a more protectionist direction, with a growing footprint of the state on the economy. But no matter what shape the new economic era for Russia takes, risks related to how to successfully adjust to the new oil price and sanctions environment will need to be managed: (i) Despite the path to more selective integration into the world economy, Russia will continue to depend on natural resource exports. Here a serious challenge will be to assure progress in adopting technology that can support exploration of less accessible oil and gas fields; (ii) Future growth in productivity may well be threatened if natural resource revenues are not invested to improve long-run growth prospects, particularly given restricted access to external financing. Specifically, less foreign direct investment could limit the transfer of innovation and technology that is critical to heighten Russia's growth potential; and (iii) Finally, as long as access to external finance continues to be a constraint, a policy of careful management of financial sector risks and buffers will be vital. Adhering to inflation targeting within a flexible exchange rate regime will help keep international reserves adequate. A greater focus on the efficiency of spending and prudent management of fiscal buffers is necessary to ensure continued fiscal sustainability at all administrative levels.

Achievements in shared prosperity are being threatened. The past decade witnessed a dramatic drop in poverty as large numbers of Russians were able to enter the middleclass. Poverty plunged from about 40 percent of the population in 2001 to about 10 percent in 2010, and in 10 years the middleclass doubled from 30 percent of the total population to over 60 percent. The current World Bank baseline outlook, however, sees the national poverty rate increasing from 10.8 percent in 2013 to 14.2 percent in 2015 and 2016. Poverty is expected to increase because real disposable income and consumption will decline. This would be the first significant increase in poverty rates since the 1998-1999 crisis. Russia weathered the 2008-2009 crisis well as disposable incomes continued to grow slightly. Given the current limited fiscal space, additional support for the poor and vulnerable is likely to be less generous than it was during the 2008-2009 crisis. Although people at the bottom of the income distribution are the most vulnerable, there will be less opportunity for an increase in shared prosperity in 2015-2016, and there is a worrisome possibility that recent achievements might be reversed.

PART I

RECENT ECONOMIC DEVELOPMENTS

Russia avoided a recession in 2014. The modest growth of 0.6 percent lacked momentum, with seasonally adjusted quarterly growth persistently near zero. In addition to the structural slowdown that began in 2012, Russia had to internalize two major events. The first was a terms-of-trade shock when oil prices more than halved between July and December 2014. The ensuing ruble depreciation and monetary tightening made credit scarce and expensive, further dampening domestic demand. The second shock was related to the geopolitical tensions that began in March 2014 and led to economic sanctions. A heightened perception of risk and the financial sanctions imposed on Russia in late Julyall but extinguished investment. Nevertheless, the economy was stabilized successfully. The full impact of the oil price slump and stricter sanctions, however, will be realized this year and into 2016.

1.1 Growth - A Lost Year

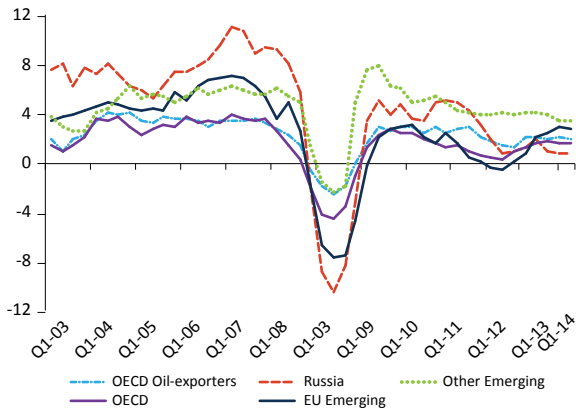
In 2014 Russia's economy barely grew at all. A steep drop in oil prices, together with uncertainty related to geopolitical tensions and sanctions, shocked the economy, where investment was already anemic and there were lingering structural problems. Domestic demand plummeted to rates not seen since 2008–2009.

In 2014 Russia's growth trajectory diverged considerably from that of other high-income and emerging economies (Figure 1). In the first quarter of 2014, growth sank to 0.9 percent from 2.0 percent in the last quarter of 2013 and stayed there for the rest of the year. However, while the global economy was slowly gathering momentum, Russia's economy was slowing (Box 1). The U.S. saw growth pick up most, but there were weaknesses in Brazil, the Euro area, and Japan. Overall, OECD countries held on to a small but expanding recovery. China was dealing with a managed slowdown, while other emerging economies were seeing a modest growth pick-up. But the oil price declines began to put economic and financial strains on oil exporters.

During the second half of 2014, external demand for Russia's exports lackened and oil prices retreated (Box 2), and throughout the year geopolitical tensions and policy uncertainty markedly reduced domestic demand. Investment growth was negative and consumption grew more slowly than it had been (Figure 2). Globally, low oil prices had already led investors to reassess the growth prospects of oil-exporting countries. This contributed to capital outflows, reserve losses, abrupt depreciations, and rising spreads on sovereign credit default swaps (CDS) for many oil-exporting countries, among them Russia, Venezuela, Colombia, Nigeria, and Angola. Real sector and financial strains could entail adverse spillover effects for partner economies through trade and financial linkages, such as remittance flows.

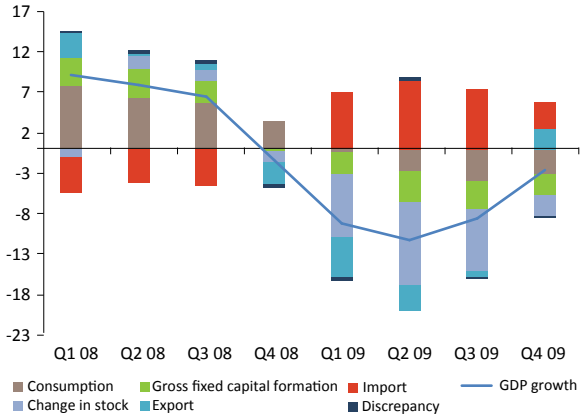
Throughout 2014, Russia's economy was void of growth momentum, with seasonally adjusted quarterly growth persistently near zero (Figure 5). Real GDP slowed from 1.3 percent in 2013 to 0.6 percent in 2014—about half of what the World Bank had projected in January 2014. Recognizing the negative impact on investor and consumer confidence of heightened geopolitical tension, increased uncertainty about policy, and the weaker ruble, the World Bank in June revised its growth projection down to 0.5 percent. In the second half of 2014, Western sanctions and

Figure 1: GDP growth, 2003–2014, percent



Source: OECD.
Note: OECD oil exporters are Australia, Canada, Chile, the Netherlands, Norway, and the United States.

Figure 2: Composition of GDP growth, percent



Source: Rosstat.

Box 1 Global economic trends in 2014

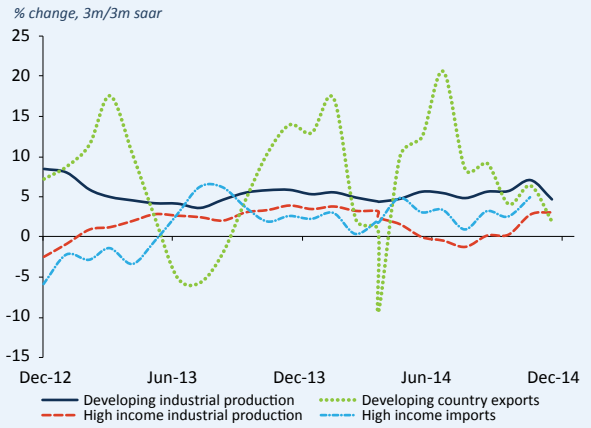
Global growth once again remained tepid in 2014. The global economy struggled to gain momentum as growth patterns in high-income economies increasingly diverged and in developing countries growth on average slowed. Overall, global growth is estimated to have averaged 2.6 percent in 2014, almost unchanged from 2012 and 2013. Growth was particularly disappointing in the Euro area and Japan and in emerging markets in Russia and Brazil.

The growth of high-income countries increasingly diverged. While overall growth in high-income countries picked up marginally, from 1.4 percent in 2013 to an estimated 1.8 percent in 2014, there was a growing gap between countries. However, in the United States growth has been above potential since mid-2013 and in 2014 reached 2.4 percent, supported by easing fiscal consolidation, robust private investment, and a surge in consumption. In the euro area, real GDP growth continued to be subdued, reaching only an estimated 0.9 percent. Confidence stabilized at the end of 2014 even as the euro weakened and oil prices fell. In Japan, at zero percent a technical recession ended in the fourth quarter as both consumption and exports recovered.

Growth in emerging and developing countries slipped. The slowdown in several large middle-income countries was mainly caused by cyclical factors, domestic policy tightening, and political tensions. India and Mexico grew well in 2014. China is undergoing a managed slowdown but growth was a still-robust 7.4 percent. In contrast to middle-income countries, economic activity in low-income countries picked up in 2014 as public investment rose, service sectors expanded significantly, and there were solid harvests and substantial capital inflows (Figure 3). For this group growth reached 4.4 percent in 2014, down only slightly from 4.9 percent in 2013.

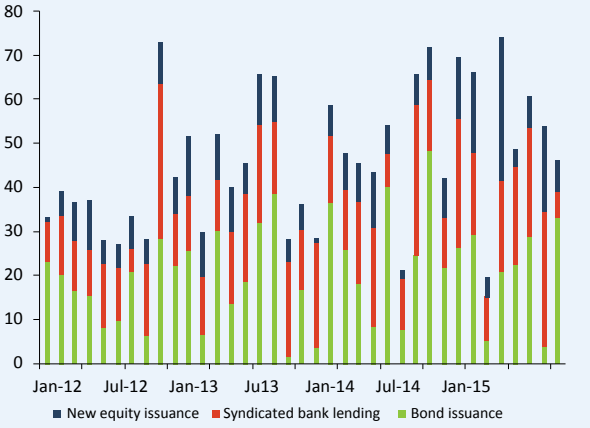
Global trade was surprisingly flaccid again, even though financing conditions were benign (Figure 4). Since the financial crisis began, global trade has slowed significantly, growing by less than 4 percent in 2013 and 2014—well below the pre-crisis average of 7 percent a year. The slowdown is due partly to a drop in demand and partly because world trade seems to be less sensitive to changes in global activity. Changes in global value chains and shifting composition of import demand may have contributed to the decline in the responsiveness of trade to growth. Benign financing conditions throughout much of 2014 allowed developing countries to tap international bond markets at a record pace. With major central banks committed to keeping their policies exceptionally accommodative to support activity, markets have tended to expect further accommodation when there is negative news.

Figure 3: Global industrial production and trade growth



Source: Datastream and World Bank prospects.

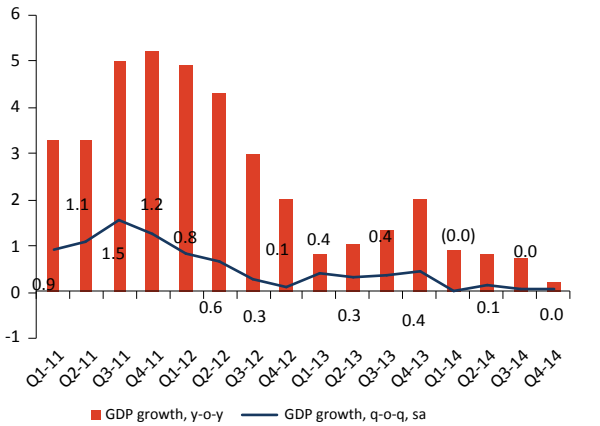
Figure 4: Gross capital flows to developing countries, US$ billions



Source: Dealogic and World Bank prospects.

plunging oil prices further depressed economic activity and consumer demand. As a result, 2014 was another lost year for the Russian economy: real GDP edged up to just 6 percent above its 2008 level. Yet the 2014 adjustment to oil prices that were about half of what they had been in 2013 seems to be playing out quite differently than the drop experienced in 2008, when a similar oil-price cut immediately pushed the economy into a deep recession (Box 3). So far, Russia has not entered a recession, despite the economy's structural weaknesses. This time,

Figure 5: Quarterly GDP Growth, y-o-y, and q-o-q, sa



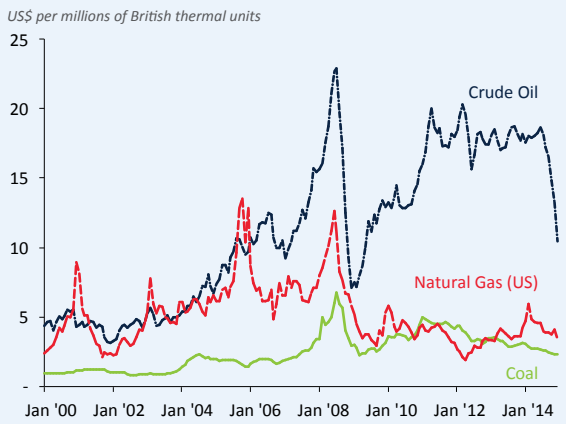
Source: Rosstat.

Box 2 Energy price trends

During 2014, energy markets reached a historic turning point. After having fluctuated within a tight band around US$105 a barrel between 2011 and 2013—making it one of the least volatile three-year periods in recent history—in the second half of 2014 oil prices began to drop. They fell further on OPEC's November decision to abandon targeting of prices. For 2014, crude oil prices ended 2014 at below US$60 per barrel, down from an average US$104 in 2013 (Figure 6).

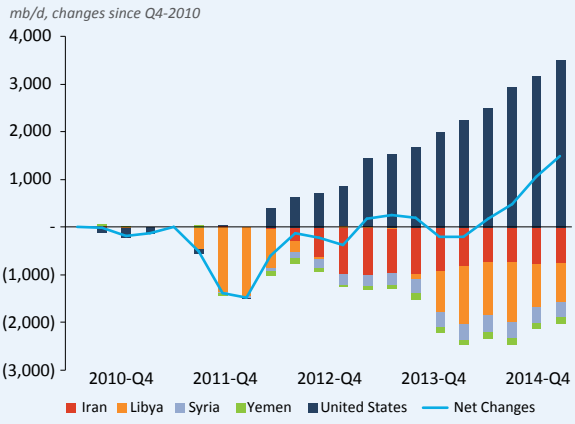
In recent years, the rapid expansion of unconventional oil production in North America was offset almost barrel for barrel by supply disruptions in the Middle East (Figure 6). These developments kept the global oil market fairly balanced and prices in the US$100-110 per barrel range. However, in the second half of 2014 some oil supply from the Middle East began returning to the market, while the U.S. continued its steady production of 1 million barrels per year. Previously in such situations Saudi Arabia—the producer with the highest spare capacity—would normally lead OPEC in production cuts to stabilize prices. However, OPEC decided to maintain its current quota, in effect ceasing to manage the global supply in order to protect its market share. This decision led to the largest supply-driven correction in prices since 1986.

Figure 6: Global energy prices



Source: World Bank.
Note: These are relative prices of different fuels in terms of energy units to ensure comparability.

Figure 7: Growth in the crude oil supply, U.S. and elsewhere



Source: World Bank and International Energy Agency.

the impact of the shocks seems to have been less severe and more gradual: external demand did not drop as much and the adjustment was more gradual because imports in the first half of 2014 had already been lowered as a result of restrained growth and a weaker ruble, which helped the domestic manufacturing sector. Limited fiscal space will restrain the government's response this time.

In 2014 investment remained depressed for the second year in a row and the contribution of consumption to growth was less than half what it had been in 2013. Since there were no major public investment projects, fixed investment contracted by 2.5 percent because private businesses were reluctant to expand. In fact, heightened uncertainty about policies and persistent structural problems meant that business sentiment continued to deteriorate. Low domestic demand and the higher borrowing costs caused by financial sanctions further limited investment. Consumption was again the main growth engine but expansion of both household and public consumption slowed. Depreciation of the ruble, high household indebtedness, and accelerating inflation eroded incomes and put the brakes on household consumption. Unexpectedly high inflation also discouraged public consumption. As a result, the contribution of aggregate consumption to GDP dropped to 1.1 percent in 2014 after reaching 2.7 percent in 2013 and 4.3 percent in 2012 (Table 1).

A brisk contraction in imports more than compensated for weakened external demand, heightening the contribution to growth of net exports. External demand slackened in 2014 because expansion of the global economy was below trend. Demand for Russian exports

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

	2007	2008	2009	2010	2011	2012	2013	2014
GDP growth, percent	8.5	5.2	-7.8	4.5	4.3	3.4	1.3	0.6
Consumption	7.4	5.7	-2.6	2.6	3.7	4.3	2.7	1.1
Households	6.9	5.1	-2.5	3.0	3.5	3.8	2.5	1.0
Government	0.5	0.6	-0.1	-0.3	0.3	0.5	0.2	0.1
Gross capital formation	4.7	2.5	-10.5	5.4	4.7	0.7	-1.6	-1.3
Fixed capital investment	3.9	2.2	-3.2	1.3	2.0	1.4	0.3	-0.5
Change in stocks	0.8	0.3	-7.2	4.1	2.8	-0.7	-1.9	-0.8
Exports	2.1	0.2	-1.5	2.0	0.1	0.3	1.4	-0.6
Imports	-5.5	-3.2	6.7	-5.3	-4.3	-1.9	-0.8	1.5

Source: Rosstat and World Bank staff calculations.

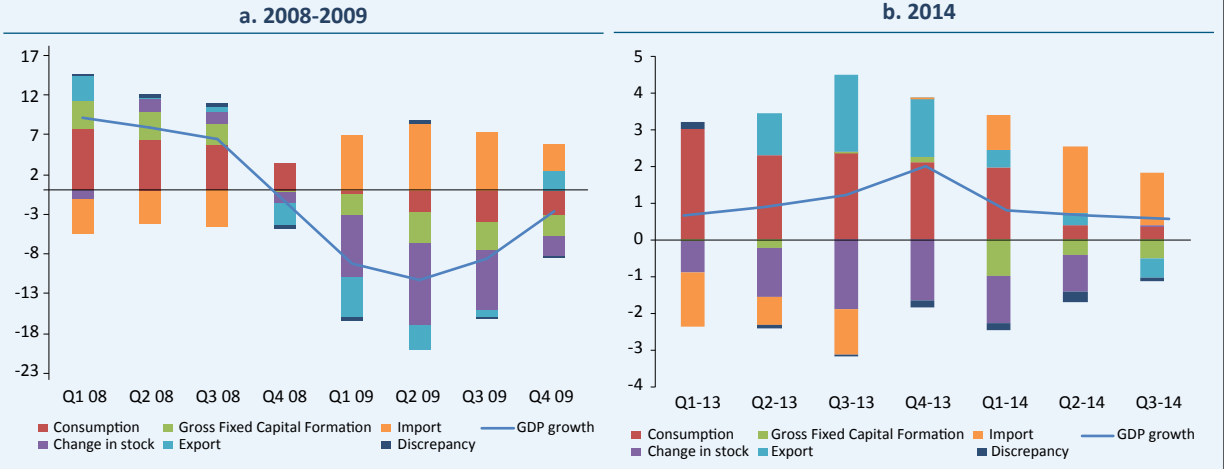
Box 2 How does this adjustment compare to the crisis in 2008-2009?

In 2008 the economy fell into a deep recession in the fourth quarter while in 2014 the economy suffered a gradual slowdown. In 2008, the oil price dropped from US$90 per barrel in September to US$35 in December. Similarly, in 2014 they dropped from US$115 per barrel in July to US$57 in December. In addition to the ebb in global trade flows, in 2008–2009 financial flows also ceased, which severely restricted access to external financing. In 2014 economic sanctions targeting the financial sector restricted access to external capital markets or made external borrowing essentially unaffordable. In both cases domestic demand, specifically consumption, sank swiftly.

Though the external shocks that hit the Russian economy in 2008-2009 and 2014 were similar, their impact differed. By the end of 2008, oil and non-oil exports had suffered much more than they did in 2014. Imports adjusted in both cases, but they did so earlier in 2014, even before the terms-of-trade shock, starting in quarter one due to low growth and a weakening ruble (Figure 8). In 2014, Russia's ban of food imports in August helped to counterbalance the export drop and prevented a widening trade deficit. In 2008-2009, imports started to adjust in quarter four with the external shock.

Russia's recovery after 2008-2009 was swift, but its growth path in 2015-2016 is expected to be a protracted recession. In 2010, led by a fast revival in external demand based on an upward adjustment in oil prices, accompanied by a quick restoration in access to external capital markets and a sizable counter cyclical fiscal program (implemented in the second half of 2009), the economy exited recession. Fiscal savings over the preceding decade that accumulated in the Reserve Fund allowed the government to finance the fiscal deficit of 6.8 percent of GDP without a significant deterioration in its debt-to-GDP ratio. In 2015, Russia's external environment is expected to remain somewhat hostile, given low oil prices and export demand. As sanctions stay in place, access to external borrowing will remain restricted. Most importantly, the government's fiscal space for countercyclical measures is more limited because the Reserve Fund is half the size it was in 2008-2009. Even though proposed amendments to the 2015 federal budget imply some consolidation of expenditures, the expected fiscal gap of 3.8 percent of GDP could severely deplete the Reserve Fund (currently equal to 4.7 percent of GDP). The anti-crisis plan for 2015 (Box 7) amounts to less than 2 percent of GDP and most funds are earmarked for recapitalization of banks.

Figure 8: GDP reactions to external shocks, 2008 and 2014

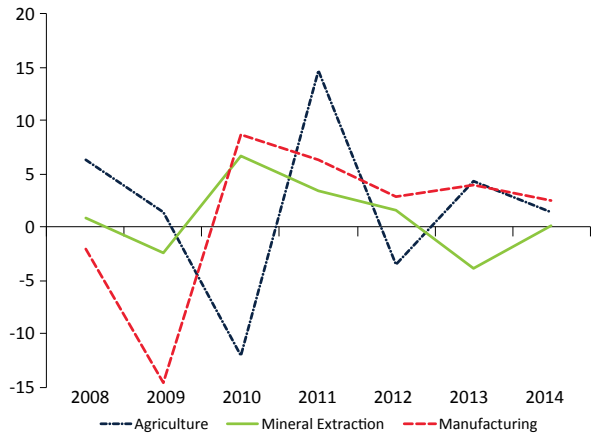


Source:RosstatSource:Rosstat

deteriorated dramatically: the contribution of exports to GDP growth turned negative, to–0.6 percent, after making a positive contribution of 1.4 percent in 2013. Yet even though external demand was disappearing, the contribution of net exports to GDP went up from 0.6 percent in 2013 to 0.9 percent. The improvement occurred because imports also contracted acutely; the ruble had begun to depreciate at the onset of the geopolitical tensions in the first half of 2014 and the depreciation accelerated in the second half. This depressed domestic demand, and the problem was compounded by Russia's ban on the import of food items on August 7, 2014.

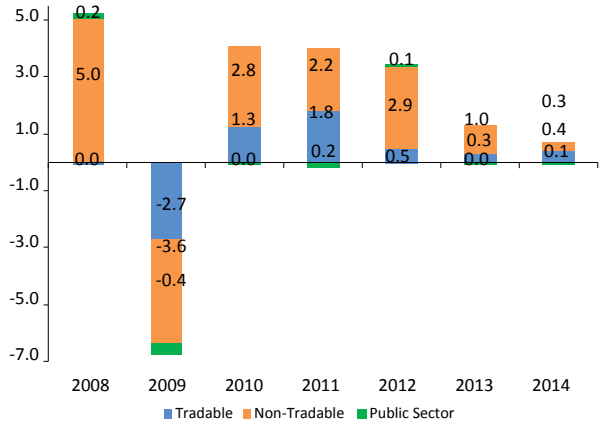
The weaker ruble and trade restrictions supported economic activities in the tradable sector, mainly in a few manufacturing industries with spare capacity (Figure 9). Some industries also benefited from a surge in military-related production. While there might be some natural substitution as resources are shifted from nontradable to tradable sectors, persistent structural rigidities and high uncertainty in 2015 are expected to limit such a shift of resources and capacity expansion. In 2014, as activity in nontradable sectors slowed, the tradable sector became the main growth engine. The aggregate contribution of the tradable sector to growth in 2014 increased to 0.4 percentage points despite the depressed demand (Figure 10). As consumption slowed further in 2014, demand for nontradable services fell, and their aggregate contribution to growth sank to 0.3 percent, from 1.0 percent in 2013 and 2.9 percent in 2012.

Figure 9: Growth in tradables, y-o-y, percent



Source: Rosstat.

Figure 10: Contribution to GDP by sector, percent of GDP



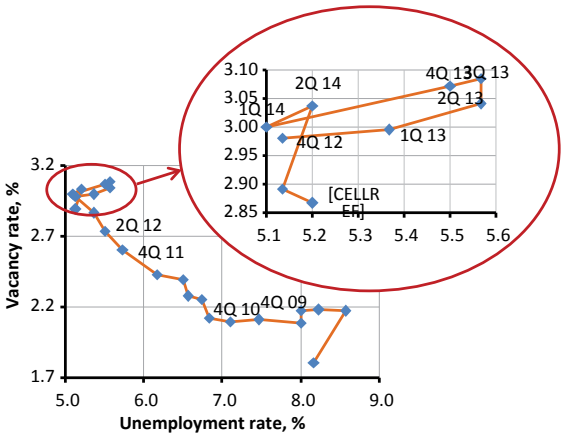
Source: Rosstat.

1.2 Labor Market – Adjustment of Wages and Incomes

Despite a continuing slowdown in the real sector, the labor market stayed tight, with unemployment barely moving from its historically low levels as the demographics of aging continue to pressure the labor supply. However, in the second half of 2014, as inflation accelerated real wages contracted abruptly; if that continues, it will mean the labor market is adjusting to lower demand.

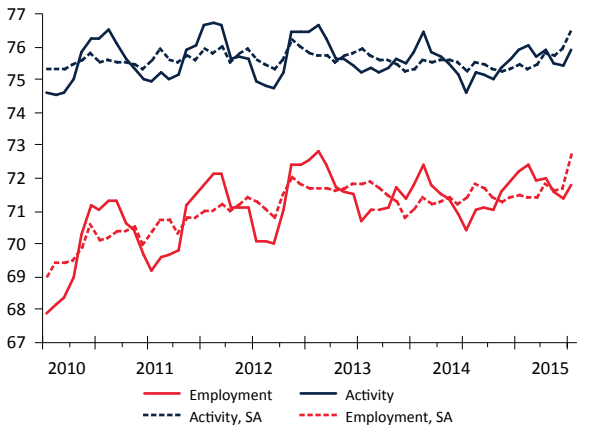
Labor demand did not change much in the second half of 2014: The seasonally adjusted vacancy rate (ratio of vacancies to total jobs) decreased only slightly, in the fourth quarter, to 2.9, from 3.0 in the second quarter. There was no corresponding growth in unemployment (Figure 11). Total employment was high throughout 2014, though the seasonally adjusted indicator

Figure 11: Beveridge curve



Source: Rosstat and World Bank staff estimates.

Figure 12: Employment and economic activity, million workers



Source: Rosstat and World Bank staff estimates.

dropped slightly at mid-year and ended the year at 71.7 million, compared to 71.2 million at the end of 2013 (Figure 12). More women (5.2 percent) than men (4.8 percent) were unemployed in the second half of 2014, but that was slightly below the 6.0 percent in the second half of 2013. In the second half of 2014 urban unemployment was just 4.2 percent, compared to 7.6 percent in rural areas. With the Russian population aging, the slow decline in the working-age population that began in 2008 continues to put pressure on labor supply and partly explains the very low unemployment rates. However, for the second half of 2014, with both demand for and supply of labor easing slightly, it is difficult to explain the further decrease in the seasonally adjusted unemployment rate, from 5.3 percent in 2013 to 5.1 percent.

Despite the slowing economy, employment and activity levels remained near their maximum historical levels, and unemployment was at a record low. A combination of factors may explain this phenomenon: Traditionally Russia's labor market adjusts to lower demand primarily through wage contraction rather than an immediate increase in unemployment (Box 4). Also contributing is the trend toward more informal employment (self-employment, working for individual entrepreneurs, migrant workers, and other forms of employment that official statistics do not capture well), and the accompanying switch from formal wages to shadow forms of remuneration. In times of crisis, this factor is likely to have more effect. Because labor market rigidities are reflected in the limited geographic mobility of labor, unemployment continues to vary widely by region: There are more unemployed in the poorest regions—the Northern Caucasus Federal District of Ingushetia (23.6 percent), Chechnya (19.7 percent) and the Tuva Republic (16.7 percent)—while in the large metropolitan areas almost everyone in the labor market is employed; unemployment in Moscow city is 1.4 percent, St. Petersburg 1.3 percent, and the Moscow region 2.7 percent.

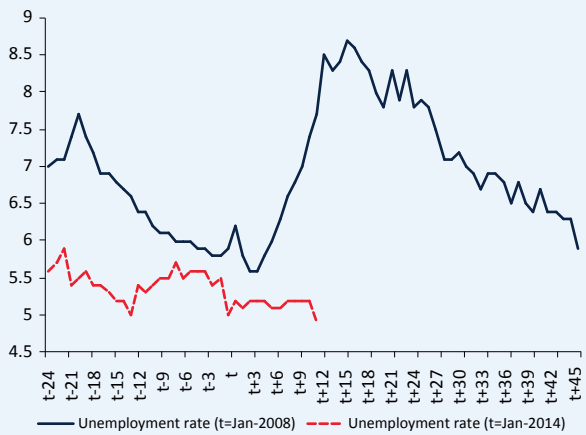
Real disposable income contracted in 2014 for the first time since 1999. For the year as a whole the decline was 1 percent, but in the fourth quarter the drop was 3.5 percent. Income dynamics were volatile throughout the year, but the negative outcome was driven by a contraction in both of the main income components, pensions and wages. Real wages and pensions both decelerated gradually during the year until the sudden contraction in December. Up to September, the wage deceleration was uniform across sectors

Box 4 How the labor market adjusted in previous crises

Keeping unemployment stable by adjusting wages is a feature of Russia's labor market. A traditional high share of public employment performs the functions social security nets play elsewhere. For this reason social protection programs are not well-developed in Russia. In the transition period of the early 1990s, when GDP declined by about 40 percent, the labor markets of Russia and other former Soviet Union republics saw a relatively low increase in unemployment (up to 15 percent) and a much higher contraction of real wages (more than 50 percent). Similarly, in 2009, although unemployment went up by 3 percentage points, wage growth contracted by 5 percent after growing 15 percent year-on-year before the crisis (Figure 13 and Figure 14). The labor market reacted similarly this time: Real wages contracted by 4 percent year-on-year in December and averaged 9 percent in January and February 2015. Continued wage adjustment is likely to contain unemployment.

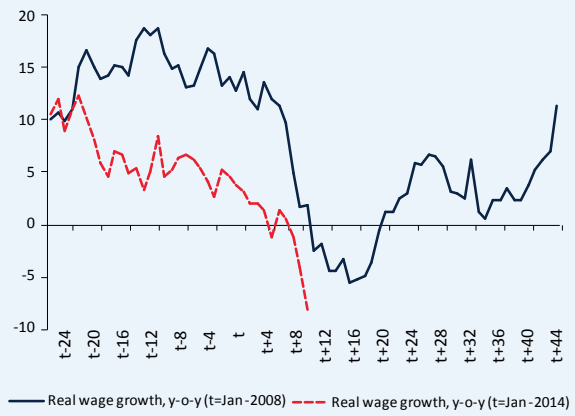
More labor market arrangements are informal during crisis periods because: (i) relatively low unemployment benefits induce people to find new jobs quickly, which, given the softer labor market, are more likely to be informal; and (ii) high variation in salaries leaves room for employers to adjust wages in different ways. Among them are an increase in informal earnings ("envelope salaries"), which allows employers to lower social insurance and other contributions. Usually, this tends more to characterize small enterprises and the self-employed, but during crises even medium and large enterprises switch in part to informal salary payments. Finally, the widespread use of migrants in some sectors of the economy, especially services and construction, is more easily adjusted during crises and the statistics on this are not fully captured.

Figure 13: Unemployment dynamics, 2008 and 2014



Source: Rosstat and World Bank staff estimates.

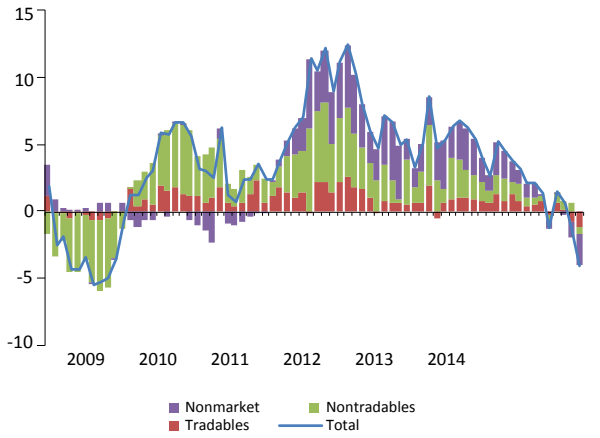
Figure 14: Real wage growth, 2008 and 2014



Source: Rosstat and World Bank staff estimates.

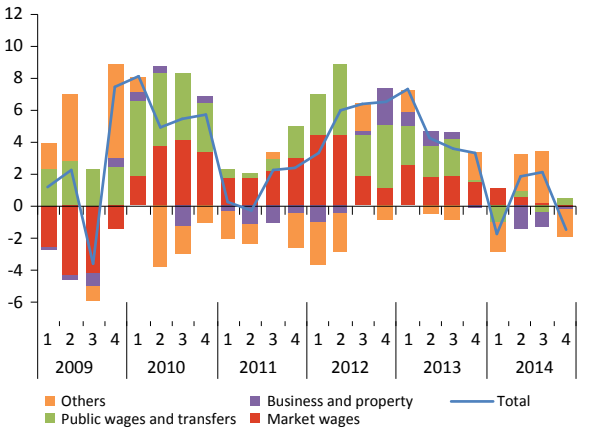
(Figure 15). According to preliminary data the November-December contraction was mainly driven by public wages and wages in the tradable sector. Wages in nontradable sectors were more resistant, though in December they declined as well. In 2014, second and third quarter income growth was significantly impacted by other factors, such as wages in small and informal enterprises and currency operations (Figure 16). Meanwhile household disposable income came under pressure from higher borrowing costs and limited opportunities for rolling over short-term consumer debt, which made debt servicing and debt repayment more expensive.

Figure 15: Real wage growth by sector, y-o-y, percentage



Source: Rosstat and World Bank staff estimates.
Note: Data for Q4 2014 are preliminary.

Figure 16: Contribution to real income growth, entire population, y-o-y, percent



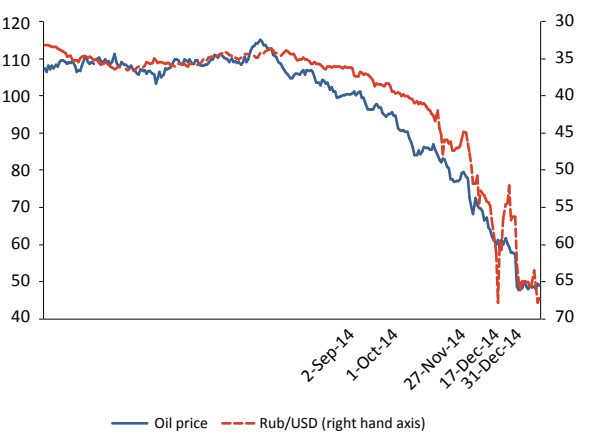
Source: Rosstat and World Bank staff estimates.

1.3 Monetary Policy and the Financial Sector - Navigating a Currency Adjustment

The steep drop in oil prices and the sanctions led to massive devaluation of the ruble. This required a shift in exchange rate policy and coordinated measures to stabilize the financial system. Significant monetary tightening failed to anchor the inflation expectations that were generated by the weakening ruble and Russia's ban on food imports.

The Russian currency was extremely volatile in 2014, and massive depreciation in the second half of the year motivated the Central Bank of Russia (CBR) to advance its switch to a free-float exchange rate system. In 2014 the ruble lost 46 percent of its value against the U.S. dollar (in 2008 the loss had only been 17.7 percent). During the second half of 2014[1] exchange rate dynamics reflected the abrupt downward adjustment in oil prices, but the sanctions and speculations about CBR plans for a shift in exchange rate policy also had a significant impact (Figure 17). The second half of 2014 saw three discrete periods of ruble exchange rate dynamics. In the first, from July to October 2014, the exchange rate mainly tracked the gradual oil price decline of 14.7 percent, showing a loss in the ruble's value against the dollar of 14 percent. Pressure on the ruble and exchange rate volatility were still moderate and the CBR had to intervene only marginally.[2] However, from early in October

Figure 17: Oil prices and the ruble exchange rate, 2014 (right hand axis in reverse order)



Source: Haver database; the Central Bank of Russia.

to November 10, 2014, pressure on the ruble intensified as oil prices slid dramatically and foreign exchange liquidity limitations surfaced as a result of the sanctions. During that period the CBR introduced several emergency measures[3] to

[1] See RER 32 for the evolution of the exchange rate in the first half of 2014.
[2] In response to rising inflation pressures,on July 29 the CBR increased policy rates by 50 basis points, to 8 percent.
[3] To increase foreign exchange (forex) liquidity the CBR on October 29 introduced 7- and 28-day repo facilities in foreign currency. The day before it had hiked policy rates by another 150 basis points, to 9.5 percent, in response to of rising depreciation pressures and accelerating inflation.

guarantee foreign exchange liquidity; in October alone it spent US$30 billion to support the currency. However, on November 10 the central bank switched to the free float to try to end the drain on reserves.[4]

The currency crisis at the end of 2014 prompted the CBR and the government to put in place coordinated measures to ensure financial stability. After November 27, when OPEC decided not to cut oil production, the ruble went into free fall, which required the CBR to resume its interventions; it spent another US$10.3 billion in the first half of December. Massive capital outflows, hoarding of foreign exchange proceeds by exporters because access to external finances was restricted for sanctioned banks and corporations, and dollarization of the savings of Russians had added to pressure on the ruble. In response to the unprecedented volatility, on December 16 the CBR hiked its policy rate by 650 basis points. The initial response was deeply negative: the very next day the exchange rate plummeted by 11 percent, prompting the CBR and the government to work urgently to keep the financial system stable (Box 5). These measures, together with the massive rate hike, helped to stabilize the exchange rate, but because of concerns about the continued bleak outlook for oil prices, a looming recession, and waning chances that sanctions would be removed, the pressure on the ruble did not abate.

In December, the Consumer Price Index (CPI) reached 11.4 percent (Figure 18). Despite all the CBR's efforts to tighten, inflation had nearly doubled from the 6.5 percent at the end of 2013, soaring past the initial CBR target of 5.0 percent by 6.4 percentage points to 11.4 percent. Russia had not seen double-digit inflation since 2008. In the first half of 2014 inflation was already higher than expected because of the weakness of the ruble induced by the geopolitical tensions. In the second half, the situation worsened: Core inflation, which had been 7.5 percent in June, year-on-year, hit 11.2 percent in December. Russia's ban on major food imports in early August was another non-monetary factor that continued to push up food inflation, and thus the CPI,in the second half of 2014.[5] Food inflation shot up from 9.2 percent in June to 15.4 percent in December, year-on-year, especially for meats (20.1 percent), milk products (14.4), and fresh fruit and vegetables (22.0 percent). In January 2015, inflation gained another 3 percent, hitting 15.0 percent, year-on-year, again driven by high food inflation (20.7 percent) and the pass-through effect of the ruble devaluations in December and January. The result was core inflation of 14.7 percent, year-on-year—a level not seen since 2002.

Box 5 December 2014: Policy moves to enhance financial stability

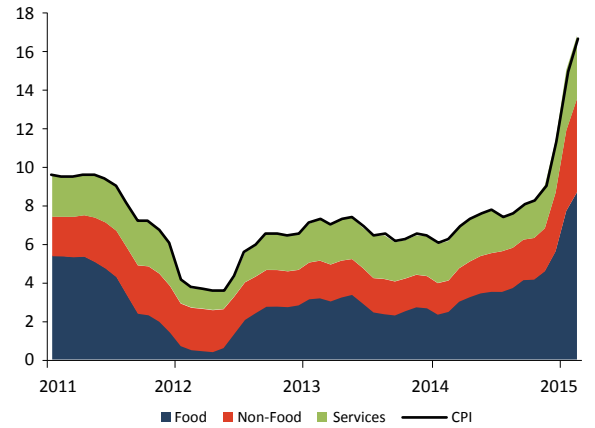
The ruble collapse in December prompted the Russian authorities to implement coordinated measures to stabilize the exchange rate and ensure financial stability. In addition to the new foreign exchange repo facilities introduced in November, the following measures were introduced:

- The Ministry of Finance sold foreign exchange in the amount of US$1.5 billion.
- The CBR introduced 28- and 365-day foreign currency loans to the 11 banks with capital of over RUB100 billion.
- Five major state-owned exporters were given a deadline of March 1, 2015, to cut their net foreign assets back to the level of October 1, 2014.
- On December 30, a RUB1 trillion bank recapitalization program was launched by issuing Treasury bonds.
- The State Duma approved a bill allowing the government to invest up to 10 percent of the National Wealth Fund in subordinate deposits and subordinate bonds of Russian banks.

[4] The CBR spent US$86.5 billion of foreign currency reserves in 2014, leaving it with a balance of US$390 billion (10.7 months of imports) at year end.

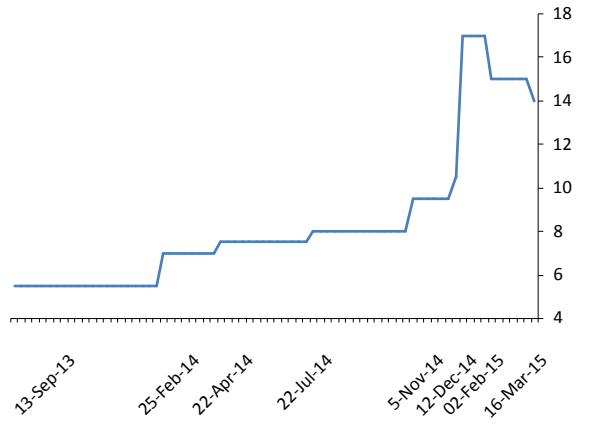
[5] Imports of both food and non-food items constitute about 15-20 percent of Russia's consumer basket items. Yet some imports (e.g., meats, fruit, and vegetables) account for a significantly higher share in total consumptions. Thus how the ban affected inflation differed for food items.

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



Source: CBR.

Figure 19: CBR policy rate hikes



Source: Rosstat.

To anchor inflation expectations the CBR continued to tighten throughout 2014, hiking the policy rate to 17 percent in six steps, for a total of 1,150 basis points (Figure 19). As a result, growth in money supply (M2) slowed from 15.2 percent in 2013 to 8.5 percent in 2014, and for the first time since 2009 monetization of the economy (M2/GDP) decreased. Since the inflation pressures and expectations were largely inflicted by nonmonetary factors, tighter monetary policy was only partially effective. On January 30, 2015, the CBR cut its key policy rates by 200 basis points, back to 15 percent, citing as reasons stabilization of devaluation and inflationary expectations. Unfortunately, the market reaction was so negative that the CBR once again had to intervene with US$700 million to stabilize the ruble. In February, the 12-month CPI surged to over 16 percent, largely driven by food inflation, which soared to over 20 percent. However, a slowing of monthly inflation in February suggests some moderation of inflationary pressure, likely as a result of the tapering-off pass-through effect of the ruble devaluation and constraints on consumer demand. On March 13 the CBR lowered its policy rates by another 100 basis points, citing downside risks to growth as the reason for its decision.

The tighter monetary policy brought on by the weakness of the ruble and the international sanctions that limit the access of many of Russia's larger banks to low-cost medium-term financing have put considerable stress on the banking system. Several banks with non-ruble debt to external creditors now have higher debt servicing costs and thus lower net cash flows and profits. Meanwhile, the currency depreciation and the ensuing tighter monetary policy have caused a severe increase in bank funding costs. As a result, growth of credit has declined and interest rates are higher—for example, interest rates on 1–3-year loans to small and medium enterprises are averaging more than 14 percent, and interbank loans to maintain banking system liquidity have been averaging 11-12 percent.

It is likely that the current health of the financial sector is overstated, given the regulatory forbearance the CBR has been exercising to carry banks through this volatile period. As of 2014, banking system return on assets was 1.5 percent, return on equity was 12.1, and nonperforming loans (NPLs), taking into account regulatory forbearance, were under 7 percent. The capital adequacy ratio for the system was 11.9 percent. The CBR has allowed banks some flexibility in classifying overdue loans and in their provisioning during this crisis. This means in effect that NPLs are much higher than reported and banks would have larger capital shortfalls if they were to classify and provision their credit portfolios accurately. The CBR has allowed forbearance by not requiring banks to mark all

their assets to market value (letting them use original book value) so that they can avoid having to recapitalize their balance sheets immediately. The policy is based on expectations that the losses in value will be temporary.

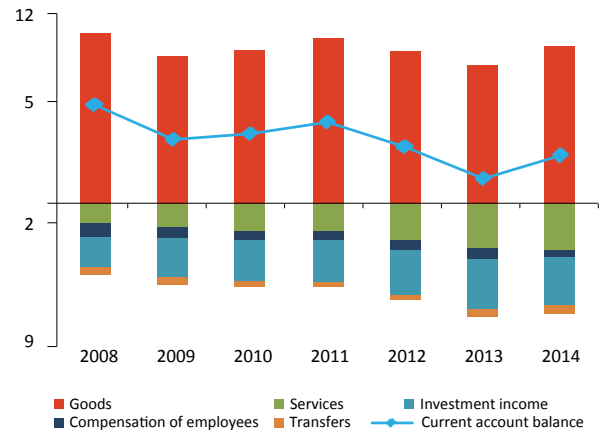
To assure financial stability, the CBR and the government have injected liquidity and capital into the banking system (Box 5), though these injections have gone only to specific banks, not the entire system. In early January, the government unveiled an anti-crisis program that incorporates measures to support bank recapitalization through the budget and the National Welfare Fund (see the fiscal section, Box 7). For example, in December 2014, the CBR gave the medium-sized Trust bank the equivalent of US$1.9 billion to help it avoid insolvency. An additional US$538 million was given to FC Otkrytie, which had acquired Trust. Though these and other measures are giving banks some relief, they may also be heightening systemic risks because they mean that bank liabilities are increasing in relation to their liquid assets or the real earning potential of those assets (see Section 2.2).

1.4 Balance of Payments Deteriorates as Capital Flees

As imports tumbled, the current account surplus doubled from 1.6 percent of GDP in 2013 to 3.0 percent, but this could not outbalance massive net capital outflows. These reached US$130.5 billion (7 percent of GDP)—close to the net capital outflows of 8 percent of GDP in the crisis of 1998.

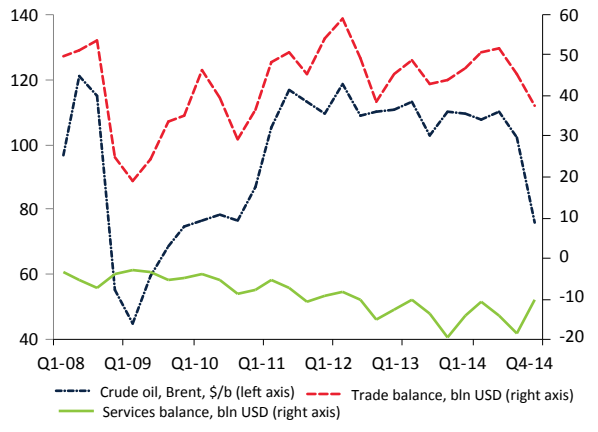
In the fourth quarter of 2014, Russia's balance of payments (BoP) suffered a severe terms-of-trade shock due to falling oil prices, which was accommodated by a significant drop in imports. The current account (CA) strengthened from US$34.1 billion in 2013 to US$56.7 billion in 2014 (Figure 20), with the non-oil CA deficit narrowing to US$265.5 billion (equivalent to 14.2 percent of GDP) compared to a deficit of US$316.1 billion (15.2 percent of GDP) in 2013 (Table 1.2). The CA surplus nearly doubled back to 2012 levels for the following reasons: despite a reduction of US$2.2 billion in the value of exports in the first three quarters, the trade balance remained positive (Figure 21). Import demand slackened as the economy grew more slowly and the ruble depreciated. The restrictions Russia imposed in August on the import of food products from a number of Western countries likely contributed to a decrease in imported goods of US$15.3 billion, year-on-year. Imports of services also fell, mainly because transport services declined. In the fourth quarter, falling oil prices produced a terms-of-trade shock but it was mostly absorbed by a drop in imports. In the fourth quarter of 2014, oil and gas export proceeds dropped by

Figure 20: Current account balance, percent of GDP



Source: CBR and World Bank staff estimates.

Figure 21: Trade and services balances and oil prices



Source: CBR, Bloomberg and World Bank staff estimates.

US$25.1 billion (27.3 percent, year-on-year) while imports dropped by US$24.3 billion (19.3 percent, year-on-year).

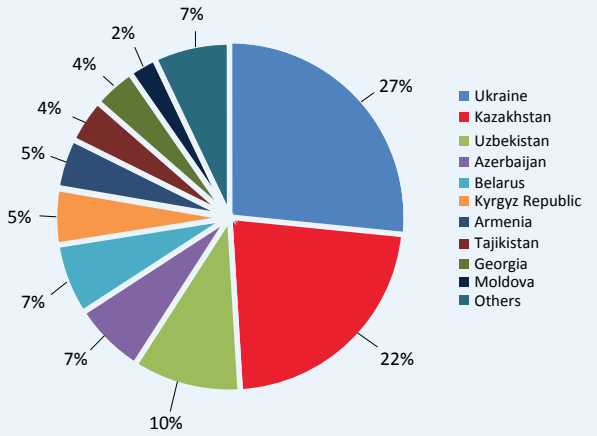
A second factor that helped to increase the CA balance was the increase in the investment income balance, especially in the second half of 2014, when external liabilities decreased due to the lack of opportunities for Russian banks and companies to roll over debt, given their restricted access to international markets. However, the steep ruble depreciation in 2014, which pushed the real effective exchange rate (REER) down by 8.1 percent, did not help to promote non-oil exports, which dropped by 1.5 percent in nominal terms. The CA was also supported by the improved balance of employee compensation as the depreciation caused outward remittances to plunge at the end of 2014 (Box 6).

The real crisis for the BoP in 2014 was the massive capital outflow caused mainly by the geopolitical uncertainties and related sanctions. Russia's capital and financial accounts balance quadrupled to a deficit of US$146.6 billion (7.8 percent of GDP) in 2014, compared to a deficit of US$45.4 billion (2.2 percent of GDP) in 2013. High geopolitical uncertainty and the second-round effect of the drop in oil prices led net capital outflows from the private sector to more than double, from US$60.7 billion in 2013 to US$130.5 billion (adjusted for currency swaps and correspondent accounts of resident banks in the CBR; Table 3).[6] For all of 2014, net purchases of foreign currency constituted 26.1 percent of net capital outflows and amounted to US$33.9 billion.[7] Massive capital outflows created pressure on the ruble and led to CBR interventions of US$86.5 billion in 2014, compared to US$21.8 billion in 2013 and to

Box 6 Migration and remittance trends

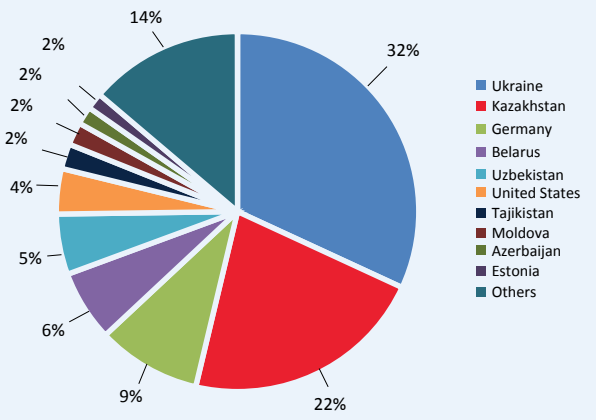
Russia is the second largest host of immigrants worldwide. In 2013, nearly half of the 11 million immigrants in Russia came from Ukraine (2.9 million) and Kazakhstan (2.5 million). Other major countries of origin were Azerbaijan (0.7 million), Belarus (0.7 million), the Kyrgyz Republic (0.6 million), Armenia (0.5 million), Tajikistan (0.5 million), and Georgia (0.4 million) (Figure 22). Of the 10.8 million Russians living abroad, most were in Ukraine (3.5 million) and Kazakhstan (2.4 million), followed by Germany (1 million), Belarus (0.7 million), Uzbekistan (0.6 million), and the U.S.(0.4 million) (Figure 23). After the U.S. (46 million), Russia hosts the second largest number of migrants worldwide (11 million), followed by Germany (10 million) and Saudi Arabia (9 million). However, this number fell from 11.9 million in 2000 to 11.0 million in 2013; the number of Russians living abroad held steady at about 10.8 million.

Figure 22: Top 10 countries sending workers to Russia, 2013



Source: UN population division.

Figure 23: Top 10 countries to which Russians migrate, 2013



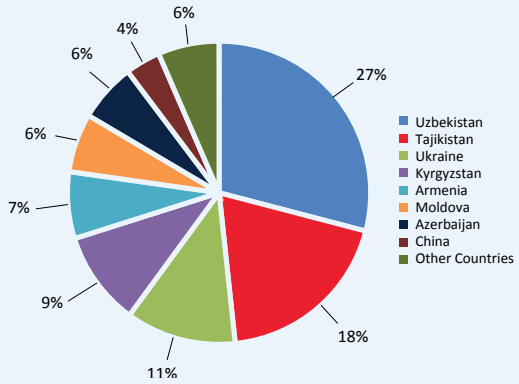
Source: UN population division.

[6] Net capital outflows had several components: private firms and banks increasing their net asset positions abroad, net purchases of foreign currency by private companies and households, and FDI. In addition, the restricted access to capital markets resulted in firms and banks deleveraging their external debt, paying it rather than rolling it over. FDI flows are a small part of capital outflows and include in part repatriated offshore money from Russian firms.

[7] In 2013 there had been US$0.3 billion in net sales of foreign currency.

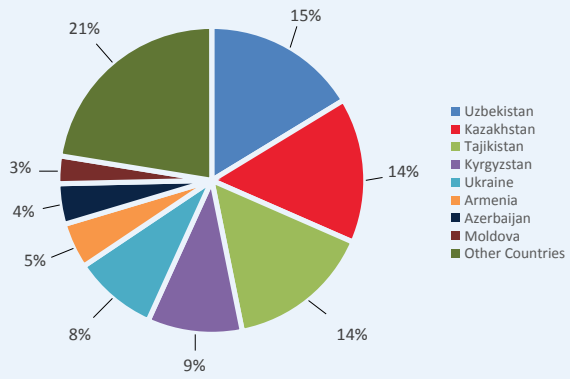
Outward remittances in 2014 were impacted by the ruble depreciation. Of a total of US$20.2 billion remittances from Russia, more than 88 percent went to: Uzbekistan (US$5.6 billion), Tajikistan (US$3.7 billion), Ukraine (US$2.2 billion), Kyrgyzstan (US$1.9 billion), and Armenia (US$1.2 billion) (Figure 24). Remittances to these countries have been going up steadily since 2009 and most noticeably in 2009-13. However, in 2014, the currency depreciation meant that the value of remittances to these countries was 14 percent less than in 2013. The cost for sending remittances from Russia (2.4 percent) is the lowest among all G20 countries—only a third of the G20 average (8.1 percent).[1] Remittance inflows into Russia (US$4.2 billion) are about a fifth of outflows. Some 43 percent of all remittance inflows come from three countries: Uzbekistan, Kazakhstan, and Tajikistan (US$0.6 billion each) (Figure 25). Inflows to Russia have been growing in recent years.

Figure 24: Remittance outflows, 2014



Source: Central Bank of Russia.
[1]Cost of sending US$200 / local currency equivalent.

Figure 25: Remittance inflows, 2014

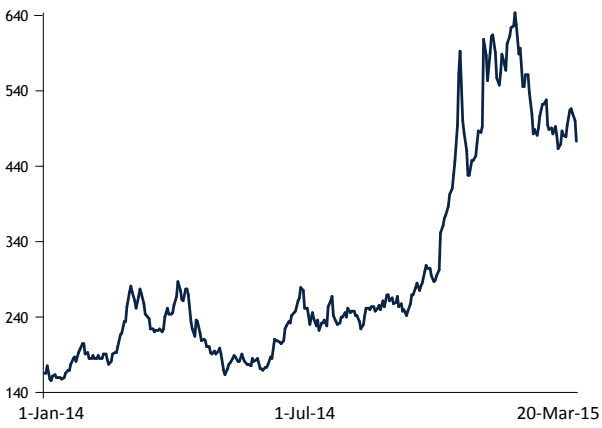


Source: Central Bank of Russia.

the US$155.3 billion of international reserves spent during the 2008-2009 crisis. At the end of 2014, the ratio of international reserves to months of imports remained at a comfortable 10.7 months. However, if the National Welfare Fund and Reserve Fund are subtracted, this ratio falls to 6.1 months of imports.

External borrowing had virtually vanished by the end of 2014 as the cost of borrowing skyrocketed due to sinking oil prices and sanctions restricting access to international financial markets. Sanctions that targeted big state companies and banks, introduced in July, together with heightened geopolitical risk, limited external borrowing for Russians in the third quarter of 2014. As of October 1, 2014 external debt[8] was down to US$524.7 billion, from US$539.9 billion on July 1, 2014 (Table 4). In the fourth quarter, as oil prices continued to slip, for all Russian firms and banks the cost of external borrowing soared to a prohibitive level, in essence closing most external financing options. The rollover ratio fell from 100 percent in the first half of 2014 to 62 percent in the third quarter. Early in January 2015, Fitch downgraded Russia's sovereign debt rating to one notch above noninvestment; later in January and February, S&P and Moody's both downgraded Russia's sovereign rating to below investment grade. The increased risk is reflected in Russia's CDS spreads on 5-year bonds, which reached close to 600 basis points in February 2015, compared to 160 basis points a year previously (Figure 26).

Figure 26: Russia CDS spreads for 5-year bonds, basis points



Source: Bloomberg.

[8] Debt to nonresidents in foreign currency.

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

	2008	2009	2010	2011	2012	2013	2014	Q1 2014	Q2 2014	Q3 2014	Q4 2014
Current account balance	103.9	50.4	67.5	97.3	71.3	34.1	56.7	26.8	12.9	6.4	10.5
Trade balance	177.6	113.2	147.0	196.9	191.7	181.9	185.6	50.9	51.9	45.4	37.5
Non-oil current account balance	-206.2	-140.3	-186.6	-244.5	-275.5	-316.1	-265.5	-57.3	-76.3	-75.6	-56.3
Capital and financial account	-139.8	-40.6	-21.6	-76.0	-30.9	-45.4	-146.6	-64.0	-16.5	-7.8	-58.2
Errors and omissions	-3.1	-6.4	-9.1	-8.7	-10.4	-10.8	3.4	-3.3	6.8	3.0	-3.1
Change in reserves (- = increase)	38.9	-3.4	-36.8	-12.6	-30.0	22.1	86.5	40.5	-3.2	-1.6	50.8
Memo: average oil price (Brent, US$/barrel)	96.9	61.5	79.7	111.1	112.0	108.9	98.8	107.9	109.8	102.1	76.0

*Source: CBR.Note: *Preliminary estimates.*

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

	2008	2009	2010	2011	2012	2013	2014	Q1 2014	Q2 2014	Q3 2014	Q4 2014
Total net capital inflows to the private sector	-133.6	-57.5	-30.8	-81.4	-53.9	-61.0	-130.5	-61.7	-8.9	-0.4	-59.5
Net capital inflows to the banking sector	-55.2	-32.2	15.9	-23.9	18.5	-7.5	-28.8	-34.3	-2.2	25.0	-17.3
Net capital inflows to the non-banking sector	-78.3	-25.3	-46.7	-57.4	-72.4	-53.5	-101.7	-27.4	-6.7	-25.4	-42.2

*Source: CBR. Note: *Preliminary estimates.*

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

	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
Total debt	538.9	557.5	570.6	598.9	636.4	691.7	707.8	716.3	728.9	715.8	732.4	679.4	599.5
Corporate	492.6	509.1	517.1	538.8	566.4	614.6	632.9	636.0	651.2	646.9	650.2	614.5	547.6
Banks	162.8	169.2	175.4	189.9	201.6	205.9	211.9	207.1	214.4	211.9	208.8	192.1	171.1
of which Private Banks	89.5	90.6	78.7	84.1	86.2	81.1	82.4	79.4	81.4	76.3	74.9	68.9	
Non-financial corporations	329.8	339.8	341.7	348.9	364.8	408.8	420.9	428.9	436.8	432.8	450.6	422.4	376.5
of which Private Non-fin. Corporations	227.8	236.0	234.2	237.7	251.3	255.5	259.5	265.3	271.6	263.9	279.7	259.3	

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

1.5 The Government Budget - The Calm before the Storm?

The federal fiscal balance continued to register a deficit of 0.5 percent, but the non-oil deficit went up to 11 percent of GDP. Compared to 2013, subnational debt rose by 0.8 percent of GDP, to 3.4 percent. Many of Russia's fiscal buffers are committed to supporting investment demand and ensuring financial stability.

The Ministry of Finance estimates that the 2014 federal budget was executed at a deficit of 0.5 percent of GDP, the same as in 2013. The June 2014 budget revision projected a slight surplus, but that turned to a deficit with the issuance of Treasury bonds in the amount of RUB1 trillion (1.4 percent of GDP) on December 30, 2014, to recapitalize the Russian banking system (Table 5). As a result of the bond issue and transfer of the bonds to the Deposit Insurance Agency, spending in the budget category of support to the national economy went up by 1.5 percent of GDP. Together with spending on defense that was higher by 0.2 percent of GDP and higher federal transfers of 0.1 percent of GDP, federal spending rose by 0.7 percent to 20.9 percent of GDP. Federal budget spending year-on-year went down by 1.0 percent of GDP for social policy and 0.1 percent each for education, health, and housing and utilities. Government revenue rose to 20.4 percent of GDP from 19.7 percent in 2013 as oil revenues grew from 9.9 percent of GDP to 10.5 percent of GDP due to the ruble depreciation. Federal non-oil revenue saw a moderate increase of 0.1 percent of GDP from 2013 to 9.9 percent in 2014 due to higher VAT proceeds. However, import tariffs fell by 3 percent in nominal terms as imports fell steeply. The federal non-oil deficit reached 11.0 percent of GDP, up by 0.6 percent of GDP since 2013.

The consolidated budget deficit was 1.2 percent of GDP in 2014, compared to a 1.3 percent deficit in 2013. The budget saw a large drop in the revenues and spending of federal extra-budgetary funds (EBFs).For the first time, consolidated federal EBFs were executed at a small deficit (less than 0.1 percent of GDP), driven by a decrease in federal transfers by 1.0 percent of GDP compared to 2013 (Table 6). Simultaneously there were significant cuts in Pension Fund spending on social benefits (by RUB370 billion) and other social policy items (by RUB420 billion). Year-on-year, however, consolidated budget revenue and spending did not change much. That was also true of subnational budgets. However, subnational debt rose from 2.6 percent of GDP in 2013 to 3.4 percent because of the higher borrowing costs seen across the economy that are making debt rollover more expensive. The heavy dependence of federal EBFs, especially the Pension Fund, on federal transfers and the rising indebtedness of subnational entities are becoming worrisome fiscal risks.

Table 5: Federal budget 2012-2014, percent of GDP

	2012	2013	2014	2014	2014
	Execution	Execution	Budget Law	2014 June Amendment	Execution
Expenditures	20.6	20.2	19.0	19.5	20.9
Revenues	20.5	19.7	18.5	19.9	20.4
Balance	-0.1	-0.5	-0.5	0.4	-0.5
Oil revenues	10.3	9.9	8.9	10.5	10.5
Non-oil balance	-10.4	-10.4	-9.4	-10.1	-11.0
Urals oil price, US$/barrel	110.4	107.9	101.0	97.0	97.6

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

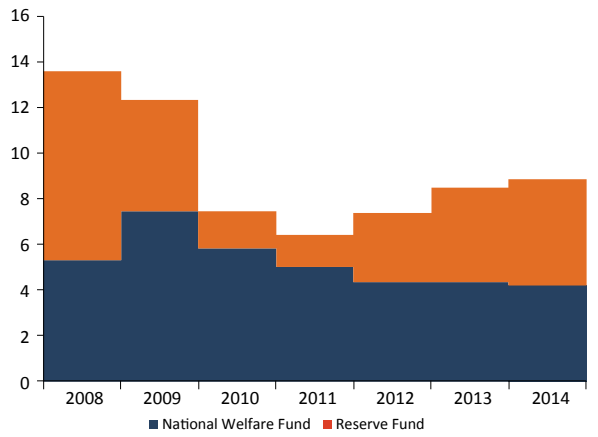
Table 6: Consolidated budget, consolidated subnational budget, consolidated federal EBFs, 2011-2014, percent of GDP

	2011 Execution	2012 Execution	2013 Execution	2014 Execution
Consolidated Budget				
Expenditures	35.9	36.6	38.2	38.3
Revenues	37.5	37.0	36.9	37.2
Balance	1.6	0.4	-1.3	-1.2
Consolidated Subnational Budget				
Expenditures	13.8	13.3	13.3	13.2
Revenues	13.7	12.9	12.3	12.5
Balance	-0.1	-0.4	-1.0	-0.6
Subnational Debt	2.1	2.1	2.6	3.4
Consolidated Federal EBFs*				
Expenditures	9.6	11.1	12.1	10.7
Revenues	10.4	12.0	12.2	10.7
Balance	0.8	0.9	0.1	0.0

Source: Ministry of Finance, World Bank staff calculations.
*Note: *Main federal EBFs are the Pension Fund, the Social Security Fund, and the Mandatory Medical Insurance Fund.*

Russia's main fiscal buffer, the Reserve Fund, was replenished during 2014. In August, US$6 billion was deposited in the Reserve Fund, bringing the total to US$87.9 billion (4.7 percent of GDP) by the end of 2014, compared to US$87.4 billion (4.2 percent) last year (Figure 27). The replenishment represented oil revenue accrued to the federal budget in 2013 that was more than originally budgeted.

Figure 27: Reserve fund and National Welfare Fund, percent of GDP



Source: Ministry of Finance, World Bank staff calculations.

The second buffer, the National Welfare Fund (NWF) was increasingly committed to boosting investment demand. The NWF was down to US$78 billion by the end of 2014 (4.2 percent of GDP) compared to US$88.6 billion (4.3 percent) at the end of 2013. However, in ruble terms, it went up to RUB4,338 billion, having gained about RUB1,500 billion from the depreciation. In June, the government changed the NWF investment rules, raising the limit on resources that could be used to finance domestic infrastructure projects to 60 percent; previously no more than 40 percent (not to exceed RUB1.16 trillion) could be invested in debt securities and stocks of Russian companies to finance infrastructure projects approved by the government. After June, an additional 10 percent (not to exceed RUB290 billion) was released for purchase of debt securities and stock of companies implementing projects in which the Russian Direct Investment Fund (RDIF) is participating.[9] Another 10 percent (not to exceed RUB290 billion) could be used to purchase debt securities and stock of companies

[9] The RDIF was established in June 2011 on the initiative of the President and Prime Minister to attract foreign investment into leading sectors of the Russian economy.

implementing projects in cooperation with state corporation Rosatom.[10] The government also approved for financing a long list of projects amounting to about RUB900 billion, including a new Central Ring Road in Moscow, upgrades to the Trans-Siberian and Baikal-Amursk railways, and other projects to improve energy efficiency and Internet connectivity. Yet by the end of 2014 only RUB5.13 billion (US$80 million) had been invested in bonds of Russian companies cooperating with the RDIF on IT projects and improving Internet connectivity. The likely reason is that those projects are required to mobilize 60 percent in co-financing from sources other than the NWF, which in the current high-interest rate environment is difficult.

Box 7 The government anti-crisis plan

On January 27, 2014, the government adopted an anti-crisis plan with the goal to ensure sustainable economic development and social stability in an unfavorable global economic and political environment. It announced that in 2015–2016 it will take steps to advance structural changes in the Russian economy, provide support to systemic entities and the labor market, lower inflation, and help vulnerable households adjust to price increases. To achieve the objectives of positive growth and sustainable medium-term macroeconomic development the following measures are planned:

- Provide support for import substitution and non-mineral exports;
- Support small and medium enterprises by lowering financing and administrative costs;
- Create opportunities for raising financial resources at reasonable cost in key economic sectors;
- Compensate vulnerable households (e.g., pensioners) for the costs of inflation;
- Cushion the impact on the labor market (e.g. provide training and increase public works);
- Optimize budget expenditures; and
- Enhance banking sector stability and create a mechanism for reorganizing systemic companies.

The government aims to achieve a balanced budget in the medium term and intends to cut budget expenditures by 5 percent in real terms in the next three years. In 2015, the plan is to cut 10 percent of spending across all categories except military, agriculture, and external debt-servicing. The Ministry of Finance currently plans to use the Reserve Fund to optimize federal budget spending. It is expected that about RUB1.4 trillion of the anti-crisis plan will be financed this year, of which up to RUB972 billion will be financed from the federal budget and RUB550 billion with the NWF.

It is estimated that the plan will cost RUB2.4 trillion, of which 67 percent is earmarked for bank recapitalization, which will operate through three channels: (i) Treasury bonds worth RUB1 trillion had already been transferred to the Deposit Insurance Agency in December 2014. In February the government approved a list of 27 banks eligible for recapitalization. Banks to be recapitalized are expected to increase mortgage loans, loans to small and medium enterprises, and loans to key economy sectors by 1 percent a month and increase their own capital by at least half of the amount received from the Deposit Insurance Agency; (ii) The NWF will finance a second channel, investing RUB250 billion in subordinated deposits and bonds of the systemic banks that have capital of RUB100 billion (US$1.6 billion). The interest rate should at least cover the CPI inflation rate. On October 1, 2014, nine banks met the criteria. Banks that receive these deposits are expected to finance government-approved investment projects; and (iii) Another RUB300 billion will be channeled through the NWF to Vnesheconom bank to provide credit to the real sector.

About 13.9 percent of the anti-crisis plan (RUB320 billion) will go to direct support of the real sector: RUB200 billion in state guarantees for systemic companies, RUB50 billion for support of agricultural enterprises, and RUB10 billion for the transport utilization program. The government has approved a list of 199 systemic enterprises eligible for state guarantees, among them all major Russian companies. Companies on the list produce 70 percent of GDP of Russia. These steps mainly address the development of sustainable enterprises given lower domestic demand, an unfavorable global environment, and high credit costs. Some administrative measures are expected to smooth state procurement, which was hit by the exchange rate crisis.

Another 12.9 percent (RUB296 billion) is earmarked for social support, including pension indexation higher than the federal budget law envisaged, RUB52.2 billion for easing the labor market, RUB30 billion for payments for registered unemployed, and RUB16 billion for additional medical support.

About 7.0 percent (RUB160 billion) will be transferred to the regions through budget loans.

[10] Rosatom is the state corporation established to develop a variety of civil and military nuclear energy projects, including production, research, design and construction of power stations, and uranium enrichment.

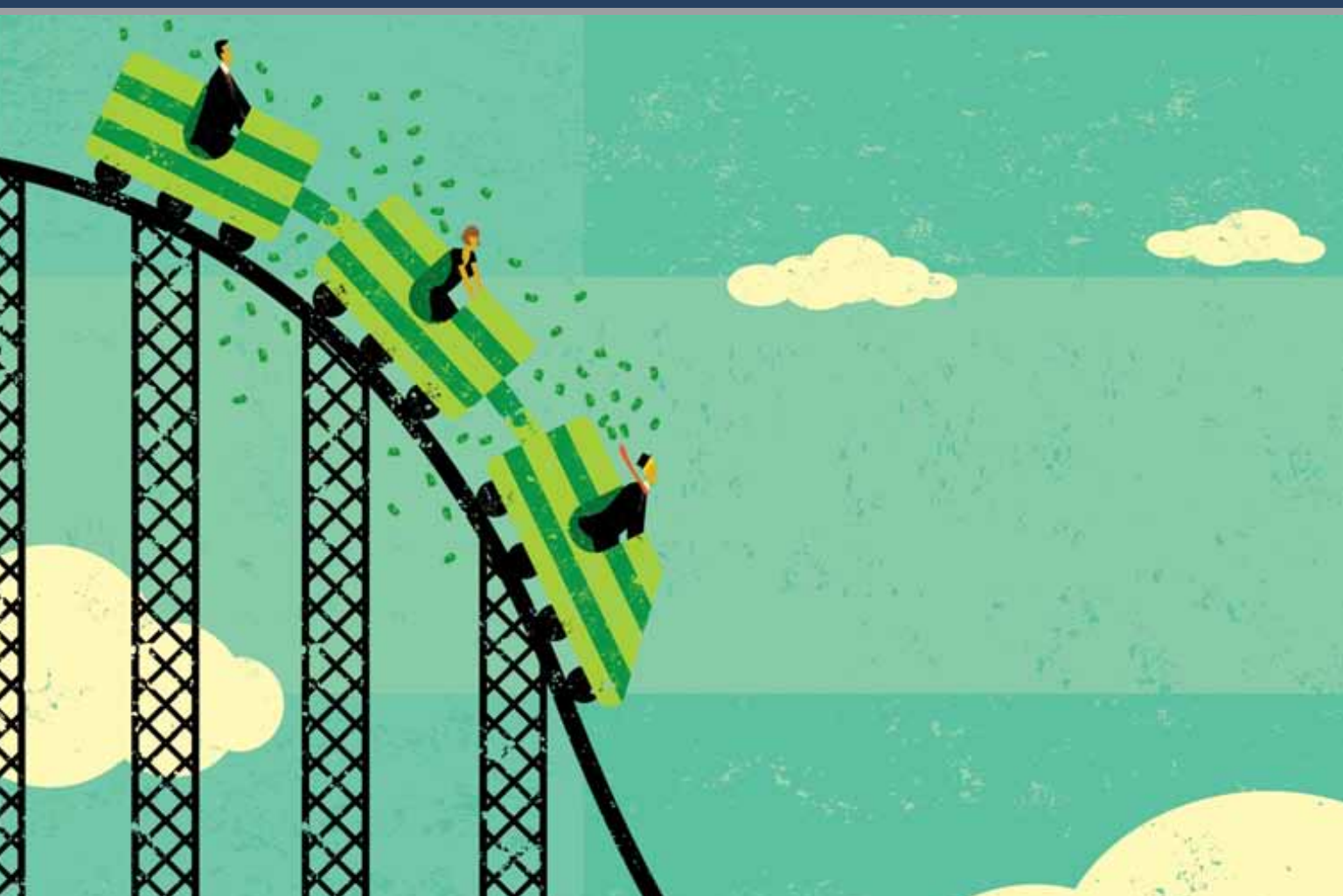
As sanctions were imposed, the government allowed further discretionary use of NWF resources, this time to help stabilize the financial system. In December, to recapitalize them and to heighten the stability of the financial system, the government allowed the NWF to invest in the stocks of Vneshtorgbank (VTB),[11] Rosselkhozbank,[12] and Gazprombank[13] to a ceiling of RUB279 billion. That month the government also allowed the NWF to invest up to 10 percent of its resources in subordinated bank deposits for financing government-approved real sector projects. With this, the upper limit of NWF ruble investments reached about 50 percent. In December RUB100 billion had already been deposited with VTB in 30-year accounts at an interest rate exceeding the inflation rate by 1 percentage point; the goal was recapitalization and lending to government-approved investment projects. In January, the government announced an anti-crisis plan that also envisions some financing from the NWF (Box 7).

[11] Venshtorgbank is a state-owned bank which works primary with corporate clients.
[12] Rosselkhozbank is a state owned bank which was created to service agricultural companies.
[13] Gazprombank is the third largest Russian bank (with over fifty percent state-ownership) which services corporate clients and households.

PART II

ECONOMIC OUTLOOK

Russia's medium-term growth prospects are threatened by the recent slide in oil prices and the continued impact of sanctions. The World Bank growth outlook for Russia projects that in 2015 these two shocks will push the economy into recession. The baseline scenario sees contractions over the next two years of 3.8 percent in 2015 and 0.3 percent in 2016. There are upside and downside risks to the oil price projections as the global oil market continues searching for a new equilibrium price. To account for this risk, the World Bank Russia outlook has two alternative scenarios for Russia straddling the baseline scenario, one reflecting an upper-bound oil price and the second a lower-bound price. In the medium term, the economy will need to adjust to both the new oil prices and continued uncertainty related to geopolitical tensions and sanctions. Both new realities have the potential to alter the structure of the Russian economy and the ways Russia integrates with the rest of the world.



2.1 Outlook for Russia – Protracted Recession

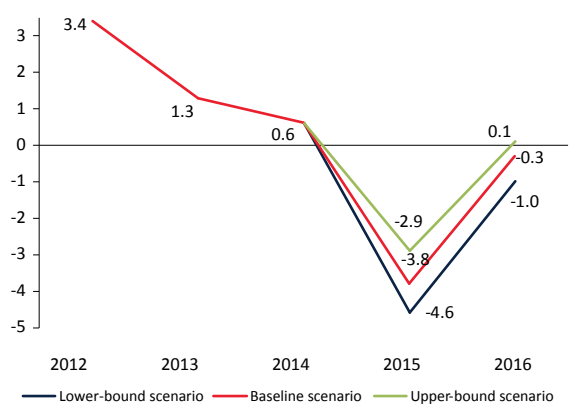
The World Bank has set out three scenarios: the baseline, an upper-bound oil price scenario and a lower-bound oil price scenario. The baseline projects recession, given the most likely oil price prospects and the assumption that economic sanctions will be in effect throughout 2015 and 2016.

Medium-term growth prospects for Russia are dim. The World Bank growth outlook projects that the continued impact of sanctions and lower oil prices will push the Russian economy into a protracted recession. With continuing low oil prices at an average US$53 per barrel in the baseline scenario, the economy is projected to contract by 3.8 percent in 2015, pushing real GDP down below what it was in 2012 (Figure 28 and Figure 29). With oil prices expected to recover only marginally, to US$57 per barrel, in 2016, growth is likely to continue to be below zero. The two alternative scenarios presented in the growth spectrum largely reflect differences in how oil prices are expected to affect the main macro variables.

The assumptions underlying the outlook have changed since previous growth forecasts. The steep drop in oil prices and the negative effect of sanctions in the second half of 2014 have already impacted the Russian economy. Not only did abrupt devaluation and high inflation erode real incomes much faster than anticipated, but credit costs have become prohibitively high for both consumers and investors. Continued geopolitical tensions led to the revised assumption that sanctions will carry over through 2016. This is likely to keep external borrowing costs high and access to international capital markets limited, so that investment demand would continue to be depressed. Those factors, which are undermining Russia's medium-term growth prospects, require that the economy adjust not only to new oil prices but to a fundamentally altered economic environment.

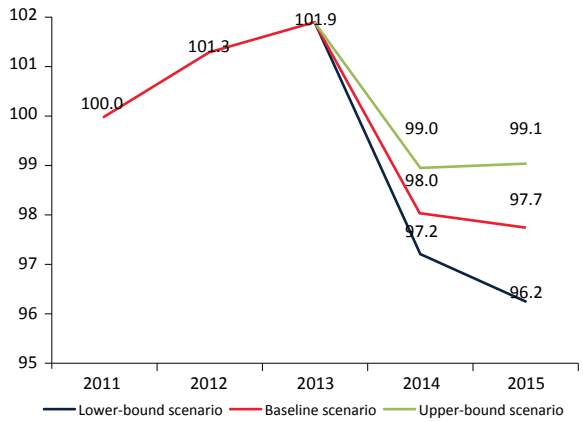
Russia's medium-term growth outlook again depends heavily on the trajectory of oil prices. The World Bank oil price assumptions have changed significantly; the September projections assumed stable oil prices of about US$100 per barrel in both 2015 and 2016. The new baseline parameters reflect revised World Bank global growth and oil price projections (Box 8). The average oil price now projected for 2015 is US$53

Figure 28: Real GDP growth, y-o-y, percent



Source: World Bank staff estimates.

Figure 29: Real GDP, percent, 2012=100



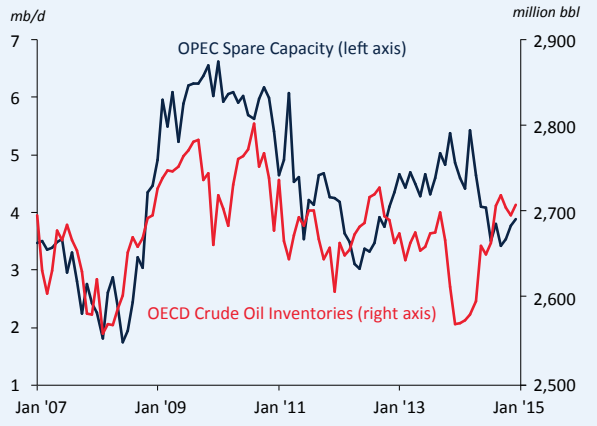
Source: World Bank staff estimates.

Box 8 Oil price outlook

With supplies surging and demand diminishing, oil inventories have been building up. OECD stocks recovered to about 2.7 billion barrels at yearend 2014 and now exceed their 5-year average. The build-up in stocks was nearly continuous after they reached 9-year lows in 2013. Inversely, OPEC's spare production capacity eased back to 3.7 million barrels per day in the fourth quarter of 2014 on increased output, after peaking at almost 5 million barrels per day at the end of 2013 (Figure 30).

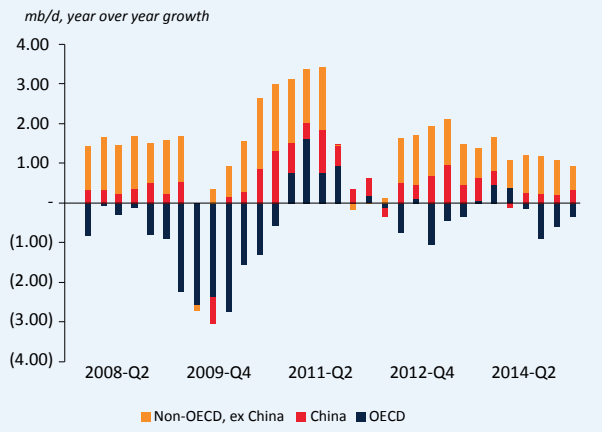
The World Bank projects that oil prices will average US$53 per barrel in 2015, 45 percent less than in 2014. It is assumed that OPEC will abstain from any form of supply management and that there will be no deterioration in the global economic environment. This forecast reflects the shift in OPEC policy, easing of geopolitical tensions, ample supplies, and moderating demand (Figure 31). The production capacity already in place suggests that low prices will continue for some time, with prices expected to recover only modestly, by US$4 a barrel, in 2016. The weakness in crude oil prices will extend to other energy markets, especially European and Asian markets for natural gas. In 2015 prices for European natural gas are expected to decline by 15 percent.

Figure 30: Global oil spare capacity and inventories



Source: International Energy Agency.

Figure 31: Growth in global oil demand



Source: World Bank and International Energy Agency.

per barrel and for 2016 US$57. At present, the oil market is searching for a new equilibrium price as OPEC and non-OPEC producers compete for market share—especially since OPEC's November decision not to cut production—so there are both upside and downside risks to this projection. That is why there are two alternative scenarios: the lower-bound scenario assumes average oil prices of US$45 per barrel in 2015 and US$50 in 2016, the upper-bound US$65 in 2015 and US$69 in 2016. Not anticipated are shifts in government policy over the projection period that could significantly affect how changes in oil prices are transmitted to the economy. The projections also assume that the government will follow its new anti-crisis plan no matter what the oil price may be in 2015.

The second core assumption of the new forecast relates to the impact and duration of economic sanctions. Previous baseline forecasts assumed that the impact would be limited to 2015 and that 2016 would see geopolitical tensions resolved and sanctions terminated. The current forecast assumes that economic sanctions will be in effect throughout 2015 and 2016. The inference is that the access of major Russian state-owned banks and corporations to external funding will stay restricted, limiting their ability to roll over debt and thus impacting the capital account and investment in both years. Nevertheless, the assumption is that geopolitical tensions will gradually subside toward the end of the projection period, making new economic sanctions less likely. The assumed

effect of sanctions is similar in all three scenarios. Uncertainty about their protracted impact will continue to depress business and consumer sentiments in both years, postponing recovery in domestic demand.

Baseline Scenario

The World Bank baseline scenario for Russia projects contractions of 3.8 percent in 2015 and a minimal 0.3 percent in 2016. Consumer demand would be undermined by deteriorated confidence, still-high household debt, and slowing growth in incomes. The recent steep devaluation of the ruble is expected to bring about much higher inflation than initially anticipated, which will further depress incomes and wages. Since the government has cancelled a planned indexation of public wages, growth in public wages will be negative. Unemployment would grow moderately to an average of 6.5 percent for this year; the labor market will adjust mainly through wage cuts. With average inflation for 2015 assumed to be 16.5 percent, credit costs are likely to stay high, causing consumer credit activity to stagnate.

Consumption is projected to contract by 5.3 percent in 2015 after a negligible expansion in 2014 (Table 7). In 2016 a negative carry-over effect of the 2015 recession, a slow recovery in credit activities, and stagnating incomes would lead consumption to contract further by 1.9 percent. In 2015, the government is scaling down and delaying some large infrastructure projects due to revenue shortfalls, price pressures, and the high cost of borrowing. It is expected that private investors are also cutting back on investment programs as restricted access to external funding and increased credit costs put pressure on profit margins. Policy uncertainty and geopolitical tensions will continue to weigh on business sentiments and investment activities.

It is projected that investment demand will continue to be deeply depressed in 2015, with an estimated decline in gross capital formation of 15.3 percent. In 2016, with external and credit conditions somewhat improved, investment would see a marginal recovery. The weaker ruble could create incentives for small-scale expansions in some tradable industries, financed by profits. However, with imported investment goods and credit much more expensive, such natural substitution would be realized primarily through better utilization of capacity. Thus its potential effect is likely to be limited.

Low oil prices and sanctions will continue to exert moderate pressure on the external accounts. Projections of external demand for

Table 7: Economic indicators for the baseline scenario

	2012	2013	2014	2015	2016
Oil price (US$ per barrel, WB average)	105.0	104.0	97.6	53.2	56.9
GDP growth, percent	3.4	1.3	0.6	-3.8	-0.3
Consumption growth, percent	6.4	3.9	1.5	-5.3	-1.9
Gross capital formation growth, percent	3.0	-6.6	-5.7	-15.3	1.1
General government balance, percent of GDP	0.4	-1.3	-1.2	-3.6	-3.1
Current account (US$ billions)	71.3	34.1	56.7	73.7	62.9
Percent of GDP	3.6	1.6	3.0	6.0	4.4
Capital and financial account (US$ billions)	-32.3	-56.2	-143.2	-122.1	-60.0
Percent of GDP	-1.6	-3.0	-7.7	-10.0	-4.2
CPI inflation (average)	5.1	6.8	7.7	16.5	8.0

Source: Rosstat, Ministry of Finance, CBR, and World Bank staff estimates.

Russia's exports are aligned with the recent World Bank global outlook (Box 9). Though exports will drop further due to low demand and low oil and commodity prices, the resultant pressure on the current account will be more than offset by an expected sharp contraction of imports caused by the weaker ruble and depressed domestic demand. Thus, the 2015 current account balance will rise to US$73.7 billion, 6.0 percent of GDP (Table 7). Economic sanctions will continue to limit both access to external funding for major Russian banks and corporations and their rollover capacity. However, since in 2015 the debt payment profile is easier than it was in 2014, and devaluation expectations are subsiding, pressure on the capital account is expected to moderate: The capital account deficit will drop from US$143 billion in 2014 to US$122.1 billion in 2015. Exchange rate volatility will abate as the geopolitical environment and oil prices begin to stabilize so that the CBR will not have to intervene.

The baseline scenario makes the following monetary and fiscal policy assumption: The CBR will continue inflation targeting, although political pressure might materialize to relax monetary conditions sooner to support growth. The CBR is also likely to continue lowering its policy rates from the current 14 percent. The scenario assumes, however, that inflationary expectations will stay high through the first half of 2015 and projects that CPI inflation will average 16.5 percent in 2015 (Table 7). With the ruble stabilizing, in 2016 inflationary expectations will subside further,so the 2016 CPI average is estimated at 8.0 percent. The fiscal projections, based on 2015-2017 budget proposals, are summarized in Box 10. Low oil prices and an eroded non-oil tax base are expected to put

Box 9 Global outlook

Global growth is expected to rise moderately in 2015 (Table 8). At present, recovery is relying heavily on robust growth in the U.S.: above-trend growth (with job creation)is expected to carry over into 2015 and to outpace global growth for the first time since 1999. In the Euro area, conditions are in place for improvement in the first quarter of 2015 despite rising uncertainty about the Greek bailout plan and unresolved tensions related to Russia. High-income countries are likely to see growth slightly up from the 1.7 percent posted in 2014 as labor markets gradually recover, fiscal consolidation ebbs, and financing costs stay low. Meanwhile, activity indicators in China continue to signal a gradual deceleration. As the domestic headwinds that held back growth in developing countries in 2014 abate and recovery in high-income countries slowly firms up, growth is projected to gradually accelerate.

Table 8: Global GDP growth, percent

	2009	2010	2011	2012	2013	2014e	2015f	2016f	2017f
World	-1.8	4.3	3.1	2.4	2.5	2.6	2.9	3.2	3.2
High-income countries	-3.6	3	1.9	1.4	1.4	1.7	2.1	2.4	2.2
Developing countries	3.0	7.8	6.3	4.7	5.0	4.5	4.5	5.1	5.3
Euro area	-4.5	2	1.7	-0.7	-0.4	0.9	1.4	1.7	1.6
Russia	-7.8	4.5	4.3	3.4	1.3	0.6	-3.8	-0.3	2.2

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

Global activity over the medium term should be supported by declining oil prices, but the positive effect will be offset in 2015 by tough adjustments in oil-exporting economies (e.g., Russia and Venezuela) and persistent headwinds among larger net importers, such as the Euro area and Japan. Overall, lower oil prices mean that prospects for oil-exporting and oil-importing countries will diverge. Empirical estimates suggest that growth in some oil-exporting countries could contract by 0.8–2.5 percentage points in the year after a 10 percent decline in the annual average oil price. The slowdown would compound revenue losses in these countries as fiscal break-even prices exceed current oil prices for most oil exporters. However, such fiscal pressures can partly be mitigated by sovereign wealth funds or reserves. In Brazil, Indonesia, South Africa, and Turkey, falling oil prices will help suppress inflation and reduce current account deficits—a major source of vulnerability for many emerging economies. Growth in low-income countries is expected to stay strong, but the moderation in oil and other commodity prices will hold back growth in those low-income countries that export commodities.

heavy pressure on the fiscal accounts. Despite the positive effect of depreciation, revenues are projected to be severely compressed due to lower oil export receipts, reduced import duties, and the contraction in GDP. Because the 5 percent projected decline in real government spending will not be enough to compensate for the revenue shortfall, additional domestic borrowing or drawdowns from the Reserve Fund will be necessary. Parliamentary elections in 2016 are likely to induce increased spending, especially by indexing public wages and pensions. The government deficit is therefore projected to go up from 1.2 percent of GDP in 2014 to 3.6 percent in 2015 and 3.1 percent in 2016.

Alternative Upper-bound Oil Price Scenario

The upper-bound oil price scenario projects a contraction in real GDP of 2.9 percent in 2015 followed by recovery to 0.1 percent growth in 2016. Better growth outcomes than in the baseline are largely explained by higher oil prices and their spillover effect onto other economic activity. For 2015 the oil price is projected at US$65 a barrel and for 2016 at US$69. External conditions and the impact of sanctions would be similar to the baseline. As oil prices adjust upward over the year, the ruble is expected to strengthen, which would lessen inflation expectations and the pass-through effect on inflation. Consumer price inflation would average 14 percent in 2015—2.5 percentage points lower than in the

Box 10 The 2015-2017 budget projections

The amendments to the budget law apply to 2015, with the Ministry of Finance planning to introduce changes related to 2016 and 2017 by September 2015. This temporary lack of medium- term perspective leaves all budget entities deeply uncertain. It is however, similar to what happened during the 2008–2009 crisis when there was no medium-term budget projection in 2009. The new macroeconomic assumptions for the 2015 amendments to the federal budget law project an average oil price of US$50 per barrel (down from US$100 per barrel) and a GDP contraction of 3.0 percent.

In 2015, federal budget revenue is projected to decrease by 3.3 percent of GDP (13.5 percent in nominal terms) with oil and gas revenues falling by 12.1 percentage points (2.7 percent of GDP). The oil price used to calculate the oil extraction tax and customs duties, has a tax-exempted part (US$25 per barrel), and with oil prices low its share becomes proportionally higher. As for non-oil revenues, VAT is projected to decrease most, due to shrinking domestic demand and the REER depreciation.

Federal budget expenditures will decrease marginally, from 20.9 percent of GDP in 2014 to 20.8 percent in 2015. The main challenges for the spending side are the weaker ruble and high inflation, which put upward pressure on expenditures through indexed social payments and the cost of procuring imported goods. In 2015, government priorities favored social policy and national defense. In 2015, social policy expenditures will increase by 0.9 percent of GDP (a nominal 22.1 percent increase) with the majority of the increase devoted to pensions and social provisioning of households. National defense spending will increase by 0.7 percent of GDP (a nominal 25.7 percent increase) compared to 2014 as the government adheres to its long-term program of modernizing the army. Spending on the national economy is planned to decrease by 1.4 percent of GDP. Intergovernmental transfers will decrease by 0.3 percent of GDP, but this will be partly compensated by budget loans to the regions in the amount of RUB160 billion (0.2 percent of GDP). Expenditures for health will decrease by 0.2 percent of GDP and for education 0.1 percent.

T**he federal budget projects a deficit of 3.7 percent of GDP in 2015, compared to a 0.5 percent deficit in 2014.** The primary budget deficit will increase to 2.9 percent of GDP from the surplus of 0.1 percent in 2014. The non-oil deficit will reach 11.5 percent of GDP compared to the 10.9 deficit in 2014. With access to international financial markets restricted and credit costs high, the Reserve Fund will be the main source for deficit financing. By the end of the year, it is projected to decrease from RUB3.1 billion to RUB2.6 billion. The amendments suggest that an additional RUB 500 billion could be used for deficit financing in 2015—a possible downside risk. The anti-crisis plan will have limited effect on federal budget spending in 2015. Budget financing of RUB713.8 billion (1 percent of GDP) will be required in addition to RUB260 billion already earmarked in the anti-crisis fund in the law on federal budget. RUB230 billion will be recorded as below the line operations for state guarantees.

Government has reduced the number of projects it plans to finance with the NWF from 10 to 6: (i) the Central Ring Road in Moscow; (ii) upgrades to the Baikal-Amursk railway; (ii) the Hanhikivi nuclear station in Finland; (iv) improving Internet connectivity; (v) gas extraction infrastructure at the Yamal peninsula; and (vi) locomotives for the Russian Railway. Their total cost in 2015 is about RUB500 billion. In February 2015, the government placed RUB75 billion (US$1.16 billion) from the NWF in bonds of OAO Yamal SPG for financing gas extraction at the Yamal peninsula. The total of NWF resources placed into securities of companies conducting government-approved infrastructure projects reached RUB80 billion (US$1.3 billion).

baseline. This would improve the dynamics of real incomes and wages. In response to faster deceleration of inflation the CBR is likely to cut the policy rate more aggressively, which should support credit growth. As a result, in the upper-bound scenario, in 2016 consumption would contract by 3.0 percent, or 2.3 percentage points less than in the baseline, and recover faster in 2016 (Table 9). In 2015, gross capital formation would contract by 10.8 percent (15.3 in the baseline). A slow recovery in investment in 2016 would be compensated for by faster action on infrastructure projects by the government and companies in the oil sector. Investment demand would also benefit from lower interest rates and higher oil prices.

In the upper-bound scenario Russia's fiscal position will firm up and external balances will stay virtually the same as in the baseline. Higher oil prices and a larger non-oil tax base would bring in more revenue. No major changes in spending are expected in 2015 because the government would continue adjusting its fiscal policy to lower oil prices. The same 5 percent cut in real expenditures is assumed for 2015, but in 2016, with oil prices higher and parliamentary elections imminent, the government is likely to spend more. Large infrastructure projects are expected to accelerate relative to the baseline, which would increase the general government deficit to 2.8 percent of GDP in 2015 and 2.1 percent in 2016; it would largely be financed from the Reserve Fund and domestic borrowing. BoP outcomes for both 2015 and 2016 are similar to the baseline. Given the same effect as in the baseline of sanctions on bank and corporate capacity to roll over debt, the size of capital outflows and the impact on the capital account will be comparable. The current account is expected to be somewhat weaker than in the baseline in both 2015 and 2016 because higher imports will more than offset the positive impact of higher oil prices on trade balances.

Alternative Lower-bound Oil Price Scenario

The lower-bound oil price scenario projects a larger contraction of 4.6 percent in 2015, and in 2016 a second recession year with a 1 percent contraction. It assumes a further drop in oil prices, to an average of US$45 per barrel in 2015 and US$50 in 2016. A sharper contraction of both consumption and investment than in the baseline explains the difference in growth outcomes. First, the ruble would continue to depreciate moderately in response to lower oil prices. This would keep inflationary expectations higher than in the baseline, so the CBR is likely to keep monetary policy tight. Higher average inflation of 18.0 percent in 2015 and 9.0 percent in 2016 would depress real incomes more than

Table 9: Economic indicators for the upper-bound oil price scenario

	2012	2013	2014	2015	2016
Oil price (US$ per barrel, WB average)	105.0	104.0	97.6	65.5	68.7
GDP growth, percent	3.4	1.3	0.6	-2.9	0.1
Consumption growth, percent	7.0	3.5	0.9	-3.0	-0.6
Gross capital formation growth, percent	1.5	-5.6	-8.2	-10.8	1.8
General government balance, percent of GDP	0.4	-1.3	-1.2	-2.8	-2.1
Current account (US$ billions)	71.3	34.1	56.7	61.7	54.0
Percent of GDP	3.6	1.6	3.0	4.5	3.5
Capital and financial account (US$ billions)	-32.3	-62.2	-143.2	-105.5	-48.6
Percent of GDP	-1.6	-3.0	-7.6	-7.7	-3.1
CPI inflation (average)	5.1	6.8	7.7	14.0	7.0

Source: Rosstat, MinFin, CBR and World Bank staff estimates.

projected in the baseline, and higher interest rates would slow credit activities more. Together with higher unemployment these factors would cause consumption to contract by 6.6 percent in 2015 and 2.7 percent in 2016 (Table 10). In 2015 both private and public investment would contract more than in the baseline because of more expensive imported investment goods, higher credit costs, and lower consumer demand. Public and quasi-public infrastructure projects would be scaled down and delayed more than in the baseline, keeping investment demand depressed in 2016.

Table 10: Economic indicators for the lower-bound oil price scenario

	2012	2013	2014	2015	2016
Oil price (US$ per barrel, WB average)	105.0	104.0	97.6	45.0	50.0
GDP growth, percent	3.4	1.3	0.6	-4.6	-1.0
Consumption growth, percent	6.4	3.9	1.5	-6.6	-2.7
Gross capital formation growth, percent	3.0	-6.6	-5.7	-17.1	-0.4
General government balance, percent of GDP	0.4	-1.3	-1.2	-4.5	-2.6
Current account (US$ billions)	71.3	34.1	56.7	83.1	79.7
Percent of GDP	3.6	1.6	3.0	7.1	5.8
Capital and financial account (US$ billions)	-32.3	-62.2	-143.2	-130.2	-79.7
Percent of GDP	-1.6	-3.0	-7.6	-11.1	-5.8
CPI inflation (average)	5.1	6.8	7.7	18.0	9.0

Source: Rosstat, MoF, CBR and World Bank staff estimates.

2.2 Risks to the Growth Outlook

Risks to Russia's external environment, the global outlook, and especially oil price trends are prominent. Russia's medium-term growth outlook will also depend on how Russia will master the adjustment to the oil price and the sanctions shocks, taking into account the risks to financial stability and fiscal sustainability.

Risks to Russia's growth outlook stem partly from what may happen in the global outlook: Global recovery may continue to move slowly. If the Euro area or Japan slips into prolonged stagnation or deflation, global trade could decline even more. Although this is a low-probability event given China's substantial policy buffers, a worse decline in its growth could trigger a disorderly unwinding of financial vulnerabilities that would have severe implications for the global economy. Financial market volatility, compounded by the risk of a sudden deterioration in liquidity, could heighten the borrowing costs of emerging and developing countries—an unwelcome development considering that these countries have been quite active in the capital markets for several years. Intensifying geopolitical tensions, bouts of volatility in commodity markets, or financial stress in major emerging markets could make it necessary to reassess risk.

There are significant risks to the global energy price forecast. On the supply side, while the costs of extracting unconventional oil may be above current oil prices, it will take at least a year before supply moderates, probably through cancellation of new projects. Furthermore, most energy companies have been busy reducing their costs so that they can continue with most projects. On the demand side, the January 2015 assessment of the International Energy Agency

expects further softening, with oil consumption projected to average 93.3 million barrels per day in 2015, down from 94.1 million projected in its July 2014 assessment. There are also risks related to uncertainty about future OPEC policy: a significant part of the drop in oil prices has been driven by OPEC's November decision to let markets determine the price rather than engaging in supply management. Before that decision, Saudi Arabia—OPEC's largest and most influential member—had offered a series of discounts to Asian oil importers, signaling its intention to abandon price targeting. Since November OPEC officials have repeatedly stated that the cartel will not act even if prices fall to US$20 per barrel.

A second set of risks relates to how successfully Russia will manage adjustments to the oil price and sanctions shocks. Specifically, sanctions are likely to linger for longer and could well alter the structure of the Russian economy and how Russia integrates with the rest of the world. A notable shift is its reorientation to new trade partners and to markets other than Europe and the West. This includes efforts at closer integration with former Soviet Union republics, East Asia, and Latin America. It also appears that Russia is already adapting the structure of its economy, through more protectionism and other promotion of domestic industries and a footprint of the state in the economy that is once again growing. Despite the path to more selective integration into the world economy, Russia will continue to depend on its natural resource exports. Here it will be important to assure progress in adopting technology that can support exploration of less easily accessible oil and gas fields. Future growth in productivity may well be threatened if natural resource revenues are not invested effectively so as to counterbalance restricted access to external financing. Specifically, less foreign direct investment (FDI) could limit the innovation and technology transfer that is critical to heighten Russia's growth potential.

As long as access to external finance continues to be a problem, careful management of financial sector risks and buffers will be vital. Adhering to inflation targeting within a flexible exchange rate regime will help keep international reserves adequate. A tighter focus on the efficiency of spending and prudent management of fiscal buffers would ensure continued fiscal sustainability at all administrative levels. The vulnerability of Russia's financial sector has heightened. Government and central bank measures are providing some relief to banks but could also be pushing up systemic risks. Parts of the January government anti-crisis plan relate to measures to support financial stability (Box 7). Bank liabilities keep increasing in relation to liquid assets and the real earnings potential of those assets. Deteriorating asset values will require injections of capital (which may not be possible) and will thus make banks more vulnerable to funding shortfalls and possible deposit runs. Thus, the financial condition of banks, especially smaller ones that are not considered systemically important, is likely to worsen during 2015. Liquidity support from the central bank is likely to rise, and the collateral requirements for CBR loans could expose the declining market value of assets on bank balance sheets—to the point that more of the 800 or so banks might close.

The financial authorities need to continue earmarking financial resources to support Russia's systemically important banks and prevent a financial crisis. Many such banks are state-owned or state-controlled, so that the government is the main shareholder and equity provider. However, support would need to be selective; the government would not be able to cover the entire financial system, given the amounts in government reserve funds and the potential capitalization needs—not to mention other emergency demands on the budget. One advantage banks retain is that their net foreign asset holdings are still positive and thus currency-

matching balance sheet pressures have not yet fully emerged. However, recapitalization needs could quickly erode any advantages; because banks are largely shut out of the international capital markets, their local currency funding is increasing substantially. A further decline in the ruble would exacerbate the pressure.

The main medium-term risk for Russia's growth lies in the continued dearth of affordable credit and the low investment demand. On one hand, high interest rates could continue to exert pressure on Russian banks as their costs of funding rise (though supplemented by CBR loans for some time), credit levels decline, and more loans default. The result could be a vicious cycle of a shortage of project credit caused by the slowdown of the economy, higher lending rates, and the tightening of access to credit. Meanwhile, despite CBR forbearance, NPL ratios are expected to rise. But other, more fundamental, factors could limit investment demand. The uncertainty related to geopolitical tensions and sanctions is still holding investors back and it is likely to take some time until the confidence of investors is restored. The economy still grapples with large inefficiencies in factor allocation, as reflected, e.g., in limited labor mobility but also in weak institutions to regulate markets, which leads to significant variation in how the rule of law is applied. Private investment would need to be reassured by a level playing field, increased competition, and less corruption. Systematically lower investment rates will ultimately lower Russia's prospects for growth in the coming years and limit already modest growth potential.

2.3 Risks to the Poverty and Shared Prosperity Outlook

Given the growth outlook, Russia's achievements in the last decade with regard to poverty reduction and the upward mobility of a large part of the population might be under threat. The first significant increase in the poverty rate since the 1998-1999 crises is expected, since Russia has limited fiscal space to protect the most vulnerable.

In the past decade, Russia has witnessed unprecedented growth in household welfare, which has lifted many out of poverty and allowed many others to join the ranks of a growing middle class. The poverty rate—the share of the population with per capita consumption equal to or below US$5/day—fell from 40 percent in 2001 to 10 percent in 2010. At the same time, the middle class—those with per capita consumption equal to or above US$10/day—grew from 30 percent to 60 percent of the total population. And although the middle class in Russia and many other middle-income countries was disproportionately affected by the 2008-2009 global financial crisis, the number of middle-class households recovered quickly and continued to grow after the crisis, though more slowly.

Russia became a middle-income society where growth was driven by consumer demand. By 2010, the middle class controlled 74 percent of total household income and 86 percent of total household consumption. When it came to private consumption, in fact, the middle class became the only game in town. Positive and sustained economic growth for most of the period translated into notable growth in per capita consumption from US$9/day in 2001 to almost US$17/day in 2010 (2005 PPP). There was a significant decline in poverty, and to a lesser extent vulnerability.

Upward economic mobility was the result of both increases in average incomes and changes in the distribution of income. Using an established decomposition technique (Dattand Ravallion 1992) to examine the impact on

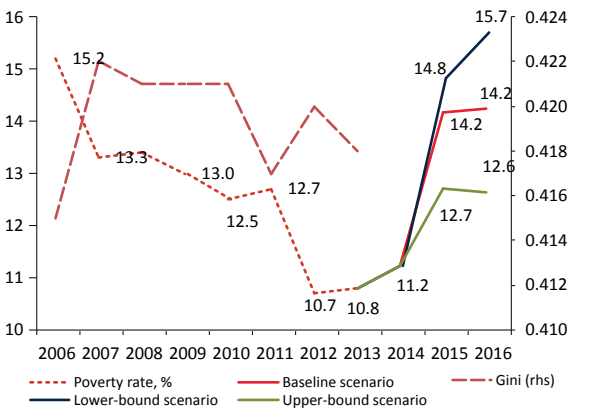
economic mobility of changes in the distribution of household per capita income between 2001 and 2010, particularly the emergence of the middle class, it was found that over three-fourths of the observed decline in poverty could be explained by changes in average income; the remaining fourth was explained by changes in the distribution of income. In contrast, growth in average income levels accounted for only half of the movements into the middle class; the other half was linked to changes in the distribution of income. This differed from the experience of other European and Central Asian countries, where changes in the distribution of income had a negative (though very small) impact on the growth of the middle class during the same period, as well as the experience of countries in Latin America and the Caribbean, where income growth explained almost all the growth in the middle class observed in 1995-2010.

The main platforms for the rise of the middle class in Russia were access to good, productive jobs and wage growth in both private and public sectors. Significant increases in pensions also helped many escape poverty and vulnerability and join the middle class, particularly in 2006-2010. Today, with economic growth slowed and fiscal resources constrained, the sustainability of those trends is increasingly threatened.

In 2014, though national poverty and shared prosperity measures have been flat, the risks for vulnerable groups have gone up. The 2014 poverty rate increased from 10.8 percent in 2013 to 11.2 percent in 2014. The increase was due to poverty changes in the final quarter of 2014, but through the third quarter inter-year dynamics were in line with 2013 (Table 11).

Based on the growth outlook, in all three scenarios the World Bank projects that poverty will again rise in 2015 and 2016 (Figure 32). The baseline scenario projects that the poverty rate will rise to 14.2 percent in 2015 (equivalent to 20.3 million people) and remain there in 2016 (equivalent to 20.5 million). This would be the first significant increase in the poverty rate since the 1998-1999 crises: poverty did not grow in 2008-2009 because there was some growth in disposable income. The increase in poverty would be driven by an expected decline in disposable income and consumption and by an increase in the poverty line caused by high inflation. Because the share of food items in the subsistence basket for the poor is higher than for the rest of the population, they would be more heavily affected if food prices outpace headline inflation. Recently announced measures, such as the agreement of the biggest retail chains to control food prices, could partly offset the increase in the poverty rate but will not fully compensate for it because controls could be applied to only part of the subsistence basket. Such measures are not as effective as others, such as targeted social support for the poor.

Figure 32: Poverty rate projections, percent of population



Source: Rosstat and World Bank staff estimates.

Table 11: Poverty rates, percent

	2010	2011	2012	2013	1Q 2013	2Q 2013	3Q 2013	4Q 2013	1Q 2014	2Q 2014	3Q 2014	4Q 2014
Poverty rate, cumulative	12.5	12.7	10.7	10.8	13.8	13.0	12.6	10.8	13.8	13.1	12.6	11.2

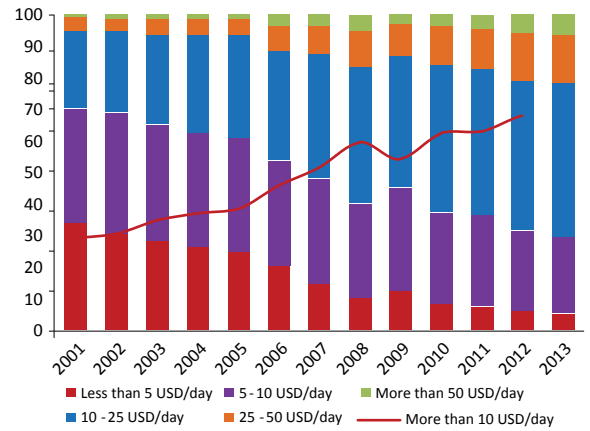
Source: Rosstat.

[14] These estimates were done on RLMS data in an approach comparable to the Focus note of Russia Economic Report no. 31. However, all the estimates should be taken with caution because survey data is usually biased downward due to underreporting of incomes and expenditures and under-representation of people with high incomes.

People at the bottom of the income distribution are the most vulnerable. As fiscal space in 2015-2016 is limited, additional support for the poor and vulnerable is likely to be less generous than in 2008-2009. Public wages will not be indexed this year, and pensions, social benefits and other transfers will decrease in real terms because their indexation is based on 2014 inflation, which was much lower than the price growth projected for 2015. Currently, pensioners, public employees, and employees of state-owned enterprises constitute a significant share of the bottom 40 percent income group; other vulnerable groups are those employed in the informal sector and families with children. As a result, 2015-2016 will see less opportunity for an increase in shared prosperity.

Russia's share of the population belonging to the middle class continued to grow in 2013. In 2013, the share of Russians belonging to the middle class, defined as people with per capita income exceeding US$10 PPP per day[14] (Figure 33) increased by 2 percentage points, reaching 70 percent of the population as the trends of the previous decade continued. Within the Europe and Central Asia region, Russia is one of the best-performing countries when this definition of middleclass is applied. However, a closer look at how that growth was distributed shows that it was driven by expansion of the share of the relatively richest people within the group. The share of population with a per capita income of more than US$50 per day in 2013 increased faster by 0.7 percentage points to reach 6.4 percent. The share of the population with a per capita income of US$10-25 and US$25-50 per day grew more slowly.

Figure 33: Share of the population with per capita income in US$ PPP/day



Source: Rosstat and World Bank staff estimates.

PART III

THE ECONOMIC IMPACT OF SANCTIONS[15]

Since the start of the geopolitical tensions, Russia has been subject to several rounds of sanctions by developed economies. First, sanctions directed at specific individuals, groups, and companies imposed restrictions on travel and business operations and froze their assets. Later, sanctions aimed at Russia's military, energy, and financial sectors followed. In August, Russia introduced counter sanctions, banning food imports from sender countries. Sanctions and counter sanctions hit the economy through three channels: (i) Massive capital outflows made the foreign exchange market more volatile and caused a significant depreciation of the ruble; (ii) Financial sanctions restricted access to international financial markets for some Russian banks and firms and made external borrowing very expensive for others; and (iii) The already low confidence of domestic businesses and consumers in future growth prospects diminished further, reducing consumption and investment. Sanctions also started to impact trade flows. International experience shows that sanctions are likely to last for long periods.

[15] This note was produced by Birgit Hansl, Nancy Benjamin, and Julie Saty Lohi with contributions from Michael Ferrantino and Karlygash Dairabayeva.

3.1 Introduction

In 2014, Russia became subject to sanctions resulting from the Russia-Ukraine geopolitical tensions. These tensions and the related sanctions affected investor and consumer decisions and trade flows. First, they created much uncertainty: equity and currency markets entered a prolonged period of acute volatility as they gradually internalized the uncertainty. They also exacerbated the crisis in confidence the economy had entered in 2012-2013, weighing heavily on consumption and investment. As the September 2013 edition of the Russia Economic Report said,[16] in the first half of 2014 the impact of Western sanctions on Russia's growth was channeled mainly through adjustments in financial flows. The gradual imposition of financial sanctions and more limited trade sanctions started in late July 2014, and those on the financial sector began to make an impact in the second half of 2014. Other sanctions with trade implications will likely make their full impact known only throughout 2015. Statistics on output dynamics by economic sectors since the second quarter of 2014 (immediately after the geopolitical tensions arose) suggest a sluggish economy but with a small positive impulse coming from the weaker ruble.

This note offers an early assessment of the economic impact of sanctions on Russia. First, it will assess impact through the main sanction channels, based on the data currently available. In doing so, it will also suggest potential long-term impacts and areas for future research. Second, it will review international experience with economic sanctions in terms of their impact on the sanctioned country. In general terms, economic sanctions are pressures, such as trade restrictions, disinvestment campaigns, and restrictions on credit from international banks, that are imposed, either unilaterally or multilaterally, on a given country or group of countries.

3.2 The Economic Impact of Sanctions

The methodologies that have been used to evaluate the economic impact of sanctions fall into two categories: statistical analysis of situations and game theory (Box 11). Many of the evaluation exercises measured direct costs incurred, such as losses in export sales and market shares, job losses, compliance costs, and losses incurred by suppliers of inputs to sanctioned countries. Indirect costs have also been identified. The methodologies applied evaluate the impact of sanctions by measuring both the direct and indirect costs incurred by the target and compare them with different aspects of past sanctions episodes, such as the size of the partners and the trade flow between them, the intensity and length of sanctions applied, and the extent of international cooperation.[17] Studies of how sanctions impact senders are rare.

In addition to these methodologies, industrial surveys have been conducted to capture the indirect costs, which are notoriously hard to quantify. Hufbauer (1990) and the EABC (1997) looked at indirect costs typically incurred by the sender of a sanction, such as loss of reliability as a supplier, loss of opportunities for forming critical business relationships or participating in joint ventures, and loss of competitiveness because of loss of market share. For example, in 1998 the president of Caterpillar, Inc., reported that Russians still doubt the company's reliability as a supplier following U.S. sanctions on the former Soviet Union gas pipeline to Western Europe (see USITC 1998, p. 49).

[16] See World Bank Russia Economic Report №32, *Policy Uncertainty Clouds Medium-Term Prospects*.
[17] Hufbauer et al. 1983, 1990; Bergeijk 1994; Carter 1988; Eaton and Engers, 1992, and Miyagawa 1992 evaluate the impact of economic sanctions through factors such as trade costs incurred in various sanctions episodes.

Box 11 Methodologies of economic sanctions evaluation

The statistical approach used in evaluating the impact of economic sanctions include gravity, partial equilibrium, and general equilibrium models. The gravity model of bilateral trade flows assesses bilateral trade patterns and what drives them. The basic gravity equation[1] is often augmented with a sanctions variable to quantify the impact of sanctions on trade patterns (e.g., Hufbauer et al., 1997; Askariet et al., 2003; International Economics Policy Brief, 2003). The partial equilibrium model makes it possible to examine the welfare impacts of economic sanctions on the markets involved; the general equilibrium model links restricted markets and sectors to all other markets in the economy.

Richardson (1993)[2] pioneered sanctions evaluation using the partial equilibrium model. The model considers demand and supply disruptions in sender and target countries due to sanctions to assess the impact of each[3] sanction under varying degrees of imperfect competition, cost structures, and number of firms and countries. A limitation of partial equilibrium models in general is their inability to distinguish between sectors, which mitigates substitution or input cost effects on other sectors due to sanctions in one sector—the second-order effects on goods or sectors not targeted as a result of sanctions on a targeted sector. The general equilibrium model fills the interaction gap left by partial equilibrium models. General equilibrium modeling allows for full interactions between flows of output, income, and consumption because it is based on the social account matrix, which is the complete data base of sectoral flows and the aggregate of an entire economy for a given period. Canes (1998) used general equilibrium modeling to evaluate the implications of economic sanctions for energy policy and Becker et al. (1990) used it in evaluating the costs of economic sanctions on South Africa.

Unlike the empirical approaches, the game theory approach does not yield quantified estimates of the costs incurred by the countries involved. Applying game theory in the context of economic sanctions allows for qualitative analysis of their impact. In using the game theory approach to evaluate sanctions, the countries involved (sender and target) are treated as two opposed subjects where each country makes strategic policy decisions vis-à-vis the strategy adopted by the other.[4] Costs, especially to the sender, are attributed to an overall sanction strategy (see, e.g., Eaton and Engers 1992; Bergeijk 1994; Bergeijk and Marrewijk 1994; Bonetti 1994; Barrett 1998; and the USITC 1998). It also considers the potential impact of a threat of sanctions, which can in itself negatively impact countries. Even if sanctions are not imposed, the threat can be an efficient strategy for the sender, one the target country could avoid by cooperating.

1 The basic determinants or explanatory variables of bilateral trade patterns in the gravity equation are geographical distance between the two partners, official language in common, colonial links, contiguity (whether they share a border), and the GDP of each partner.
2 See also Hufbauer et al. 1983, 1990. The application of the partial equilibrium model in these papers does not accommodate some features of the 1993 Richardson model, such as enlarged numbers of suppliers and demanders, and varying degrees of imperfect competition.
3 This refers to distinct impacts of a sanction, such as export embargoes or restrictions on export financing.
4 Game theory is based on a mathematical model of conflict and cooperation that is traditionally used in economics to study rational decision making by two players assuming a zero sum-game, such that the loss of one party equals the gain of the other party. Game theory applications today can diverge from the zero-sum equilibrium and allow a mixed-strategy equilibrium with even a cooperative game by multiple players (see Koller and Milch 2003).

3.3 Lessons from International Experience with Sanctions

This section builds on past international experience with economic sanctions to illustrate potential medium- and long-term impacts. It explores sanctions against South Africa in terms of their economic impact on the targeted country. This example was chosen for its possible relevance to Russia's sanction experience because this country has some similar characteristics, being resource-rich and having also had to deal with sanctions that impacted the financial sector and investment flows. However, each sanction set was unique, as was the country circumstances when the sanctions hit, which makes outright comparison of impacts difficult.

South Africa

South Africa was subject to economic sanctions starting in the 1960s which were implemented on a more significant scale after the mid-1980s. Many governments and institutions banned South African exports to their countries and advocated disinvestment in corporations and banks doing business in or with South Africa. In the U.S. alone, by the late 1980s 26 states, 22 counties, and over 90 cities had passed laws banning transactions with companies doing business in South Africa. The divestment movement pressured institutions, including many universities, and public pension funds to divest holdings in companies doing

business in South Africa. Governments also intensified the pressure by adopting selective purchasing policies, whereby preference in suppliers of goods and services was given to companies that did not do business in South Africa. Financial sanctions closed off access to foreign savings. Trade restrictions targeted imports of the South African Krugerrand (then the South African gold coin), certain steel and iron products, and products of state-controlled enterprises dealing with uranium, coal, textiles, agricultural products, food, and petroleum products. The campaign of disinvestment and the international trade restrictions continued until 1994.

During the sanctions South Africa continued to mine and export minerals, diamonds, and gold. The mineral exports allowed it to buy oil and other necessities despite sanctions, although at higher cost. A variety of manufactures persisted, often based on local raw materials, agriculture, livestock, and minerals. Agriculture diversified to produce a few crops that had become difficult to obtain from abroad. The share prices of companies facing divestment by institutional investors changed little as other investors picked up the shares that were shed.

Sanctions eventually choked off investment (Bayoumi 1990; Gershenson 2001). Because of the uncertainty related to the financial sanctions that started in the mid-1980s, investment plunged. Fixed domestic investment fell from 26 percent of GDP in 1980-1985 to 19 percent in 1986-1990. The annual rate of growth in capital stock slowed from 4 percent in the early 1980s to 1 percent after 1985, and capital stock actually fell in agriculture, manufacturing, and construction.

The main conclusion from past international experience is that the current economic sanctions on Russia could have serious medium- and long-term impacts. Indeed, the review found that economic sanctions can cause significant deterioration in the target's economy. The sanctions have left target countries with negative economic impacts that took far longer to reverse than the length of time they were imposed. Once a target country becomes isolated from major economic and financial markets, foreigners and even domestic investors become reluctant to invest in the country, clouding its medium- and long-term economic prospects. This is especially clear from the experience of South Africa, which was cut off from international transactions during its sanctions period. The isolation from international economic activities, such as trade and bank transactions, that are pivotal to a country's growth, have proven to be very damaging for targeted economies even if the sender also suffers to some extent from missed trading opportunities with the sanctioned country.

3.4 The Economic Impact of Sanctions on Russia

Russia is currently subject to multilateral economic sanctions resulting from the Russia-Ukraine geopolitical tensions. First, in March-April 2014 sanctions introduced by the U.S., the EU, and other countries were directed at specific individuals, groups, and companies. They prohibit the entry of sanctioned individuals, freeze their assets, and ban business operations with the named individuals and companies.

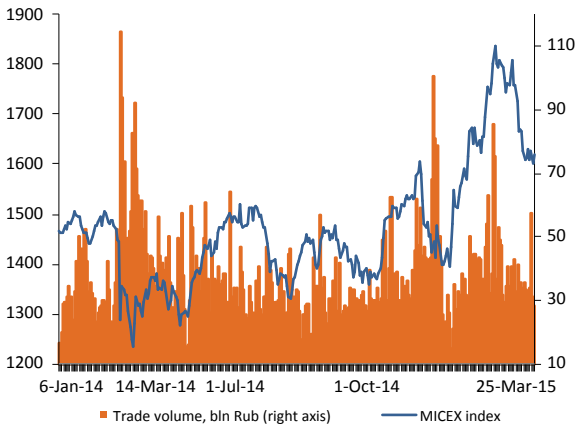
In July 2014, new sanctions were directed at Russia's military, energy, and financial sectors. Access of the six major Russian state banks and of energy and defense firms to the EU and U.S. financial markets was severely limited. As of September 2014, these companies can only apply for loans and issue debt not exceeding 30 days maturity. In the defense sector, the U.S and the EU cut access to financing exceeding

30 days maturity for Russia's major companies and banned the export of dual-use goods and technology for 14 mixed-defense companies. Sanctions on cooperation with Russia in the military sector were also introduced by the U.K., Israel, Switzerland, and Sweden. In the energy sector, the U.S. and the EU limited access to finance for major Russian oil and gas companies; they also prohibited export of goods, services (not including financial), and technology in support of exploration or production for Russian deep-water, Arctic offshore, and shale projects. Norway, Canada, and Australia largely joined the sanctions introduced by the EU.

In response to the sanctions, Russia on August 7, 2014, banned the import of food items from several Western countries for a year (Box 12). Among them were meat, fish, seafood, vegetables, fruit, milk, dairy products, and a wide range of processed foods from the U.S., the EU, Australia, Canada, and Norway. Later, other countries were added.

Sanctions and counter sanctions hit the economy through three channels; first, they led to increased volatility on the foreign exchange market and a significant depreciation of the national currency (Figure 34 and Figure 35).

Figure 34: Stock market prices and trade volumes



Source: MICEX.

Figure 35: Exchange rate dynamics, Euro-dollar basket (axis in reverse order)

Source: CBR.

Box 12 Russia's food import ban

On August 7, 2014, Russia imposed a ban on specific food commodities imported from the U.S., the EU, Canada, Australia, and Norway in response to the economic sanctions those countries had imposed. The banned products include beef, poultry, fish, sausages and other meat products, vegetables, fruits and nuts, milk and dairy products, and cheese. Russia also banned fresh fruits, wine, and processed meat from Moldova, and potatoes, soy beans, sunflower, and corn grits from Ukraine. The total value of affected trade is estimated at US$9.5 billion; the banned products account for 9.5 percent of total food consumption in Russia and 22.5 percent of its total food imports.

The ban heightened inflation pressures; prices have already risen for the targeted items, hurting Russian consumers but stimulating domestic food production (section 1.3). The food import ban is very broad and covers both staples and luxury items. Also, substitution by domestic products has increased the cost of food for the most vulnerable segments of the population in Russia. Russian food processing companies that rely on imported inputs that are on the banned list are experiencing increased costs. In an effort to control and prevent increases in food prices, the decree that introduced the import ban also included measures to prevent the growth of prices for related agricultural products. A list of 40 products (almost all goods of the approved in the Russian CPI food basket) was created by the Ministry of Industry and Trade of Russia, based on which the authorities monitor daily prices of traders, municipalities and regions. However, the food import ban created some incentive for domestic food production, which increased continuously in the past half year.

Some short-term and medium-term risks are connected to the food import ban. In the short term, transaction costs are rising as new channels to source food imports are sought. In the mediumterm, the trade ban could result in retaliation by trading partners, and there is a risk that WTO disputes will escalate. The EU is considering WTO dispute settlement options in response to Russia's import bans. Russia has also indicated that the U.S. (and implicitly EU) sanctions are in breach of WTO rules.

Massive capital outflows triggered by the tensions led to a deterioration of Russia's capital and financial account balance and a decrease in net international reserves (Section 1.4). The flight from the ruble was compounded in the second half of 2014, when falling oil prices caused the ruble to lose nearly half of its value against the U.S. dollar in 2014 (Section 1.3).

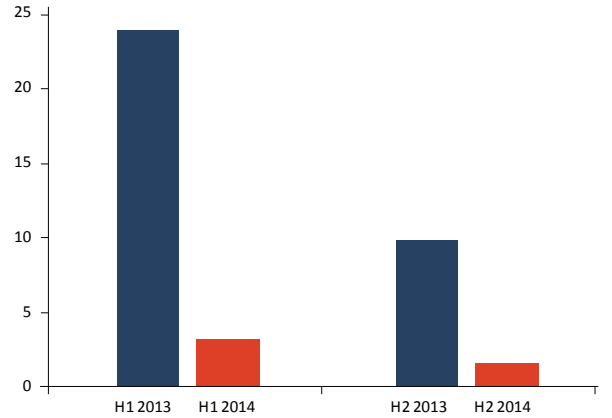
Despite the depreciation, non-oil exports did not increase. Although there is an impulse for substitution, given the persistent structural rigidities and little spare capacity to expand without further investment, its potential appears to be limited. In the short-term, the positive impulse for substitution might increasingly be used to promote protectionist measures. Even before the current geopolitical tensions started, government showed interest in supporting elected firms and sectors that would benefit, one example being the ban on pork products at the beginning of 2014.[18] There is a risk that the Russian government will continue such protectionist measures. This could delay structural reforms that could help the economy to become globally more competitive.

The ruble depreciation put pressure on inflation. The food import ban in August stimulated an acceleration of food inflation. By February 2015, food inflation had reached 23.3 percent, adding to the already high inflation pressure from the ruble depreciation pass-through. In response to these pressures and in support of the ruble, in the latter half of 2014 the CBR significantly tightened monetary conditions (Section 1.3). Although this was consistent with the CBR's goals of inflation targeting and financial stability, it increased domestic borrowing rates and further restricted access to domestic credit for both investors and consumers.

The second channel through which sanctions hit the economy was the restrictions on Russia's access to international financial markets, which had already started when the geopolitical tensions arose. Even before the financial sector sanctions became effective, markets were pricing Russia's higher risk into the cost of credit, which sent sovereign CDS spreads for Russia soaring. New foreign borrowing decreased in the first half of 2014 and all but vanished in the second half of 2014 after the sanctions were introduced (Section 1.4). The tighter domestic and external credit conditions negatively affected investment and consumption decisions, leading to a delay or a scaling back of some plans. In fact, after the oil price drop in the final quarter of 2014, financial sector sanctions seem to have had the most adverse impact on domestic demand. Since they were imposed, very few international financial institutions have provided Russia with financing, and most Western financial markets remain closed to Russian banks and companies. Even for non-sanctioned firms and banks, external financing conditions have become more difficult. For example, bond issues for Russian companies dropped dramatically in both halves of 2014, year-on-year (Figure 36). At the same time the costs of issuing bonds continued to be high during 2014, though they started to decrease as 2015 began (Figure 37).

[18] In January 2014, Russia excluded the import of live pigs, pork, and pork products from the EU based on its phy to sanitary standards (SPS) policy. These products amounted in 2013 to US$1.3 billion in imports. On April 18, 2014, the EU requested consultations with the WTO Dispute Settlement Body (DSB) with regard to the ban on pork products. The pork product ban followed the detection of four cases of African swine fever in wild boar in Lithuania and Poland. However, The ban applies to live pigs, pork, and pork products from throughout the EU. One issue in the dispute involves localization requirements, which refer to attempts by a country or customs territory (such as the EU) to impose measures for control of diseased animals on part of its territory—such as quarantines—and to have the rest of the territory certified as disease-free. On July 22, 2014, the DSB established a panel for the dispute.

Figure 36: Bond issuance in US$ billion, US$ denominated



Source: CBonds.

Figure 37: Russia corporate emerging market bond index for Russia

Source: JP Morgan.

Finally, domestic business and consumer confidence, already low due to dim growth prospects, further depressed consumption and investment. The lack of confidence in the face of geopolitical tensions and sanctions was compounded by lingering policy uncertainty. Domestic demand slackened: fixed investment contracted by 2.5 percent in 2014 and the contribution of consumption to growth dropped to less than half that of 2013. Investment activities initiated abroad also declined as business and consumer confidence deteriorated.

Total FDI into Russia plunged in the first three quarters of 2014; it was 47 percent lower than the average for the same quarters in 2011-2013. The share of FDI from countries used as tax havens, such as Cyprus, Bermuda, the Caribbean, and Jersey, traditionally constitutes repatriated capital outflows and at 48 percent was high by historical standards in 2014.[19] In the first three quarters, it was mainly FDI from non-tax havens that declined, resulting in a 59 percent drop; FDI from tax havens decreased by only 3 percent. However, in quarter three of 2014, the pattern of FDI from tax havens shifted from heavy inflows into Russia in the first half of 2014 to net outflows, enough to make the flow of FDI into Russia negative. In the third quarter alone, net FDI inflows were US$1 billion, compared to US$12.1 billion in the third quarter of 2013. Capital outflows from Russia into tax havens like Cyprus was US$4.6 billion in the third quarter of 2014 and US$900 million went to Bermuda and the British Virgin Islands. If foreign and domestic capital continue to be averse to investing, Russia's medium- to long-term growth prospects will suffer.

Sanctions have already impacted trade flows. Some of the impact seen so far is based on early trade outcomes that compare quarter three 2014 and quarter three 2013: a plunge in imports due to the already weakening exchange rate and Russia's ban on food imports from Western countries. Imports of foods and beverages from the EU sank in the third quarter of 2014, year-on-year (Figure 38), and dairy product imports from the U.S., Japan, and Australia also dropped (Figure 39). Although the main devaluation of the ruble did not happen until the fourth quarter of 2014, it would be misleading to attribute these changes entirely to the sanctions environment. Even without sanctions, the Russian economy

[19] FDI in Russia was in the past closely intertwined with capital outflows. Historically, investors sought to avoid adverse features of the Russian investment climate by relocating investments offshore and engaging in round-tripping (Fabry and Zeghini 2002), though off-shoring for tax reasons is also likely. Russia's FDI contains a large share of inbound FDI reported as originating from Cyprus and other countries, which is likely to be round-tripping FDI of Russian origin—in other words, repatriated capital which was previously part of capital outflows from Russia. After removing FDI with a reported origin in likely tax havens, the ratio of Russia's FDI inflows for 2007-2013 was about 1.8 percent, comparable to that for India and South Africa. This comparison may understate the amount of round-tripping in Russia's inbound FDI since it may also involve other reported sources.

Figure 38: Russia's food and beverage imports: Q3-2013 and 2014 (US$ billion)

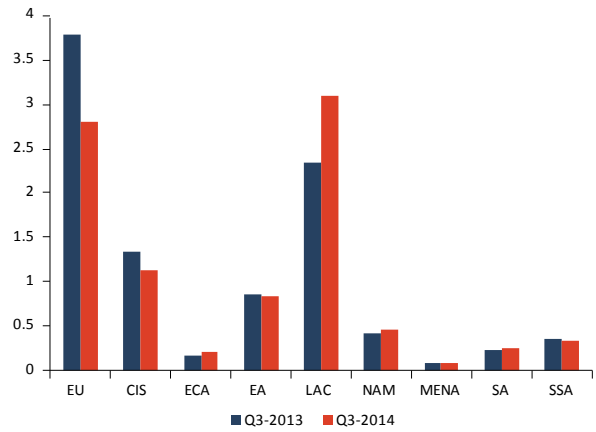
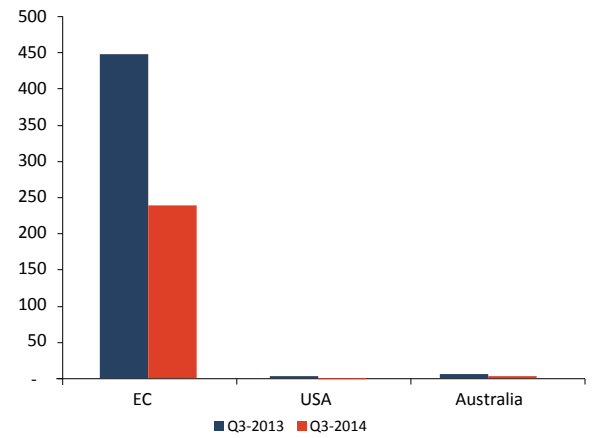


Figure 39: Russia's dairy product imports: Q3-2013 and 2014 (US$ billion)



Source: Federal Customs Services, World Bank staff calculations.
Note: EU-European Union; CIS-Commonwealth of Independent States; ECA-Europe and Central Asia, EA-East Asia and the Pacific; LAC-Latin America and the Caribbean; NAM-North America; MENA-Middle East and North Africa; SA: South Asia; and SSA: Sub-Saharan Africa.

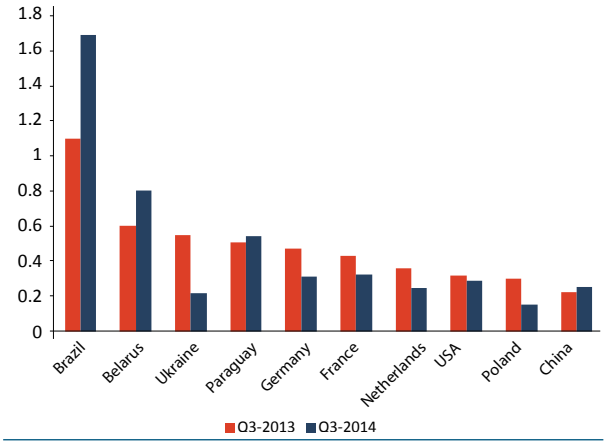
would have barely expanded due to low growth potential. In the future it will be even more difficult to attribute changes in trade patterns purely to sanctions, since the steep oil price drop in quarter four of 2014 likely had more profound effects. In 2015 oil revenues are projected to be at most two-thirds of their previous values, which implies that Russian imports would drop even further.

The economic sanctions on Russia and its counter sanctions will benefit some countries, but traditional trade partners might lose their markets. The impact of the ban on Eastern European EU members (the Baltics, Poland, the Czech Republic, Bulgaria, Romania, Slovenia, the Slovak Republic, and Croatia) is likely to be negative but small because they do not export much to Russia. In total, exports of the banned items constituted only 0.001-0.5 percent of their GDP, though for Lithuania, they constituted 2.9 percent. However, some sectors in those countries have sizable exposure to Russia; for instance, 68 percent of Polish apple exports and 65 percent of Lithuanian cheese exports went to Russia before the countersanctions were imposed. The net impact on these food industry segments will depend on whether the exporting companies are able to divert products to other markets. Other non-EU member countries, such as Turkey and some former Soviet Union republics(except for Moldova and Ukraine), are likely to benefit from the trade ban.

Latin American countries and Belarus appear to have been able to expand production and exports to Russia to fill the gap in targeted items. In the third quarter of 2014 shares of Russian food and beverage imports increased for Brazil, Paraguay, and Belarus (Figure 40). This stems mainly from an increase in cereal imports from Paraguay and meat imports from Brazil. For example, the value of cereal imports from Paraguay went up from about US$155 million in quarter three of 2013 to US$209 million in the same quarter of 2014—a more than 35 percent increase (Figure 41).

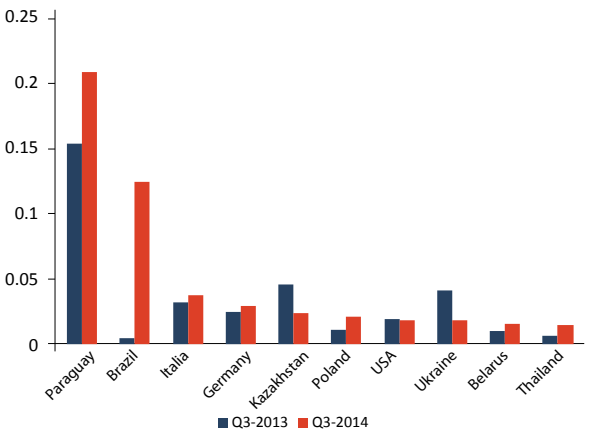
The impact of sanctions on Russia's energy exports is not yet evident. Coal exports declined in quarter three of 2014, year-on-year, not only to European destinations, but also to East Asia, traditionally Russia's second largest coal market, and the former Soviet Union republics, the third largest market (Figure 42). This might reflect changes in global coal prices. Oil and gas exports

Figure 40: Russia's food and beverage imports by country: Q3-2013 and 2014 (US$ billion)



Source: Federal Customs Services, World Bank staff calculations.

Figure 41: Russia's cereal imports by country: Q3-2013 and 2014 (US$ billion)



Source: Federal Customs Services, World Bank staff calculations.

seem to have seen little change so far (Figure 43). Oil and gas contracts are usually for set periods and any changes in the traded amount and price are only expected in 2015-2016. The effects of sanctions, which might reduce production due to inability to tap international financing, have yet to materialize; they thus constitute a longer-term risk. Similarly, the impact of concerted efforts by some major importers of Russia's oil and gas, including the EU, to identify alternative energy supplies is likely to take a long time, with no immediate impacts expected.

It is too early to quantify the impacts of the economic sanctions on all the targeted sectors of the Russian economy. However, the sanctions will most likely be felt most in investment, especially in oil and gas. For example, restrictions on the export of high-tech oil-drilling equipment may delay some new drilling investments. However, such investments may slow down independently when global demand is weak and international oil prices low. Restrictions on new medium-and long-term borrowing will restrict external funding for all new investments. State-

Figure 42: Russia's coal exports, Q3-2013 and 2014 (US$ billion)

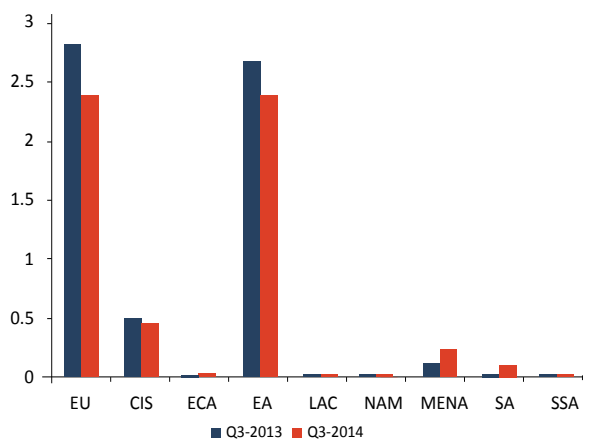
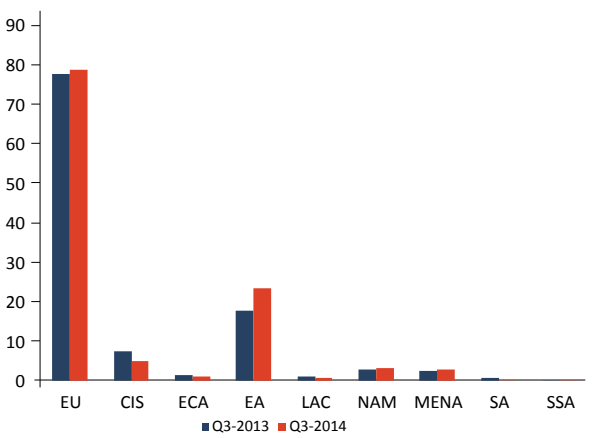


Figure 43: Russia's fuel exports: Q3-2013 and 2014 (US$ billion)



Source: Federal Customs Services, World Bank staff calculations.
Note: EU-European Union; CIS-Commonwealth of Independent States; ECA-Europe and Central Asia, EA-East Asia and the Pacific; LAC-Latin America and the Caribbean; NAM-North America; MENA-Middle East and North Africa; SA: South Asia; and SSA: Sub-Saharan Africa.

owned enterprises that have been sanctioned have their solvency guaranteed by state resources, but global uncertainty about the environment in which they function, reinforced by international sanctions, may cause potential foreign financiers to hesitate. This uncertainty may compound the instability in the exchange rate brought on by both low oil prices and measures the CBR is taking to compensate for them. Any decline in real investment will reinforce the economic slowdown.

The economic impact of sanctions on Russia is expected to linger. As geopolitical tensions persist, international sanctions will continue to influence the Russian economy, especially given lower oil prices. Growth of the Russian economy has slackened due to unresolved structural constraints and the uncertainty created by the geopolitical tensions and sanctions. The economic effects of the sanctions are unfolding in the context of lower global oil demand and worsening oil prices and export earnings. These trends are expected to continue through 2015, when the impact of previous and new rounds of sanctions will be felt most, pushing the economy into recession.

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Annex: Main indicators

Output Indicators	2014																				2015	
	2007	2008	2009	2010	2011	2012	2013	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2014	Jan	Feb
GDP, % change, y-o-y	8.5	5.2	-7.8	4.5	4.3	3.4	1.3	-	-	0.9	-	-	0.8	-	-	0.7	-	-		0.6	-	-
Industrial production, % change, y-o-y	6.8	0.6	-10.7	7.3	5.0	3.4	0.4	-0.2	2.1	1.4	2.4	2.8	0.4	1.5	0.0	2.8	2.9	-0.4	3.9	1.7	0.9	-1.6
Manufacturing, % change, y-o-y	10.5	0.5	-15.2	10.6	8.0	5.1	0.5	0.0	3.4	3.5	3.9	4.4	0.3	2.4	-0.6	3.6	3.6	-3.0	4.1	2.1	-0.1	-2.8
Extraction of mineral resources, % change, y-o-y	3.3	0.4	-2.8	3.8	1.8	1.0	1.1	0.9	0.8	0.6	1.1	0.9	0.8	0.2	0.8	2.4	1.9	2.5	3.0	1.4	1.5	0.1
Fixed capital investment, % change, y-o-y	23.8	9.5	-13.5	6.3	10.8	6.8	0.8	-7.3	-4.5	-4.7	-2.6	-2.7	-0.7	-0.9	-1.6	-1.9	-0.8	-7.8	-1.1	-2.7	-6.3	-6.5
Fiscal and Monetary Indicators																						
Federal government balance, % GDP [1/]	5.4	4.5	-5.9	-4.1	0.8	-0.1	-0.5	9.7	0.3	0.7	0.3	1.4	1.9	1.7	2.0	2.1	1.9	1.9	-0.5	-0.5	-4.2	-7.4
M2, % change, p-o-p [2/]	51.3	27.2	-3.5	30.6	23.3	17.9	15.4	-4.0	1.1	-2.2	1.2	0.3	0.6	0.3	0.5	-0.1	-1.2	1.2	4.8	7.3	-2.1	
Inflation (CPI), % change, p-o-p	9.0	14.1	11.7	6.9	8.5	5.1	6.8	0.6	0.7	1.0	0.9	0.9	0.6	0.5	0.2	0.7	0.8	1.3	2.6	7.8	3.9	2.2
Producer price index (PPI), % change, p-o-p	25.1	-7.0	13.9	16.7	13.0	6.8	3.4	0.4	-0.4	2.3	0.7	0.4	0.8	1.6	0.0	-0.8	0.3	-0.5	0.8	6.1	1.3	2.1
Nominal exchange rate, average, Rb/USD	25.6	24.8	31.7	30.4	29.4	31.1	31.8	33.5	35.2	36.2	35.7	34.9	34.4	34.6	36.1	37.9	40.8	45.9	55.4	38.4	61.7	64.6
Reserve Fund, bln USD e-o-p		137.1	60.5	25.4	25.2	62.1	87.4	87.1	87.5	87.5	87.9	87.1	87.3	86.6	91.7	90.0	89.6	88.9	87.9	87.9	85.1	77.1
National Wealth Fund, bln USD, e-o-p		88.0	91.6	88.4	86.8	88.6	88.6	87.4	87.3	87.5	87.6	87.3	87.9	86.5	85.3	83.2	81.7	80.0	78.0	78.0	74.0	74.9
Reserves (including gold) billion $, end-o-p	478	427	439	479	499	538	510	499	493	486	472	467	478	469	465	454	429	419	385	385	376	360
Balance of Payment Indicators																						
Trade Balance, billion $ (monthly)	123.4	177.6	113.2	147.0	196.9	191.7	181.9	18.7	12.5	19.8	20.0	18.0	13.9	17.0	16.2	12.2	14.2	13.4	12.9	188.7	15.0	
Current Account, billion $	72.2	103.9	50.4	67.5	97.3	71.3	34.1	-	-	26.8	-	-	12.9	-	-	6.4	-	-	10.5	56.7	-	-
Export of goods, billion $	346.5	466.3	297.2	392.7	515.4	528.0	523.3	39.6	36.5	47.0	47.7	44.1	40.6	46.2	41.5	38.1	41.1	36.7	37.6	496.7	27.5	
Import of goods, billion $	223.1	288.7	183.9	245.7	318.6	335.7	343.0	20.9	24.0	27.3	27.7	26.1	26.7	29.2	25.3	26.0	26.9	23.3	24.7	308.0	12.5	
Financial Market Indicators																						
Average weighted lending rate for enterprises, % [3/]	10.8	15.5	13.7	9.1	9.3	9.4	9.4	9.2	9.4	10.3	10.5	10.6	10.7	10.7	10.6	10.6	10.8	12.0	18.3	18.3	19.9	
CBR policy rate, %, end-o-p	10.0	9.5	6.0	5.0	5.3	5.5	5.5	5.5	5.5	7.0	7.5	7.5	7.5	8.0	8.0	8.0	8.0	9.5	17.0	17.0	17.0	15.0
Real average rate for Ruble loans, % (deflated by PPI)	-3.4	-6.8	-0.1	-6.5	-3.2	3.9	5.5	4.5	6.0	5.0	3.1	1.6	1.7	1.6	4.6	6.9	5.4	5.6	11.7	11.7	12.0	
Stock market index (RTS, eop)	2,291	632	1,445	1,770	1,382	1,527	1,443	1,301	1,267	1,226	1,156	1,296	1,366	1,219	1,190	1,124	1,091	974	791	791	737	897
Income, Poverty and Labor Market																						
Real disposable income, (1999 = 100%)	245.6	251.5	259.3	272.5	274.7	286.2	297.7	202.8	267.8	258.8	298.3	273.6	287.9	290.6	299.8	277.6	297.8	289.9	398.7	294.7	200.7	266.2
Average dollar wage, US $	532	697	588	698	806	859	942	838	812	882	923	929	1,003	910	833	811	748	660	749	841	449	500
Share of people living below subsistence, % [1/]	13.3	13.4	13.0	12.5	12.7	10.7	10.8	-	-	13.8	-	-	13.1	-	-	12.6	-	-	11.2	11.2	-	-
Unemployment (%, ILO definition)	6.1	7.8	8.2	7.2	6.1	5.1	5.6	5.6	5.6	5.4	5.3	4.9	4.9	4.9	4.8	4.9	5.1	5.2	5.3	5.3	5.5	5.8

Source: Rosstat, CBR, EEG, staff estimates.

[1/] Cumulative from the year beginning.

[2/] Annual change is calculated for average annual M2.

[3/] All terms up to 1 year.

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