

The World Bank in the Russian Federation

# RUSSIA ECONOMIC REPORT

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## *The Long Journey to Recovery*



**WORLD BANK GROUP**  
Macroeconomics & Fiscal Management



# Russia Economic Report

## *The Long Journey to Recovery*

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- I. Recent Economic Developments
  - II. Economic Outlook
  - III. In Focus: Export Competitiveness and Foreign Direct Investment
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This report is produced twice a year by World Bank economists in the Macroeconomics and Fiscal Management Global Practice. The team that prepared this edition was led by Birgit Hansl (Lead Economist and Program Leader in Russia, [bhansl@worldbank.org](mailto:bhansl@worldbank.org)) and consisted of Sergei Ulatov (Senior Economist), Olga Emelyanova (Research Analyst), Mikhail Matytsin (Consultant), Michael Edwards (Lead Financial Sector Specialist), Katerina Levitanskaya (Operations Officer), Christian Eigen-Zucchi (Senior Economist), John Baffes (Senior Economist), and Irina Rostovtseva (Program Assistant). Birgit Hansl authored the focus note on export competitiveness and foreign direct investment together with Michael Ferrantino (Lead Economist) and Gabriela Schmidt (Consultant) based on a World Bank paper titled Export Performance and Foreign Direct Investment Performance across Russia's Regions. Peer reviewers included Eric Le Borgne (Lead Economist), Christos Kostopoulos (Lead Economist), and Praveen Kumar (Lead Economist). The report was edited by Sean Lothrop (Consultant), and the graphic designer was Robert Waiharo (Consultant). The team would like to thank Cyril Muller (Vice President of the Europe and Central Asia Region), Hans Timmer (Chief Economist of the Europe and Central Asia Region), Andras Horvai (Country Director for Russia), Miria Pigato (Practice Manager, Macroeconomics and Fiscal Management Global Practice), and the Russia teams at the European Bank for Development and Reconstruction, and the IMF for their advice and support. This report went to press on April 4, 2016.

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## ABBREVIATIONS AND ACRONYMS

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<b>CAR</b>	Capital Adequacy Ratio
<b>CBR</b>	Central Bank of Russia
<b>CDS</b>	Credit-Default Swap
<b>CIS</b>	Commonwealth of Independent States
<b>CPI</b>	Consumer Price Index
<b>DIA</b>	Deposit Insurance Agency
<b>ECA</b>	Europe and Central Asia
<b>ECU</b>	Eurasian Customs Union
<b>EU</b>	European Union
<b>FDI</b>	Foreign Direct Investment
<b>GDP</b>	Gross Domestic Product
<b>GRP</b>	Gross Regional Product
<b>HHI</b>	Herfindahl-Hirschman Index
<b>M2</b>	Money Supply
<b>MENA</b>	Middle East and North Africa
<b>NPL</b>	Nonperforming Loan
<b>NWF</b>	National Welfare Fund
<b>OECD</b>	Organization for Economic Cooperation and Development
<b>OPEC</b>	Organization of the Petroleum Exporting Countries
<b>PPP</b>	Purchasing Power Parity
<b>RCA</b>	Revealed Comparative Advantage
<b>REER</b>	Real Effective Exchange Rate
<b>VAT</b>	Value-Added Tax
<b>WTO</b>	World Trade Organization



## EXECUTIVE SUMMARY

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**Russia's anticipated economic recovery was delayed.** In 2015 the Russian economy began its difficult adjustment to the severe global oil-price shock and the imposition of economic sanctions in 2014. The impact of these twin shocks drove Russia's economy into a deep recession, which reached its nadir in the second quarter of 2015. Following a brief rally early in the year, a further decline in global oil prices in August 2015 derailed an anticipated recovery, and annual real GDP contracted by a total of 3.7 percent.

**The economic adjustment occurred primarily through a sharp drop in income.** The adjustment to the worsening external environment caused an estimated 10 percent drop in gross domestic income, which sapped consumer demand and discouraged investment. The renewed decline in oil prices put further downward pressure on the ruble, and the pass-through effect pushed the inflation rate into double digits. Rising inflation eroded real wages, pensions and other transfers, contributing to an estimated 9.6 percent decline in household consumption, the first such contraction since the global financial crisis of 2008. The authorities' efforts to manage inflation slowed the pace of monetary easing, and the central bank has kept its key policy rates at 11 percent since August 2015. Meanwhile, economic sanctions have been extended, limiting access to global financial markets, restricting capital inflows and damaging investor confidence. High capital costs and plummeting consumer demand provided firms with little incentive to invest, and gross capital formation dropped by 18.7 percent in 2015, contracting for a third consecutive year.

**Thus far, the government's policy response has facilitated Russia's economic adjustment.** The central bank's flexible exchange-rate policy fostered exchange rate alignment in support of

the economic transition. In 2015, the average nominal ruble exchange rate depreciated by 37.4 percent against the US dollar, while oil prices dropped by 47 percent. Meanwhile, a 16.5 percent depreciation of the real effective exchange rate drove down imports by 25.7 percent, nearly doubling the current-account surplus to 5.2 percent of GDP. Relative prices now favor Russian firms, and export performance improved in some non-energy commodity sectors such as coal, metals and chemicals. Due to the flexible exchange rate, the fiscal impact of the adjustment was less severe for Russia than it was for other oil exporters, though a fiscal consolidation plan remained necessary. The plan appears appropriate, as the accumulated spending increases of recent years could not be sustained in an environment of slumping oil and gas revenues, which still constitute about 40 percent of federal revenue. While federal spending decreased in real terms, the federal fiscal deficit reached 2.4 percent. The Reserve Fund was used to finance the deficit, which caused it to drop by 50 percent to US\$46 billion at end-2015. However, a separate government RUB2.4 billion anti-crisis plan, which fully indexed pensions, helped mitigate the impact of the consolidation and supported financial sector stability through bank recapitalization.

**Opportunities have arisen to increase the competitiveness of Russia's non-resource sector.** Falling oil prices have exposed serious weaknesses in Russia's current growth model, but the depreciation of the ruble has also created an opportunity to enhance the competitiveness of its non-resource economy through export diversification and expansion into nontraditional markets. The special focus chapter included in this edition of the Russia Economic Report describes the complex structural and historical challenges facing Russia's export sector. For decades, the growing dominance of the natural

resource sector has undermined economy-wide competitiveness, as high commodity prices have skewed the country's economic and export structure in favor of oil, gas and mining. Russia's export pattern has narrowed on both the extensive and intensive margins, becoming increasingly concentrated in terms of both products and markets as the high rate of return offered by primary commodities discouraged value addition and stifled the development of new exports. Leveraging emerging opportunities to develop a broader and more sophisticated product and export mix will require a substantial increase in private investment. The current perhaps temporary price advantage generated by the depreciation may not be sufficient to attract investors unless it is accompanied by sustained improvements in the investment climate.

**Current projections indicate a long journey to recovery.** The conditions that pushed Russia's economy into recession show slow signs of abating, but the World Bank's current baseline scenario anticipates a further contraction of 1.9 percent in 2016. In 2017 GDP growth is projected to return to a positive, albeit modest, growth rate of 1.1 percent. Oil prices are projected to average just US\$37 per barrel in 2016, before rebounding to around US\$50 per barrel in 2017 and beyond. Commodity prices in general will continue to dominate Russia's medium-term outlook, and in addition to the baseline projection this report includes both a lower-bound and an upper-bound oil-price scenario. Under the lower-bound scenario the economy could contract by as much as 2.5 percent in 2016 before recovering to a modest growth rate of just 0.5 percent in 2017. Conversely, the upper-bound scenario projects a more modest 0.7 percent contraction in 2016 followed by a stronger recovery, with growth reaching 1.7 percent in 2017.

**The recession is reversing Russia's substantial achievements in poverty reduction.** In 2015, Russia's poverty rate rose from 11.2 to 13.4

percent, as the poor population increased by 3.1 million to a total of 19.2 million. High inflation contributed to the erosion of real wages by 9.5 percent in 2015, while nonwage income sources such as pensions and other transfers were indexed below headline inflation. However, declining real wages blunted the recession's impact on the labor market, and unemployment increased only slightly from a record low of 5.3 percent in 2014 to 5.6 percent in 2015. Nevertheless, poverty is projected to increase further under all scenarios due to a continued rise in unemployment compounded by marginal income growth, as the demands of the fiscal consolidation restrict the government's capacity for antipoverty spending. Under the baseline scenario the poor population is expected to increase by another 1.1 million people in 2016 as the poverty rate rises to 14.2 percent. This would be the largest increase in the poverty rate since the economic crisis of 1998-1999, and it would undo nearly a decade's worth of gains. However, improved growth prospects in 2017 are expected to stabilize the poverty rate.

**Risks to Russia's outlook are tilted to the downside.** The economy faces an uncertain global recovery, and as it gradually adapts to an adverse external environment marked by lower oil prices and ongoing economic sanctions, the focus of its economic adjustment is now shifting to fiscal and financial sector challenges. However, the policy space for Russia's continued adjustment has narrowed as its fiscal buffers have become increasingly depleted. As part of the planned fiscal consolidation, a strategic expenditure restructuring that goes beyond general budget cuts, as well as efforts to strengthen the nonoil revenue base, will be necessary to adapt to a protracted downturn in oil and gas revenues. Returning to a credible medium-term fiscal framework will be crucial to boost consumer and business confidence by reducing fiscal uncertainty. Maintaining fiscal discipline will require bold choices during the 2017 budget-planning process, as the authorities strive to determine new medium-term fiscal

policy priorities. A massive bank recapitalization temporarily stabilized the financial sector, but managing systemic vulnerabilities will require constant vigilance and readiness to implement further stabilization measures.

**Russia's longer-term growth trajectory will depend on the effectiveness of its structural reforms.** Policies designed to bolster investor confidence could greatly enhance Russia's long-term growth prospects. Administrative barriers to doing business, high transportation and logistics costs, and the perception of an uneven playing field all discourage investment, particularly in the non-resource sectors. Recognizing the importance of addressing structural constraints, the government's new anti-crisis plan does

not focus exclusively on emergency measures, but also includes a number of medium-term economic development initiatives intended to spur investment, including reforms designed to diminish regulatory uncertainty and strengthen judicial processes and law-enforcement systems. The swift and comprehensive implementation of these measures would clearly signal the Russian government's commitment to improving the investment climate. Without rapid and sustained investment in new industries, Russia may miss the opportunity afforded by its current price advantage, and achieving sufficient productivity growth to raise the country's long-term economic trajectory will prove extremely challenging unless structural constraints to investment can be effectively addressed.





## PART I

# RECENT ECONOMIC DEVELOPMENTS: *Searching for a Way Out of the Recession*

*In 2015 the Russian economy began its difficult adjustment to the combined impact of the economic sanctions regime imposed in July 2014 and the collapse of global oil prices later in the year. These twin shocks sharply decreased national income and depressed both consumer and investment demand, causing Russia's real GDP to contract by an estimated 3.7 percent in 2015. Following a brief rally, a second drop in global oil prices in August 2015 delayed the anticipated economic recovery. Persistently low oil prices contributed to a dramatic depreciation of the ruble, but the country's flexible exchange rate enabled a swift adjustment in imports, protected the central bank's foreign-currency reserves and limited the negative impact on fiscal revenues. However, pass-through effects resulted in double-digit inflation, undermining household purchasing power and contributing to a rapid drop in consumption, as real wages declined sharply. The deterioration of real incomes coupled with rising food prices resulted in a significant increase in poverty in 2015. Efforts to manage inflationary pressures slowed the pace of monetary easing, and the central bank has kept its key policy rates at 11 percent since August 2015. Meanwhile, economic sanctions against Russia were extended, depressing economic confidence and cutting off Russian businesses and banks from global financial markets. A lack of affordable credit and plummeting consumer demand caused investment to contract for the third consecutive year. Despite regulatory forbearance and a massive recapitalization program, the financial sector remains vulnerable. While the government announced its commitment to fiscal consolidation, continued budget overruns will further deplete the already shrinking Reserve Fund.*



## 1.1 Growth - Economic Recovery Delayed

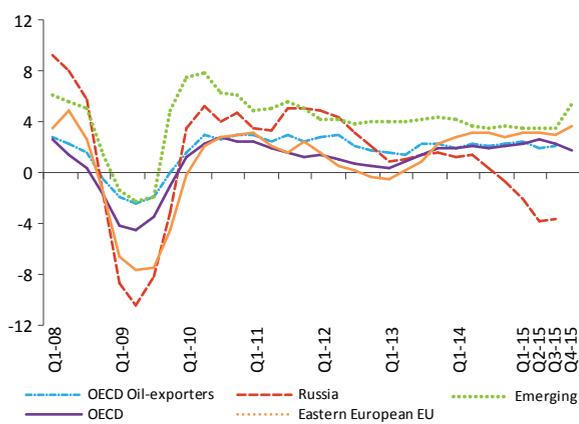
Russia's efforts to cope with the economic and macro-fiscal impacts of oil-price shocks and economic sanctions dominated economic developments in 2015. As the adjustment began, a sharp drop in income reduced consumer and investment demand, causing Russia's real GDP to contract by an estimated 3.7 percent in 2015. A second oil-price shock in August 2015 delayed the anticipated economic recovery.

**R**ussia's dependence on oil exports proved to be a serious liability in 2015, as an increasingly adverse external environment resulted in a severe economic contraction (Figure 1). Global growth once again fell short of expectations, decelerating from a rate of 2.6 percent in 2014 to an estimated 2.4 percent in 2015, as a slowdown in major emerging markets and developing economies offset a modest recovery in high-income countries. Subdued global trade, bouts of financial market volatility and weakening capital flows contributed to a deteriorating external environment for most emerging economies (Box 1). Moreover, the decline in oil prices has persisted well beyond initial expectations, and excess supply capacity in the global hydrocarbon market, policy decisions among major oil producers and a secular growth deceleration in key emerging markets have spurred a further decline in oil prices since mid-2015 (Box 2). This second oil-price shock, which occurred amid a worsening growth outlook for emerging markets,

had a negative impact on Russia's oil-dependent economy. Russia's economy contracted by an estimated 3.7 percent of GDP in 2015. Russia's ongoing recession is negatively affecting other countries in the region through reduced trade, remittances and capital flows.

**As with other oil exporters, an adverse external environment continues to threaten Russia's economic stability, but fiscal challenges now outweigh macroeconomic issues.** Key challenges for oil exporters include weakening current-account balances (Azerbaijan and Colombia) and depreciating exchange rates (Kazakhstan and Angola), which in some cases have prompted the imposition of foreign-exchange controls (Azerbaijan and Nigeria). Other challenges include accelerating inflation, tighter monetary policies, falling government revenues, and depleted fiscal buffers (Russia and Mexico). Risks to Russia's fiscal position may be exacerbated by the oil-price assumption of US\$50 per barrel used in the current budget, which significantly exceeds the World Bank's projected average of US\$37 per barrel for 2016. Russia had built up significant fiscal buffers that could have enabled it to cope with a transient terms-of-trade shock, but the persistence of the current downturn in global oil prices has already severely strained its reserves. Russia will have difficulty meeting its 2016 deficit target of 3.0 percent of GDP, and the necessity of financing budget overruns will further deplete the country's Reserve Fund. Coping with lower public revenues, continuing the process of fiscal consolidation and managing lingering inflationary pressures will remain key policy challenges over the medium term.

Figure 1: GDP growth, year-on-year, percent



Source: OECD.

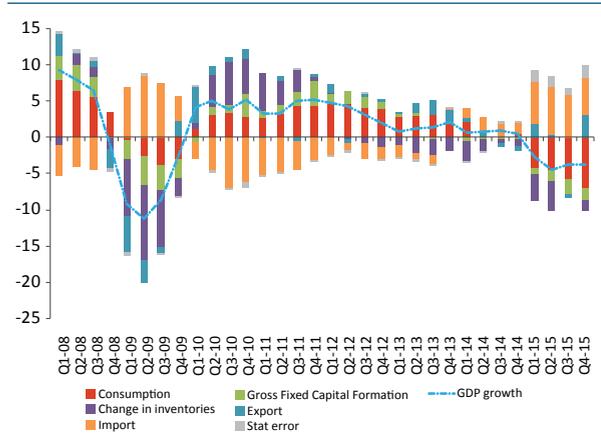
Note: Eastern European EU economies include the Czech Republic, Estonia, Hungary, Poland, Slovakia and Slovenia. Emerging economies include Brazil, China, India, Indonesia, Mexico, South Africa and Turkey. OECD oil exporters include Australia, Canada, Chile, the Netherlands, Norway and the US.

**The Russian economy adjusted to the worsening external environment through a sharp drop in income, which weakened consumer demand and discouraged investment.** Gross domestic income is estimated to have dropped by about 10 percent, primarily due to negative terms-of-trade effects. Persistently low oil prices resulted in a steep depreciation of the ruble. The free-floating exchange rate enabled imports to rapidly adjust, with a 25.7 percent decline in import volumes boosting net exports in 2015 (Figure 2), yet the ruble’s depreciation also led to double-digit inflation. The consequent decline in household purchasing power—as real wages and incomes did not keep track with inflation trends—sharply reduced consumption by an estimated 7.5 percent in 2015, its first contraction since the global financial crisis in 2008. The authorities’ efforts to manage inflationary pressures slowed the pace of monetary easing, and the central bank has kept its key policy rates at 11 percent since August 2015. The economic sanctions imposed on Russia have been extended, limiting access to global financial markets, restricting capital inflows and depressing private sector confidence. High capital costs and plummeting consumer demand have given Russian firms little incentive to expand, and as a result, gross capital

formation dropped by 18.7 percent in 2015, contracting for the third consecutive year.

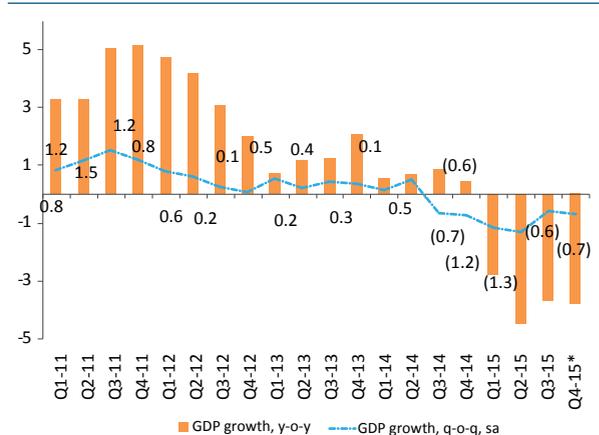
**The difficult economic adjustment pushed Russia into a deep recession, which reached its nadir in the second quarter of 2015.** The contraction in seasonally adjusted quarterly GDP accelerated from 0.7 percent in the last quarter of 2014 to 1.2 and 1.3 percent in the first and second quarters of 2015, respectively (Figure 3). However, expectations that Russia’s economy would bottom out in the third quarter of 2015 did not materialize,<sup>1</sup> and an unanticipated second oil-price shock that began in August 2015 delayed the recovery. The renewed depreciation of the ruble increased inflationary pressures and slowed the pace of monetary easing, extending the slump in domestic demand. As a result, Russia’s economy remained in recession during the second half of 2015, contracting by a seasonally adjusted 0.6 percent in the third quarter and an estimated 0.7 percent in the fourth quarter. By end-2015 Russia’s economy had contracted for six consecutive quarters, reflecting a cumulative decline in real GDP of about five percent since June 2014, while real GDP fell below the level observed in the third quarter of 2011.

Figure 2: Demand composition of GDP growth, year-on-year, percent



Source: Rosstat.

Figure 3: GDP growth, year-on-year and quarter-on-quarter, seasonally adjusted, percent



Source: Rosstat. \*World Bank staff estimates.

<sup>1</sup> The industrial sector was expected to benefit from a favorable adjustment in relative prices, lifting the economy out of its recession in the second half of 2015. But industry growth remained negative throughout the year, while the contraction of industrial output ceased as the sector went from an 8 percent contraction in June to zero growth in October. Business-confidence surveys revealed weakening sentiments, and the Purchasing Managers’ Index for manufacturing continued to fall for most of 2015.

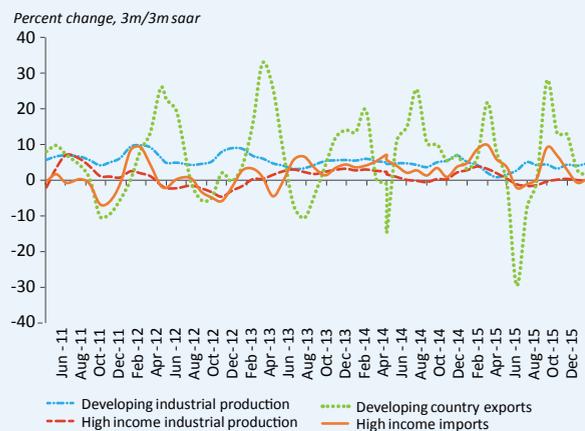
**Box 1 Global economic trends**

**Global growth weakened again in 2015. Growth in the US and the Eurozone failed to meet expectations, and Japan's economy contracted.** Meanwhile, China continued its deceleration, and Brazil and Russia remained in deep recessions. In the fourth quarter of 2015 global growth is estimated to have slowed to just under 1.4 percent (quarter-on-quarter, annualized), its lowest level since the euro zone crisis of 2012. By contrast, fourth-quarter growth accelerated in parts of East Asia and Western Europe. Global manufacturing activity remained subdued. In 2015, the sector's growth rate was less than half its 5-year average, and changes in the manufacturing Purchasing Managers' Index in January 2016 reflected contractions across major emerging markets and weakening growth in advanced economies (Figure 4).

**Global trade remains weak.** Despite a modest ongoing recovery in some advanced economies, global trade remained subdued throughout 2015, due largely to falling import demand among large commodity-exporting emerging markets such as Brazil and Russia. The increasingly pronounced rebalancing of the Chinese economy compounded this trend, negatively affecting both exports and imports. Given anemic global demand, exchange-rate depreciations have yielded limited benefits for exporters while contributing to rising costs and slowing import growth. The slow growth of global trade flows not only reduces export opportunities in the short term, but also inhibits the realization of productivity gains through increased specialization and technological transfer over the medium term. International capital flows have diminished and global equity markets remain at multi-year lows. Capital inflows to developing countries slowed to US\$763 billion in 2015, down from US\$1.3 trillion in 2014. 2015 was also the third consecutive year of net outflows from emerging market funds, as a combination of tumbling commodity prices, investment-risk rating downgrades and concerns about rising borrowing costs negatively impacted emerging-market assets. Global investors pulled a record US\$76 billion (net) from emerging market bond and equity funds, exceeding the US\$69 billion withdrawn during the global financial crisis. Outflows from emerging market bond and equity funds continued through early 2016 at a slightly faster pace for fixed income than for stocks. International bond sales by sovereign and corporate borrowers from developing countries dipped to the lowest January level since 2009, though spreads remained relatively high, as rising risk aversion pushed up borrowing costs (Figure 5). Global equity markets lost 5.5 percent of their value in January and remained near multiyear lows in February, especially oil and gas companies and banks, further tightening financing conditions.

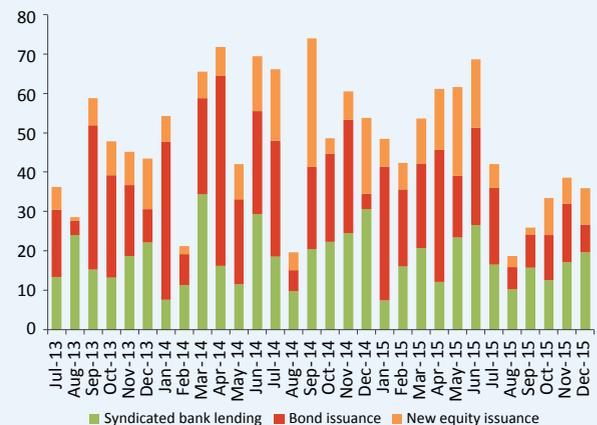
**Currency adjustments are ongoing.** Diverging monetary policies and growth prospects across advanced, emerging and developing economies are driving these adjustments. The dollar continued to strengthen as the US Federal Reserve raised its policy interest rate by 25 basis points in December, the first increase in nearly a decade, while the euro zone, Japan and China eased their monetary policies. The currencies of key commodity exporters (including South Africa, Russia, Brazil, Colombia and Malaysia) fell to multiyear lows at the start of 2016 as a result of the strong dollar and weak commodity prices. While currency depreciations can insulate countries against terms-of-trade shocks, they can also intensify balance-sheet pressures when combined with large dollar-denominated liabilities. The post-crisis credit boom has left many firms in emerging markets highly leveraged and vulnerable to a combination of weakening growth, rising borrowing costs and currency depreciation.

**Figure 4: Global industrial production and trade growth, percent change**



Source: Datastream and World Bank Prospects.

**Figure 5: Gross capital flows to developing countries, US\$ billions**



Source: Dealogic and World Bank Prospects Group.

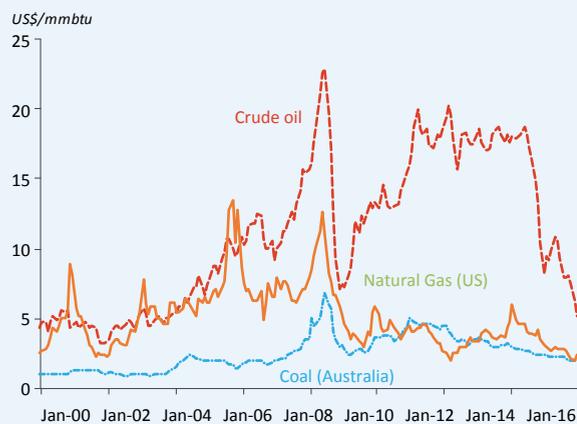
**Box 2 Global oil-price trends**

**Global oil prices dropped from a high of over US\$100 per barrel in the first half of 2014 to about US\$40 per barrel in August 2015 and reached a 13-year low of less than US\$30 per barrel in January 2016.** Oil prices continued to decline in the second half of 2015, even as investment and output in the US shale oil sector plummeted. Low oil prices impacted other energy markets, especially the European and Asian natural gas markets (Figure 6). These spillover effects have further negative implications for Russian energy exports. By end-2015, three key World Bank commodity-market indexes—energy, metals and agricultural raw materials—were down an average of about 40 percent from their 2011 peaks. Metal prices remained low due to high inventories and weakening Chinese demand.

**The protracted drop in oil prices reflects a combination of supply- and demand-side factors.** On the supply side, the ongoing shale oil and fracking boom in the US dramatically boosted global output, more than offsetting declines in Libya, Syria and Yemen (Figure 7). Meanwhile, Iranian exports rose more steeply than expected in the wake of the recent multilateral agreement regarding the country’s nuclear program. OPEC’s December 2014 decision to defend its market share eliminated the only plausible avenue for stabilizing supply in the short term. Instead, increasing production in Saudi Arabia and Iraq pushed OPEC’s total output to a record 33 million barrels per day in January following the group’s formal abandonment of its 30-million-barrel-per-day target. On the demand side, high OECD inventories, a mild winter in the Northern Hemisphere and slowing growth among major oil importers put further downward pressure on prices, which continued to fall through January 2016.

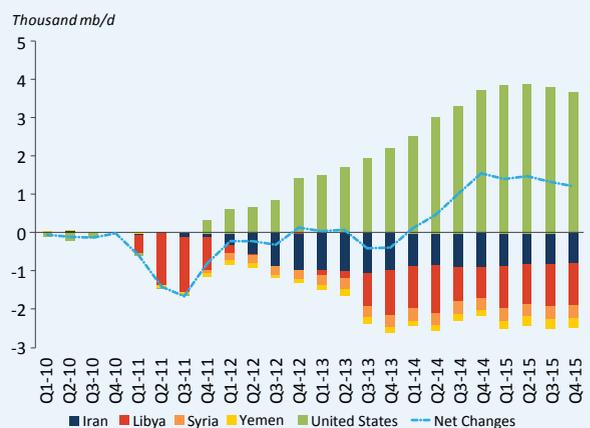
**There are signs that the slump in global oil prices may be slowly approaching its end, as overall production growth is declining, while low prices have encouraged increased consumption.** US shale oil production is slowly decelerating, though efficiency gains have increased the sector’s resilience, and other global producers are also maintaining high output levels despite sharp cutbacks in overall investment. Discussions regarding a possible coordinated supply cut by Saudi Arabia, Russia and some smaller oil exporters have yet to yield an agreement. Nevertheless, global oil production growth fell by 50 percent in the fourth quarter of 2015 compared to the average for the first three quarters. Most fourth-quarter output gains came from OPEC countries (Iraq and Saudi Arabia), following ten consecutive quarters in which non-OPEC countries (especially the US) posted the largest increases in production. Finally, while slowing economic growth depressed global oil demand, the sheer magnitude of the drop in oil prices—two-thirds of which was attributable to increased supply—has spurred consumption growth, which reached a five-year high of 1.8 percent in 2015 despite weakening slightly in the fourth quarter.

**Figure 6: Global energy prices, US\$/mmbtu**



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

**Figure 7: Crude oil supply growth, mb/d**



Source: World Bank and International Energy Agency.

**A second terms-of-trade shock in 2015 further weakened the ruble and prolonged the negative impact of its devaluation on household consumption.** The pass-through effect combined with restrictions on food imports in 2014 led to double-digit inflation in the first half of 2015. At the same time, insignificant nominal wage growth in the private sector and the limited indexation of public wages and transfers<sup>2</sup> (Section 1.5) caused household consumption to plummet by an average of 7.5 percent, year-on-year, in the first half of 2015. The renewed depreciation of the ruble began in August 2015 and intensified in November-December, prolonging the negative impact of the terms-of-trade shock on household purchasing power. The deterioration of real incomes in a context of persistently high interest rates diminished the capacity of households to service debt or take out new loans.<sup>3</sup> As a result, consumer demand remained deeply depressed in the second half of 2015, contracting by an estimated 11.4 percent, year-on-year. Exacerbated by a slight reduction in government consumption, total consumption contracted by 7.5 percent and reduced growth by 5.4 percentage points in 2015, more than

double its marginal impact during the global financial crisis (Table 1).

**Investment continued to decline sharply in the second half of 2015.** Throughout the year, the private sector scaled down investments as demand slackened. Meanwhile, the economic sanctions regime restricted access to global capital markets and chocked off foreign investment, while the costs of domestic credit remained elevated due to the suspension of monetary easing (Section 1.3). An expenditure-focused fiscal adjustment did nothing to reinforce household incomes or stimulate investment (Section 1.4). As a result, gross fixed capital investment dropped by 7.6 percent, year-on-year, trimming 1.6 percentage points from overall growth. Russian producers cut inventories sharply as consumer demand plummeted, particularly in the first two quarters of 2015.<sup>4</sup> Inventory destocking reduced annual growth by 2.3 percentage points, and its contribution was negative in all four quarters of 2015. Consequently, gross capital formation dropped by 18.7 percent, cutting 3.9 percentage points from GDP growth, more than in 2013 and 2014 combined.

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

	2007	2008	2009	2010	2011	2012	2013	2014	2015
GDP growth, percent	8.5	5.2	-7.8	4.5	4.3	3.5	1.3	0.7	-3.7
Consumption	7.4	5.7	-2.6	2.6	3.7	4.1	2.1	1.0	-5.4
Households	6.9	5.1	-2.5	3.0	3.5	3.6	1.8	0.9	-5.1
Government	0.5	0.6	-0.1	-0.3	0.3	0.5	0.3	0.1	-0.3
Gross capital formation	4.7	2.5	-10.5	5.4	4.7	1.0	-1.8	-1.4	-3.9
Fixed capital investment	3.9	2.2	-3.2	1.3	2.0	1.3	0.2	-0.1	-1.6
Change in stocks	0.8	0.3	-7.2	4.1	2.8	-0.3	-2.0	-1.3	-2.3
Exports	2.1	0.2	-1.5	2.0	0.1	0.4	1.4	0.1	1.0
Imports	-5.5	-3.2	6.7	-5.3	-4.3	-2.1	-0.5	1.3	5.4

Source: Rosstat and World Bank staff calculations.

<sup>2</sup> Pensions were indexed by 11 percent, while public wages were not indexed at all.

<sup>3</sup> The loan-default rate for households rose from 8.9 percent in November 2014 to 11.6 percent in November 2015, and banks limited consumer lending (Section 1.3).

<sup>4</sup> The pace of destocking slowed in the second half of 2015, as quarter-on-quarter contractions in consumer demand decelerated and the costs of imported inputs stabilized.

**Box 3 The production structure of GDP growth in 2015**

The nontradable and tradable sectors both contributed negatively to GDP growth in 2015, as domestic demand dampened (Figure 8). Falling consumer demand hit the service sector especially hard. Trade—the Russian economy’s largest subsector—contracted by 10.0 percent, from a 1.4 percent growth rate in 2014. Other services contracted at a similar pace, and the poor performance of nontradables reduced sectoral growth by 2.6 percentage points in 2015, compared to a positive contribution of 0.4 percentage points in the previous year. Weak domestic demand also deepened the manufacturing sector’s contraction to 5.1 percent, year-on-year, compared to a positive growth rate of 0.6 percent in 2014 (Figure 9). This contraction more than offset robust agricultural growth and a slight expansion in the extractive industries, and together the tradable sectors reduced overall growth by a net 0.5 percentage points.

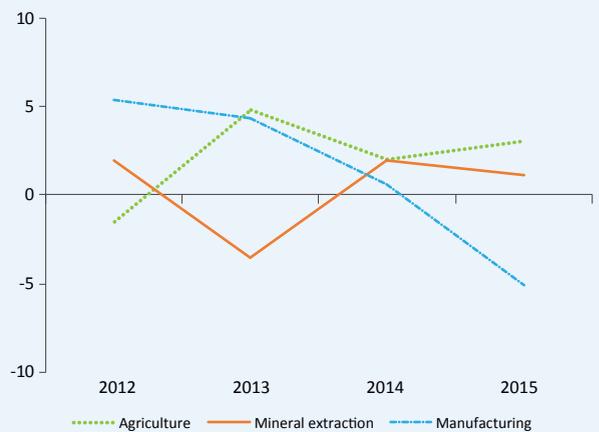
Some industries were able to take advantage of the weaker ruble to increase output and exports, but most manufacturing sectors continued to contract in 2015. Most manufacturers—who might normally be well positioned to benefit from import substitution—continued to see demand for their products fall. Here the depreciation’s positive benefits were unable to compensate for the collapse of domestic demand. Only the agricultural sector expanded notably by 3.1 percent in 2015, benefiting largely from the Russian food import ban. The sharp relative price adjustment bolstered the competitiveness of certain exports, particularly non-energy commodities such as coal, metals and chemicals, and investment and employment statistics for 2015 indicate increased factor allocation to those sectors (Figure 10 and Figure 11). However, investment in manufacturing remained negative due to spare capacity, structural rigidities, and the surging cost of imported intermediate goods.

**Figure 8: Contribution to GDP growth by sector, percent**



Source: Rosstat and World Bank staff calculations.

**Figure 9: Growth in tradables, value, added, year-on-year, percent**



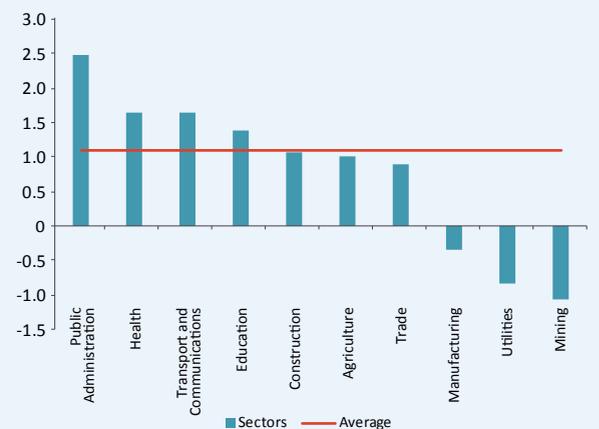
Source: Rosstat.

**Figure 10: Fixed investment growth by sector, 2015, year-on-year, percent**



Source: CBR, Haver.

**Figure 11: Employment growth by sector, 2015, year-on-year\*, percent**



Source: Rosstat, Haver, Analytics and World Bank staff estimates.

\*Data for 2015 include Crimea, which accounts for the increase in total employment in 2014.

**Rapidly falling imports drove an increase in net exports in 2015, yet this was not sufficient to compensate for the contraction in domestic demand.** Imports dropped dramatically as the depreciation of the ruble increased their relative cost, adding 5.4 percentage points to overall growth. Nevertheless, the import contraction decelerated in the second half of 2015, especially in the last quarter. The continued depreciation of the ruble also boosted export performance in certain sectors, including chemicals and oil products (Box 3). Export volumes grew by an

estimated 9.8 percent, year-on-year, in the last quarter of 2015, up from an average of just 1.6 percent in the first three quarters. As a result, total export volumes grew by 3.6 percent in 2015,<sup>5</sup> contributing 1.0 percentage points to growth. Coupled with the sharp import contraction, this pushed the positive contribution of net exports to growth to 6.4 percentage points in 2015, a fourfold increase over the previous year. These trends made net-exports the principal driver of growth dynamics in 2015.

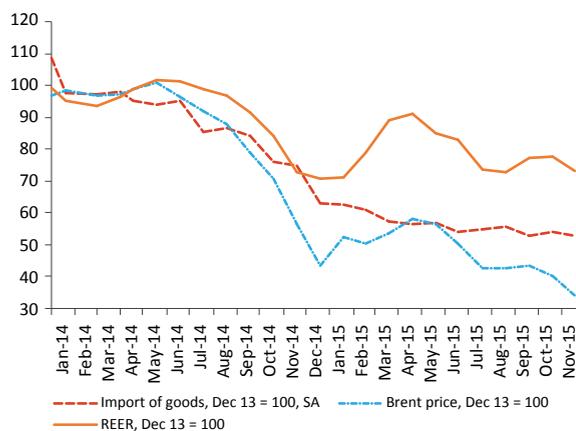
## 1.2 Balance of Payments– Swift Import Adjustment Supports the Current Account

*The Balance of Payments remained stable despite adverse terms-of-trade shocks and restricted access to international capital markets. The current-account surplus nearly doubled from 2.8 percent of GDP in 2014 to 5.2 percent in 2015, as imports swiftly adjusted to the ruble depreciation and the investment and labor income balances improved. Meanwhile, net capital outflows moderated from 7.4 percent of GDP in 2014 to 4.4 percent in 2015.*

**Russia’s external balances adjusted smoothly to external shocks, as the flexible exchange rate facilitated a rapid decrease in imports.** The flexible exchange-rate regime enabled the real effective exchange rate (REER) to adjust rapidly to commodity-price shocks in 2015, resulting in a 16.5 percent depreciation and a simultaneous drop in import demand (Figure 12). The current account surplus rose from US\$58.3 billion in

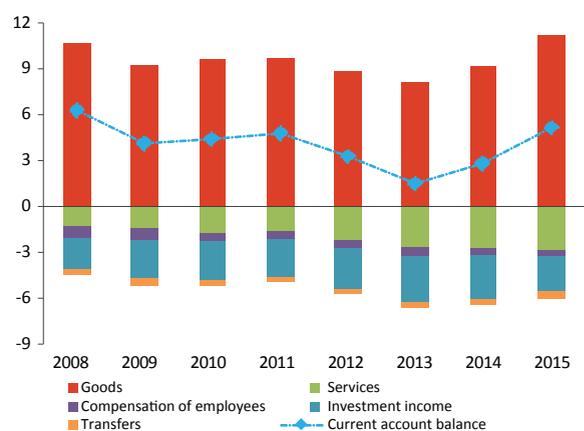
2014 to US\$69.6 billion in 2015, almost doubling as a share of GDP<sup>6</sup> from 2.8 percent in 2014 to 5.2 percent in 2015 (Figure 13). The nonoil current-account deficit improved from US\$266.7 billion in 2014 to US\$129.3 billion in 2015—or from 13.0 percent of GDP to 9.8 percent—due to the drastic reduction in imports coupled with improved investment and labor income balances.

Figure 12: Goods imports, the REER and oil prices



Source: CBR and Haver.

Figure 13: The composition of the current-account balance, percent of GDP



Source: CBR and World Bank staff estimates.

<sup>5</sup> National accounts data reflect export growth by volume and value added. These figures may differ significantly from export values reported in the balance-of-payments data, which are based on volume and export prices.

<sup>6</sup> The relative improvement in the current-account balance was also the result of the depreciation, which caused Russia’s GDP to drop by 35.4 percent in dollar terms.

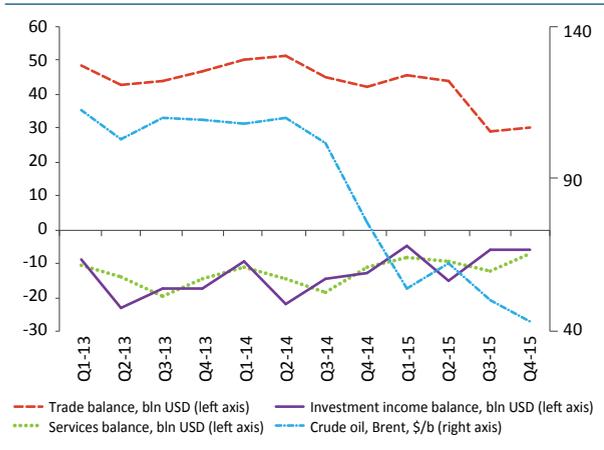
**The total value of goods imports dropped by 37.4 percent in 2015, from US\$308.0 billion to US\$193.0 billion.** This was due not only to imports becoming relatively more expensive, but also to the weakening of import demand due to the ongoing recession and restrictions on food imports. Ultimately, the sharp reduction in goods imports could not fully compensate for falling export revenues, narrowing the trade surplus from US\$189.7 billion to US\$148.5 billion. Oil and gas export receipts dropped by 38.8 percent, from US\$325.0 billion in 2014 to US\$198.9 billion in 2015, reflecting a 47.0 percent decline in the average (Brent) oil price. The value of non-energy exports decreased by 17.5 percent, from US\$172.8 billion in 2014 to US\$142.6 billion in 2015, as global prices for non-energy commodities fell and manufacturing exporters decreased prices in dollar terms. The services balance improved significantly, as a decline in service imports, mainly tourism abroad, exceeded a drop in service exports (Figure 14).

**The volume of non-energy exports increased, though the value of those exports dropped substantially.** Customs data indicate that the volume of non-energy exports increased, year-on-year, during the first three quarters of 2015, in particular for non-energy commodities such as wood and metals, which grew by an average of 7.7 and 3.1 percent, respectively, as well as

for a small number of manufactures, especially chemicals (5.6 percent) and machinery (0.4 percent). Export volumes for food products and textiles declined by an average of 4.3 percent and 6.2 percent, respectively. The special focus chapter included in this edition of the Russia Economic Report examines recent export trends in greater detail.

**The continued deleveraging of external debt and a decline in remittance outflows also supported the growth of the current-account surplus.** A substantial reduction in net external liabilities reduced outbound interest and dividend payments, nearly halving the investment income balance from US\$58.0 billion in 2014 to US\$31.6 billion in 2015. Russia’s net external liabilities had already decreased by US\$58.2 billion in the second half of 2014 when the economic sanctions regime curbed access to international capital markets, and in 2015 net external liabilities declined by a further US\$73.4 billion. The extension of the economic sanctions regime, coupled with low oil prices and negative growth, has kept external borrowing costs for Russian firms elevated. Russia’s 5-year credit-default swap (CDS) spread exceeded 300 basis points for most of 2015, up from 170 basis points in early 2014 (Figure 15). In 2015 Standard & Poor and Moody’s both downgraded Russia’s sovereign rating to below investment grade, while Fitch

Figure 14: Oil prices and the trade, services and investment-income balances



Source: CBR, Bloomberg and World Bank staff estimates.

Figure 15: Russia’s 5-year CDS spreads

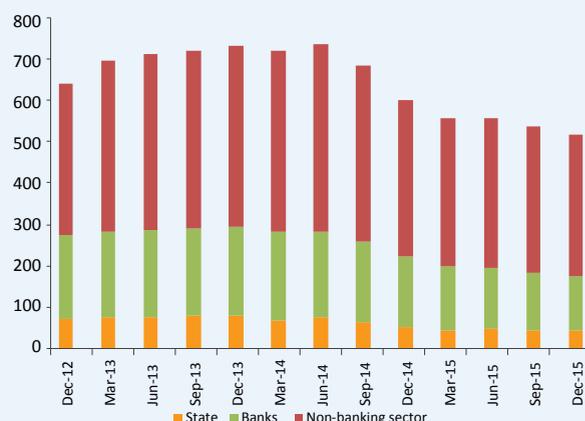


Source: Bloomberg.

**Box 4 External debt trends**

Russia's external debt decreased by about 10.0 percent adjusted for reevaluation effects to US\$515.9 billion at end-2015 from US\$599.9 billion at end-2014 (Table 2). External government debt dropped from US\$41.6 billion at end-2014 to US\$30.6 billion at end-2015. While non-residents sold off government bonds, the authorities refrained from new international borrowing and continued to make scheduled debt payments (Figure 16). After adjusting for the depreciation of the ruble, the total public debt stock dropped by 16.0 percent between end-2014 and end-2015.

The banking sector's total external debt, adjusted for depreciation, shrank by 16.8 percent between end-2014 and the end of the quarter three in 2015. This followed a drop of 11.6 percent in the second half of 2014, when the imposition of economic sanctions prompted faster external debt reduction by state-owned banks relative to private banks. However, this trend reversed in 2015, as higher interest rates, the rising cost of ruble-denominated debt service, and the stalled growth of foreign-currency credit to the nonbanking sector forced private banks to deleverage faster than state-controlled banks. State-owned companies in the non-banking sector also deleveraged faster in the second half of 2014 than in the first three quarters of 2015, while deleveraging in private firms slowed. Large scheduled debt payments among non-financial firms in the fourth quarter of 2015 (Table 3) only modestly increased pressure on the financial account, as firms managed to roll over about 60 percent of their debt. Overall, the devaluation-adjusted external debt stock of banks and non-bank firms fell by 8.2 percent in the second half of 2014 and by 7.2 percent in the first three quarters of 2015.

**Figure 16: Debt to non-residents, US\$ billion**


Source: CBR.

**Table 2: The external debt stock, 2014–2015, US\$ billion**

	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
Total debt	728.9	715.9	732.8	680.9	599.9	556.2	555.6	536.5	515.9
Corporate	651.2	646.8	659.4	615.7	547.7	510.9	509.3	494.4	474.3
Banks	214.4	214.0	208.9	192.3	171.5	154.2	148.9	140.0	131.7
of which Private Banks	81.4	76.3	73.5	69.1	63.4	53.6	51.1	47.3	
Non-financial corporations	436.8	432.7	450.6	423.4	376.2	356.7	360.4	354.4	342.6
of which Private Non-fin. Corporations	271.6	264.1	279.7	260.2	230.8	224.0	228.4	212.7	

Source: CBR. End of the month data.

**Table 3: Russia's external debt-service schedule, 2015–2017, US\$ billion**

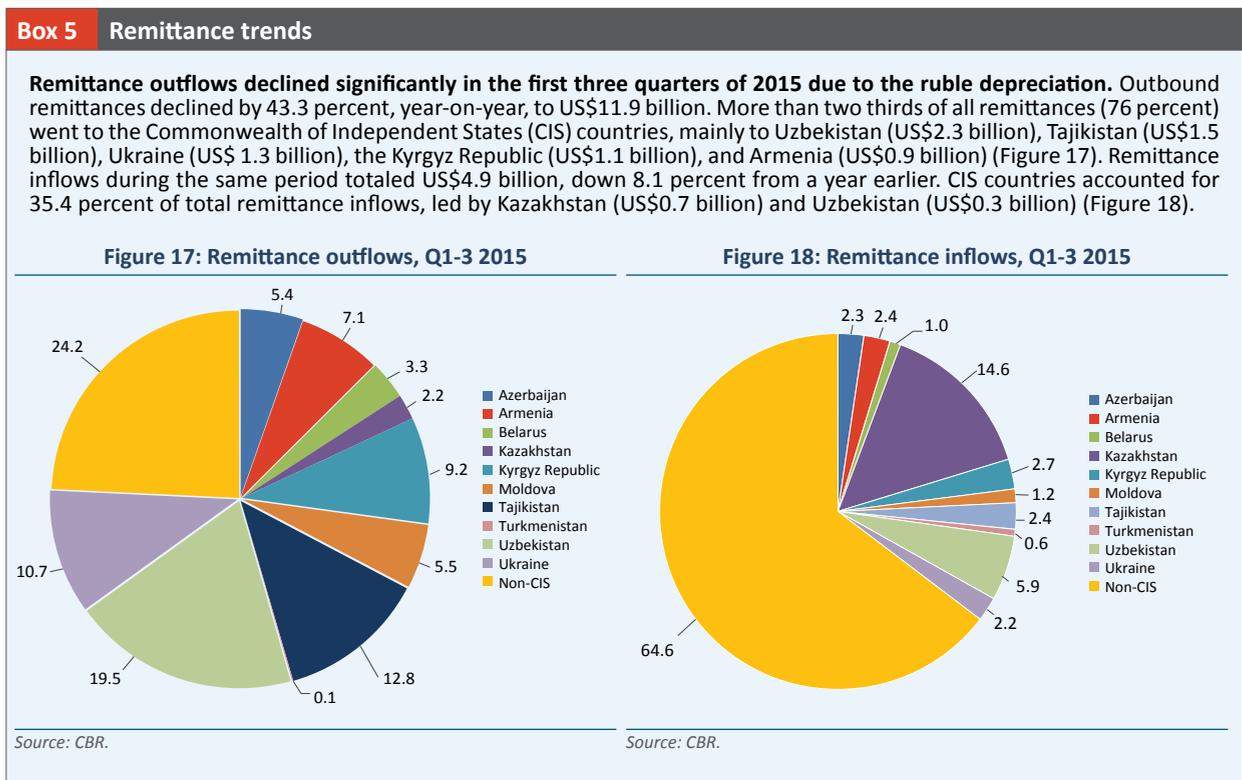
	Q4 2015	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017
Government	1.0	0.9	0.6	0.9	1.1	0.7	2.2	0.8
Banks	10.7	5.6	7.3	7.1	5.0	6.9	8.1	3.9
Non-banking sector	30.8	19.5	19.2	13.3	18.8	13.9	14.0	9.1
Total	43.0	26.0	27.1	21.3	24.9	21.6	24.2	13.8

Source: CBR.

reduced Russia’s sovereign debt rating to the lowest level in the investment-grade range. These developments amplified deleveraging across all sectors of the Russian economy. The value of Russia’s external debt dropped from US\$599.9 billion at end-2014 to US\$515.9 billion at end-2015 (Box 4), yet its external debt burden grew in relative terms, rising from 43.3 to 46.8 percent of GDP and from 12.8 to 15.7 months of exports. This increase in the relative size of the debt burden also implies that deleveraging will continue for some time. Finally, a drop in outbound remittances halved the labor-income deficit, which fell from US\$10.1 billion in 2014 to US\$5.1 billion in 2015, as the number of migrant and expatriate workers declined and the depreciation diminished the value of remittances in dollar terms (Box 5).

**Moderating net capital outflows helped improve the financial- and capital-account balances and eased pressures on international reserves.** Deleveraging continued, and private sector net

liabilities dropped by US\$67.0 billion—including US\$59.8 billion in the banking sector alone. A dramatic decline in net acquisitions of foreign assets, which dropped from US\$121.9 billion in 2014 to a negative US\$3.4 billion in 2015, drove the decline in net capital outflows between 2014 and 2015. The banking sector shed foreign assets to service external debt, while a 4.2 percent decrease in corporate profits and a 33.0 percent decrease in household income (in dollar terms) limited opportunities for non-financial firms and households to invest in foreign assets.<sup>7</sup> Outbound foreign direct investment (FDI) more than halved to US\$21.6 billion in 2015, while inbound FDI dropped from US\$22.0 billion to US\$4.8 billion. Finally, foreign-currency acquisition by households and nonfinancial firms dropped by US\$19.7 billion in 2015, compared to an increase of US\$41.8 billion during in 2014, as confidence in the ruble strengthened despite its continued depreciation. Overall, net capital outflows returned to their 2012–2013 levels, falling from US\$151.6 billion in 2014 to



<sup>7</sup> The implementation of the government’s new de-offshoring law at end-2014 and the mandated reduction in net foreign assets by oil exporters and other state-owned companies further curtailed net foreign-asset acquisition.

Table 4: Net capital flows, 2010–2015 (US\$ billions)

	2010	2011	2012	2013	2014	2015	Q1 2015	Q2 2015	Q3 2015	Q4 2015
Total net capital inflows to the private sector	-30.8	-81.4	-53.9	-61.6	-151.6	-58.5	-33.1	-18.6	3.1	-10.0
Net capital inflows to the banking sector	22.8	-27.5	7.9	-17.3	-86.0	-34.0	-14.2	-12.6	-10.9	3.7
Net capital inflows to the non-banking sector	-53.6	-53.8	-61.8	-44.4	-65.6	-24.5	-18.9	-6.0	14.0	-13.6

Source: CBR.

Table 5: The balance of payments, 2010–2015, US\$ billions

	2010	2011	2012	2013	2014	2015	Q1 2015	Q2 2015	Q3 2015	Q4 2015
Current account balance	67.5	97.3	71.3	33.4	58.3	69.6	30.0	16.6	8.0	15.0
Trade balance	147.0	196.9	191.7	180.6	189.7	148.5	45.5	43.7	28.9	30.3
Non-oil current account balance	-186.6	-244.5	-275.5	-316.1	-266.7	-129.3	-24.1	-38.3	-37.9	-29.0
Capital and financial account	-21.6	-76.0	-30.9	-46.6	-173.8	-72.9	-37.5	-19.6	-2.6	-13.2
Errors and omissions	-9.1	-8.7	-10.4	-8.9	8.0	5.0	-2.6	0.8	4.4	2.5
Change in reserves (- = increase)	-36.8	-12.6	-30.0	22.1	107.5	-1.7	10.1	2.2	-9.7	-4.3
Memo: average oil price (Brent, US\$/barrel)	79.7	111.1	112.0	108.9	98.9	52.4	53.9	62.1	50.0	43.4

Source: CBR.

US\$58.5 billion in 2015 (Table 4). This reduced the financial- and capital-account deficit by two-thirds, from US\$173.8 billion to US\$72.9 billion. As the Central Bank of Russia (CBR) refrained from intervening in foreign-currency markets, with the exception of a one-time sale of US\$2.3

billion in reserves in January 2015, international reserves remained at a comfortable level of US\$368.4 billion at end-2015 (15.7 months of imports), compared to US\$385.5 billion (10.5 months of imports) at end-2014 (Table 5).

### 1.3 Monetary Policy and the Financial Sector – Addressing Policy Tradeoffs

*The Central Bank of Russia faced the difficult policy challenge of lowering inflation in line with its medium-term target without completely stifling credit growth in a struggling economy. The authorities addressed this challenge through a measured monetary-easing strategy. Regulatory forbearance continues to prevent a thorough analysis of macro-prudential indicators, and financial sector risks linger despite a massive recapitalization program.*

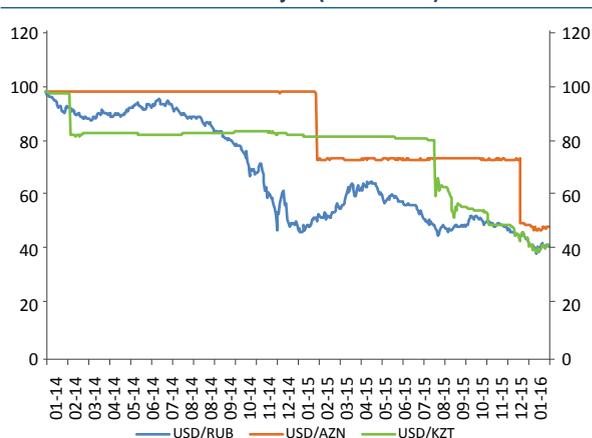
**A**dherence to the flexible exchange-rate regime helped to shield the country's foreign currency and fiscal reserves. The exchange rate remained well-aligned with prevailing economic conditions, facilitating the process of structural transformation. As foreign-exchange-liquidity pressures eased in 2015, oil prices again became

the key determinant of exchange-rate dynamics (Box 6). The ruble depreciated by 37.4 percent against the US dollar in 2015, while the average (Brent) oil price dropped by 47 percent. This led to a sharp REER depreciation which supported Russia's transition to a context of lower oil prices by allowing relative prices

to favor Russian producers and exporters. Meanwhile, the free float helped to keep the country's foreign currency reserves intact and the depreciation prevented a drain on fiscal reserves by limiting the negative impact on fiscal balances. By end-2015, the CBR's foreign-currency reserves remained strong at about 16 months of imports. This stands in contrast to the experience of other regional oil exporters such as Kazakhstan and Azerbaijan, which maintained fixed exchange rates throughout 2014 and most of 2015 despite falling oil prices, thereby depleting their reserves and running up large fiscal deficits<sup>8</sup> before allowing their currencies to depreciate<sup>9</sup> (Figure 19).

**Throughout 2015, Russia's monetary policies reinforced macroeconomic stability by slowly reigning in inflation.** A combination of monetary and nonmonetary factors kept inflationary pressures elevated throughout 2015. Nonmonetary factors, including the pass-through effect of the ruble's depreciation, the

Figure 19: Exchange-rate dynamics in Russia, Kazakhstan and Azerbaijan (2014 = 100)



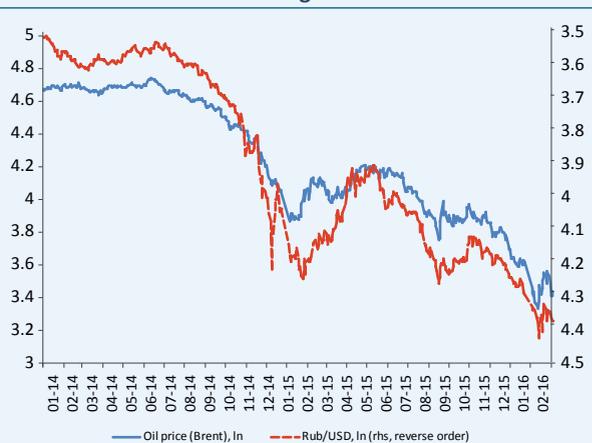
Source: CBR.

tariff increase in July and restrictions on food imports, boosted inflationary pressures in the second half of the year. This kept inflation expectations stubbornly high. As a result, inflation slowed but remained in double digits. The 12-month consumer price index (CPI) decreased from 15.0 percent in January 2015 to 12.9 percent in December (Box 7), yet it

**Box 6 Oil-price and exchange-rate dynamics**

As liquidity pressures eased in the second quarter of 2015, oil prices once again became the main driver of exchange-rate dynamics. The CBR restricted itself to a single US\$2.3 billion intervention in January, when oil prices reached record lows and the nominal exchange rate approached 70 RUB/US\$. From February to June, the free-floating ruble benefited as oil prices rallied. By May, it had appreciated by around 30 percent against the dollar and the exchange rate rebounded to around 50 RUB/US\$ (Figure 20). The ruble's appreciation allowed the CBR to launch a medium-term reserve-replenishing program in May, which called for daily purchases of US\$200 million to reach a goal of US\$500 billion by 2018. Between May and July, the CBR purchased a total of US\$10.1 billion in new reserves. However, depreciation pressures intensified in August and especially at the end of 2015, when oil prices declined further and geopolitical tensions increased. In December, the average oil price fell below US\$38 a barrel, and between May and December the ruble depreciated by 28 percent against the US dollar. In January 2016, oil prices dipped under US\$30 per barrel and the nominal exchange rate reached a record low of 83 RUB/US\$, yet the CBR refrained from intervening in the foreign-exchange market.

Figure 20: Changes in oil prices and the nominal exchange rate



Source: CBR and Haver Analytics.

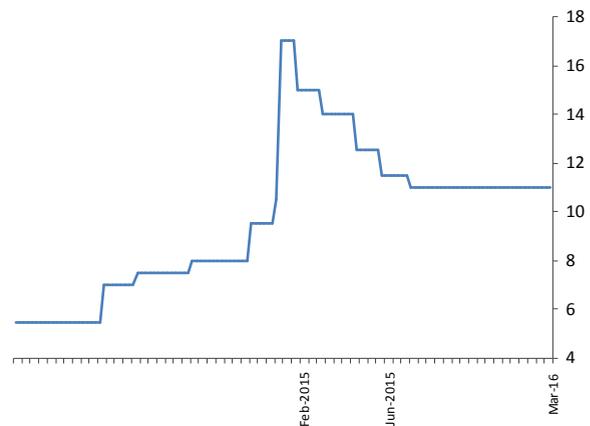
<sup>8</sup> Azerbaijan's reserves dropped from US\$13.8 billion (8.4 months of imports) at end-2014 to US\$5 billion (3.6 months of imports) at end-2015, while its fiscal balance deteriorated from a surplus of 2.7 percent of GDP to a deficit of 1.1 percent. Kazakhstan spent about 15 percent of its total reserves, including foreign assets in its sovereign wealth fund, which dropped from US\$100.8 billion at end-2014 to US\$91.3 billion at end-2015. At the same time, its fiscal balance deteriorated from a surplus of 0.9 percent of GDP to an estimated deficit of 6.6 percent.

<sup>9</sup> Kazakhstan moved to a flexible exchange rate regime in August 2015, while Azerbaijan introduced a flexible exchange-rate regime in December 2015 following a one-off depreciation of 25 percent in February.

continued to exceed the CBR’s target range of 8.2-8.7 percent established in December 2014. To manage inflationary pressures, the CBR slowed the pace of monetary easing in the second quarter of 2015 and discontinued the easing cycle altogether in August.

**In January 2015, the CBR launched a monetary-easing cycle designed to negotiate the tradeoff between successful inflation targeting and lower interest rates.** The CBR cut its key policy rate from a record high of 17 percent—a legacy of the currency crisis in December 2014—while keeping a close eye on inflation dynamics. In the first half of 2015, the CBR lowered the key policy rate by 600 basis points in five modest incremental adjustments (Figure 21), gradually easing monetary conditions (Box 8). Monetary easing substantially reduced financing costs on the interbank market, but the impact on credit growth was negligible. Credit growth continued to slow throughout the year, dropping from 25.9 percent, year-on-year, in December 2014 to 7.6 percent in December 2015 (Figure 25).<sup>10</sup> Dwindling credit growth also reflected greater risk aversion among banks, as falling asset values

Figure 21: Key policy rates, percent



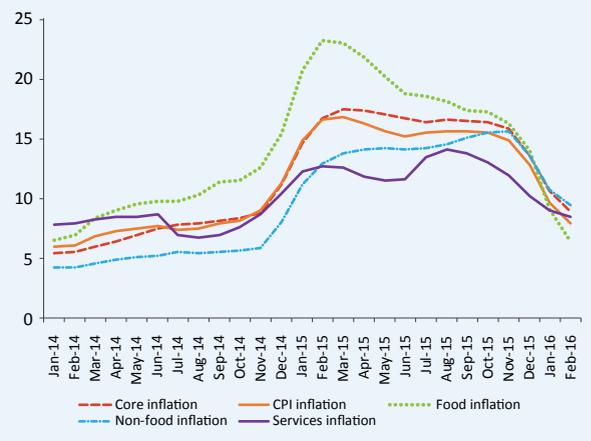
Source: CBR.

and a rising share of nonperforming loans (NPLs) negatively affected bank balance sheets. NPLs increased from 6.7 percent of total loans in January 2015 to 8.3 percent in December. Banks’ profit margins fell close to zero (Figure 26) despite regulatory forbearance. Many banks adjusted by reducing their credit portfolio, especially credit to households, which dropped by 5.7 percent, year-on-year, in December 2015, compared to an increase of 13.8 percent in December 2014.

**Box 7 Drivers of CPI inflation in 2015**

**Rising food prices drove CPI inflation in the first half of 2015, while persistently high core inflation was the key factor in the second half of the year.** Food-price inflation outpaced all other CPI components and proved highly sensitive to both the pass-through effect of the ruble’s depreciation and the impact of restricted food imports. Annual food-price inflation rose from over 20 percent in January 2015 to 23.3 percent in February, pushing headline inflation to a record high of 16.9 percent in March 2015 (Figure 22). Food-price inflation fell during the second half of the year, as the pass-through effect diminished and consumer demand weakened. As a result, 12-month food-price inflation slowed to 14 percent in December 2015. Through the second half of 2015 prices for non-food goods and services kept CPI inflation elevated. These two consumer price components climbed steadily through the third quarter due to the delayed impact of the ruble’s depreciation, keeping core inflation above 16 percent until November. Non-food inflation increased from 11.2 percent in January to a peak of 15.7 percent in November before sliding to 13.7 percent in December. The midyear tariff increase boosted service-price inflation, which rose from 12.3 percent in January to 14.1 percent in August before falling to 10.2 percent in December.

Figure 22: CPI inflation components, year-on-year, percent



Source: Rosstat.

<sup>10</sup> This can be largely attributed to the reevaluation effect on foreign-currency credit extended to nonfinancial firms.

**Box 8** Monetary dynamics in 2015

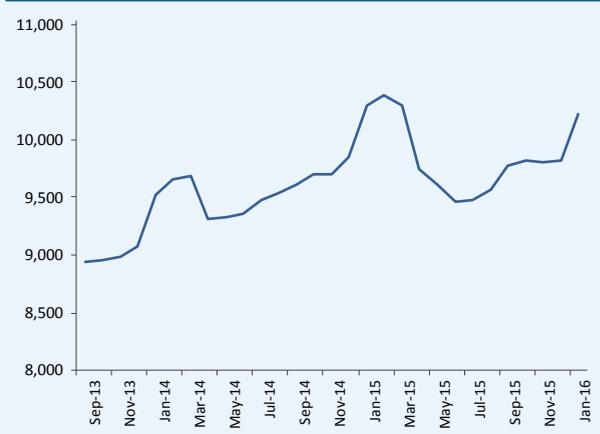
The CBR’s monetary-easing cycle began to measurably loosen monetary conditions beginning in the second quarter of 2015.<sup>11</sup> High interest rates adopted in late 2014 kept monetary conditions tight through the first quarter of 2015. The growth of the money supply (M2) decelerated, while broad money contracted sharply (Figure 23 and Figure 24). Monetary easing continued in the second half of 2015, but was suspended in August 2015 as a further decline in oil prices brought with it renewed depreciation pressures and inflationary risks. Average M2 growth accelerated in annual terms from 4.7 percent in the first quarter of 2015 to 9.5 percent in the fourth quarter. The monetization of the economy increased, with the M2-to-GDP ratio rising to 44.2 percent in the fourth quarter of 2015, a year-on-year increase of 1.4 percentage points. The CBR considers current monetary dynamics to be consistent with the achievement of its medium-term inflation target of 4.0 percent by end-2017.

**Figure 23: Money-supply dynamics**



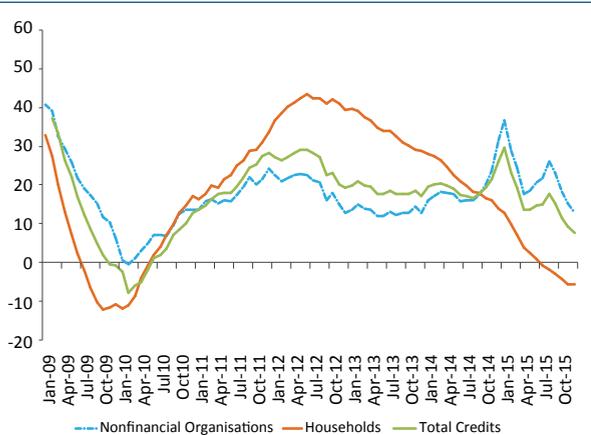
Source: CBR and World Bank staff calculations.

**Figure 24: Broad monetary base dynamics, 3-month moving average**



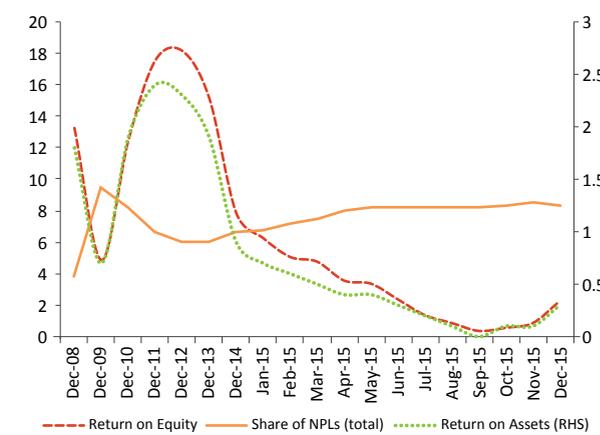
Source: CBR and World Bank staff calculations.

**Figure 25: Credit growth, year-on-year, percent**



Source: CBR and World Bank staff calculations.

**Figure 26: Profitability and credit risk, percent**



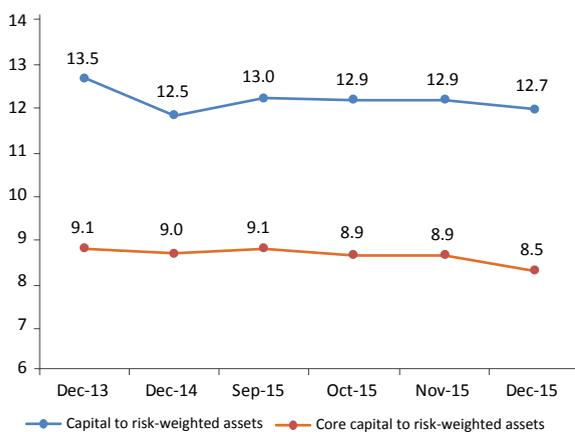
Source: CBR.

<sup>11</sup> The use of the Reserve Fund for budget financing was money supply neutral as it was sterilized by the central bank.

**The banking sector's financial indicators remain difficult to assess due to the CBR's regulatory forbearance.**<sup>12</sup> The return on equity among Russian banks dropped from 7.9 percent to 2.3 percent during the year, and decreasing profitability had an especially damaging effect on medium-to-large banks.<sup>13</sup> Thanks to a massive state recapitalization program<sup>14</sup> combined with regulatory forbearance, Russian banks appear to be adequately capitalized. The aggregate capital-adequacy ratio (CAR) remained stable in 2015

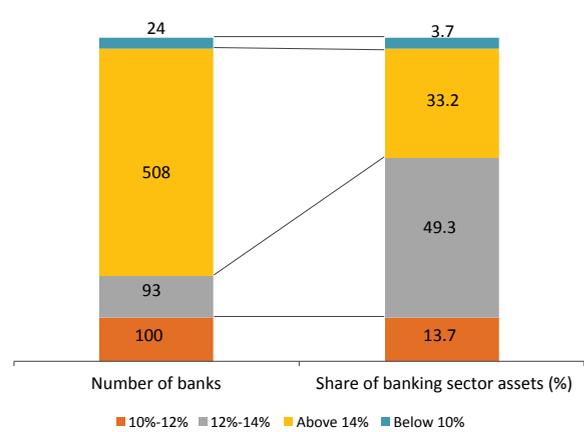
at between 12.5 and 13.0 percent (Figure 27), with almost all banks meeting the statutory 10 percent requirement (Figure 28). However, the CBR withdrew its forbearance in January 2016, and rising pressure on bank capital is expected to result in falling CARs among affected banks. Meanwhile, the CBR intensified its supervision of the banking sector,<sup>15</sup> and its delicensing of 93 financially unviable banks reduced the total number of banks from 834 to 733.

Figure 27: Capital adequacy ratio, end-of-period, percent



Source: CBR.

Figure 28: Distribution of banks by capital adequacy ratio, 2015



Source: CBR.

## 1.4 The Government Budget - Uncertainty in the Face of Unresolved Medium-Term Challenges

The federal budget deficit shot up from 0.4 percent of GDP in 2014 to 2.4 percent in 2015, prompting the authorities to draw down the Reserve Fund by almost half. The government declared a fiscal consolidation plan primarily focused on the expenditure side. Russia's fiscal position for 2016 remains uncertain as lower than projected oil prices are expected to lead to a broader revision of budgetary parameters during 2016.

**The federal deficit increased dramatically in 2015 due to the large drop in revenues, driven by rapidly shrinking oil and gas revenues.**

In 2014, the ruble's depreciation largely offset falling oil prices. However, the further depreciation of the exchange rate in 2015 could

<sup>12</sup> The CBR's forbearance includes allowing banks to use the original book value of assets rather than requiring them to use market value, meaning that they are not required to recognize asset losses. Banks were thus able to avoid having to recapitalize their balance sheets immediately, obviating the decline in their solvency margins.

<sup>13</sup> Medium-to-large banks refers to those ranked 21<sup>st</sup> to 50<sup>th</sup> by assets. By end-2015 the banking system assets had increased moderately to 103.2 percent of GDP (RUB83 trillion), up from 99.7 percent (RUB78 trillion) at the end of 2014 and 80.8 percent (RUB57 trillion) at end-2013.

<sup>14</sup> In December 2014 the government began the RUB1.0 trillion recapitalization program by issuing treasury bonds to be invested in the capital of systemically important banks. At the same time, the State Duma approved a law allowing up to 10 percent of the National Wealth Fund to be invested in subordinated deposits and bonds of Russian banks. In May 2015 the government approved the recapitalization of four banks: Rossia, Severnii Morskoi Put, Sodeistvie Obshestvennii Initsiativam and Rossiiski Natsionalni Kommercheski Bank through the provision of subordinated loans in the total amount of RUB20.1 billion. In August the government approved RUB8.5 billion to recapitalize 10 regional banks.

<sup>15</sup> The CBR appointed authorized representatives to 156 banks following new legislation on bank oversight. In most cases these appointments are for banks which received government or CBR support in 2014-2015.

not compensate for plummeting oil and gas prices, as a decline in the effective tax rate for oil exports weakened federal revenues. Oil and gas revenues shrank from 9.5 percent of GDP in 2014 to 7.3 percent in 2015, a 21.1 percent decline in nominal terms, while overall federal revenues fell from 18.6 percent of GDP to 17.0 percent, a 6 percent drop in nominal terms (Table 6). Nonoil revenues increased from 9.1 percent of GDP in 2014 to 9.7 in 2015, boosted by higher VAT and corporate income tax receipts, but this increase was not sufficient to offset the drop in oil and gas revenues. A combination of rising nonoil revenues and expenditure consolidation slightly narrowed the nonoil deficit from 10 percent of GDP in 2014 to 9.7 percent in 2015.

**In 2015 the government announced an expenditure consolidation target of 5 percent in real terms and launched a separate RUB2.4 trillion anti-crisis plan to mitigate the adverse effects of the expenditure cuts.** The 2015 anti-crisis plan was designed to support the financial and real sectors, regional budgets and social programs, buffering the impact of

the consolidation on key economic sectors and vulnerable households.<sup>16</sup> Part of the anti-crisis measures, including social and regional support, were financed through the 2015 budget.

**The government's consolidation program appears appropriate, as the accumulated spending increases of recent years could not be sustained in an environment of slumping oil and gas revenues.** Oil revenues still constitute about 40 percent of overall federal revenue (Figure 29). By end-2015, annual federal spending fell by 2.5 percent in real terms, half the original target of 5 percent.<sup>17</sup> Social and defense spending were the main spending items in 2015 (Figure 30). Defense spending rose by 18.8 percent in real terms, and social spending increased by 14.4 percent in real terms. The bulk of the increase in social spending (11 percent) went to pension indexation as part of the government's anti-crisis plan. Spending on subsidies to the economy and intergovernmental transfers decreased by 29.7 percent<sup>18</sup> and 22.6 percent in real terms, followed to a lesser extent by education and public health spending.

Table 6: Federal budget outcomes, RUB billions

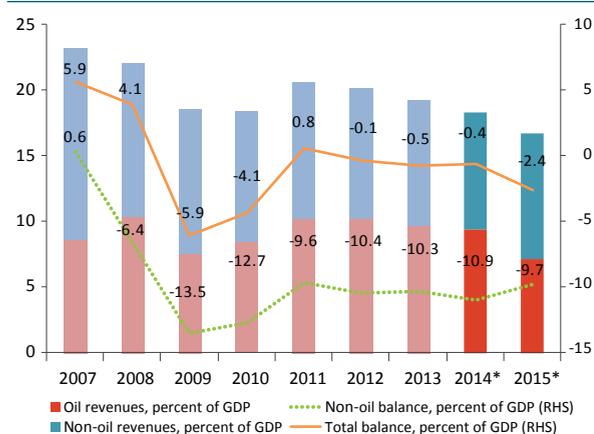
	2014	2015	2015	2015	2014-2015	2014	2015
	Execution	Original Budget Law (2014 prices)	Amended Budget Law April 2015 (2014 prices)	Execution (2014 prices)	Real Growth Percent	Execution (Percent of GDP)	Execution (Percent of GDP)
Expenditures	14,831.6	14,336.1	14,088.0	14,454.5	-2.5	19.0	19.4
Interest payments	415.6	415.7	541.7	480.3	15.6	0.5	0.6
Revenues	14,496.9	13,937.0	11,611.1	12,644.1	-12.8	18.6	17.0
Oil revenues	7,434.0	7,140.7	5,265.7	5,428.4	-27.0	9.5	7.3
Non-oil revenues	7,062.9	6,292.9	5,875.3	6,681.3	-5.4	9.1	9.7
Non-oil balance	-7,768.7	-7,447.4	-7,604.3	-7,197.5		-10.0	-9.7
Primary balance	80.9	970.2	-862.7	-273.1		0.1	-1.8
Balance	-334.7	-369.5	-2,293.4	-1,676.3		-0.4	-2.4
Government debt						13.2	13.5

Source: CBR.

<sup>16</sup> The plan included support to the financial sector (RUB1.3 trillion), state-owned and systemically important companies (RUB365 billion), as well as to regional budgets (RUB160 billion) and social programs (RUB296 billion).

<sup>17</sup> An 8 percent deflator is based on national accounts data for government consumption and fixed capital investment.

<sup>18</sup> At end-2014 the government transferred RUB1 trillion in bonds to the Deposit Insurance Agency to recapitalize the banking sector. This increased spending on support to the economy by 66 percent from 2013. Adjusting 2014 expenditures to reflect this anti-crisis measure, real budget spending increased by 4.5 percent in 2015.

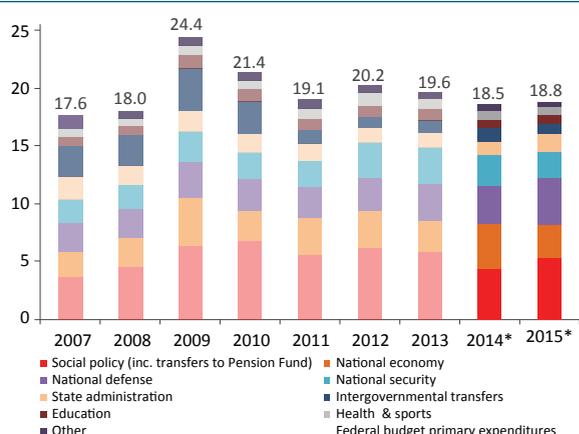
**Figure 29: Federal revenue and budget balances, 2007-2015, percent of GDP**

Source: Roskazna, Rosstat.

Note: \*Due to methodological changes in nominal GDP, figures for 2014 and 2015 are not comparable with those shaded for 2013 and earlier.

During 2015 the authorities drew down the Reserve Fund to finance the federal budget deficit and used the National Welfare Fund for off-budget stimulus to the economy. As a result, the total value of the Reserve Fund plunged from US\$87.9 billion in December 2014 to US\$46 billion at end-2015. The government used the National Welfare Fund as an off-budget mechanism to support large banks and provide investment stimulus, investing it in assets with relatively high market risk. In 2015, it invested RUB440 billion (US\$7.3 billion) from the National Welfare Fund in ruble-denominated domestic financial assets.<sup>19</sup> The National Welfare Fund decreased modestly from US\$78 billion at end-2014 to US\$71.7 billion at end-2015 due to the depreciation of the ruble.

Russia's fiscal position for 2016 remains uncertain; a further decline in oil prices in January 2016 forced the government to consider cutting the budget by an additional 10 percent, and lower prices are expected to lead to a broader revision of budgetary parameters during 2016 (Box 9). The January budget cuts

**Figure 30: Federal primary expenditures, 2014, percent of GDP**

Source: Roskazna, Rosstat.

Note: \*Due to methodological changes in nominal GDP, figures for 2014 and 2015 are not comparable with those shaded for 2013 and earlier.

exclude defense and social spending. The government is also considering an ambitious privatization plan to finance a larger-than-expected deficit, the process for which could begin as early as the second half of 2016.<sup>20</sup> In March 2016 the government approved the *Plan of Government Action for Stable Social-Economic Development in 2016*, which calls for spending of RUB684.8 billion (0.8 percent of GDP) primarily on support to selected industries and regional governments (Box 9). In addition, the federal budget is subject to contingent liabilities arising from the external obligations of Vneshekonombank (VEB), which has a total outstanding external debt of US\$9 billion.

The consolidated government budget deficit widened from 1.1 percent in 2014 to 3.5 percent in 2015 due to imbalances in both the federal budget and extrabudgetary funds. The consolidated budget encompasses all public spending, including the federal budget, subnational budgets and extra-budgetary funds (Table 7). Trends in general government revenue followed developments in federal budget

<sup>19</sup> The majority of the RUB376.1 billion (US\$6.2 billion) is being invested in bonds and shares of large state companies, including Yamal SPG (natural gas), ZapSibNeftechim (oil products), Russian Railway (transport), and Atomenergoprom (nuclear energy). A smaller part, RUB64.4 billion (US\$1.1 billion) went into deposits of large state banks (VTB and Gazprombank) to stimulate credit growth. In December 2015, the government extended VEB's payback period for a deposit of US\$6.25 billion from the National Welfare Fund, lowered the interest rate to 0.25 percent, and granted a grace period for interest rate payments until September 2018.

<sup>20</sup> Privatization may include the sale of stakes in the banking group VTB, the oil company Rosneft, the airline Aeroflot, the diamond-mining company ALROSA, the shipping company Sovcomflot, the oil-pipeline monopoly Transneft and the telecom operator Rostelecom.

**Box 9** The 2016 budget law

**In December 2015 the government approved a federal budget law for 2016 based on the following projections: an average oil price (Urals) of US\$50 per barrel, an inflation rate of 6.4 percent and a GDP growth rate of 0.7 percent.** The government instituted a 1-year planning horizon for 2016 after it suspended the legally mandated 3-year planning horizon in 2015. The fiscal rule was also suspended in 2016. The budget deficit was projected to reach 3 percent of GDP, with a nonoil deficit of 10.7 percent of GDP to be financed primarily through the Reserve Fund, which was expected to decrease by RUB 1 trillion, from 3.5 percent of GDP to 1.3 percent. Public borrowing was anticipated to reach 0.5 percent of GDP, including up to US\$3 billion in external borrowing. Both federal budgetary revenues and expenditures were projected to increase slightly as a share of GDP. However, large nominal expenditure cuts were planned in public health (7.8 percent), education (8.4 percent) and community and housing services (39 percent), while subsidies to the economy were expected to rise by 12.8 percent, and defense and national security spending by 2 percent. For the second year in a row, no wage increases were planned for public sector employees. While the government did not change the pension age, it did index pensions by 4 percent. The second pillar of pension funding will continue to be frozen, reserving those funds for special needs and leaving room for additional pension increases.

revenue, with falling oil prices putting downward pressure on overall revenues. Consolidated government spending decreased by 1.7 percent in real terms compared to 2014. Social policy and national defense, the two priority spending categories, increased by 5.8 percent and 18.8 percent in real terms, respectively. Significant cuts were made in real spending on subsidies to the economy, social security, culture and education. The federal budget deficit of 2.4 percent of GDP and the increasing imbalances in extra-budgetary funds, which registered a deficit of 0.8 percent of GDP for the first time in years, led to the worsening of the consolidated balance. The rising deficit in extra-budgetary funds, which stems primarily from the Pension Fund, constitutes a significant fiscal risk.

**The concentration of resource revenues at the federal level, coupled with anti-crisis measures, have shielded subnational budgets from the impact of falling oil prices.** Two temporary policies adopted in 2015 helped to

both ease expenditure pressures on subnational governments and finance subnational deficits. First, regional governments were not requested to increase teacher and health personnel salaries as per a presidential decree dating from May 2012. The largest expenditure cuts at the regional level were in education, which fell by 7.5 percent in real terms, and community and housing services, which fell by 12.7 percent, but real spending decreased in all expenditure categories. Second, the Ministry of Finance increased budgetary loans to regions with lower interest rates in order to ease the regional debt burden, including additional lending provided as part of the 2015 anti-crisis plan. Budgetary lending increased by RUB161.2 billion to a total of RUB808.7 billion. The share of budgetary loans in subnational debt increased from 26.9 percent at end-2014 to 30.4 percent at end-2015. Overall, subnational debt continued to grow, rising from 3.1 percent of GDP in 2014 to 3.3 percent in 2015.

Table 7: Consolidated budget, RUB billions

	2014	2015 (in 2014 prices)	2014-2015	2014	2015
	Execution	Execution	Real Growth Percent	Execution (Percent of GDP)	Execution (Percent of GDP)
<b>Consolidated Budget</b>					
Expenditures	27,611.7	27,136.8	-1.7	35.4	36.4
Revenues	26,766.1	24,531.6	-8.3	34.4	32.9
Interest payments	537.3	612.0	13.9	0.7	0.8
Balance	-845.6	-2,605.3		-1.1	-3.5
Government debt				15.5	15.8
<b>Consolidated Subnational Budget</b>					
Expenditures	9,353.3	8,777.5	-6.2	12.0	11.8
Interest payments	121.7	137.9	13.3	0.2	0.2
Expenditures w/t int. payments	9,231.6	8,639.6	-6.4	11.9	11.6
Revenues	8,905.7	8,618.7	-3.2	11.4	11.6
Revenues w/t extrabudgetary transfers	7,234.9	7,060.3	-2.4	9.3	9.5
Balance	-447.6	-158.9		-0.6	-0.2
Government debt				3.1	3.3
<b>Extrabudgetary Funds</b>					
Expenditures	8,005.0	8,793.4	9.8	10.3	11.2
Revenues	7,979.4	8,164.0	2.3	10.2	11.0
Balance	-25.6	-629.4		0.0	-0.8
<b>Federal Budget</b>					
Expenditures	14,831.6	14,454.5	-2.5	19.0	19.4
Interest payments	415.6	480.3	15.6	0.5	0.6
Expenditures w/t int. payments	14,416.0	13,974.3	-3.1	18.5	18.8
Revenues	14,496.9	12,644.1	-12.8	18.6	17.0
Oil revenues	7,434.0	5,428.4	-27.0	9.5	7.3
Non-oil revenues	7,062.9	7,215.8	2.2	9.1	9.7
Primary balance	-7,768.7	-7,238.8		0.1	-1.8
Balance	80.9	-1,330.1		-0.4	-2.4
Government debt				13.2	13.5

Source: Roskazna. Extrabudgetary funds include the Pension Fund, the Social Security Fund, and the Federal Fund for Mandatory Health Insurance.

## 1.5 Income and Poverty Trends – The Labor Market Weakens

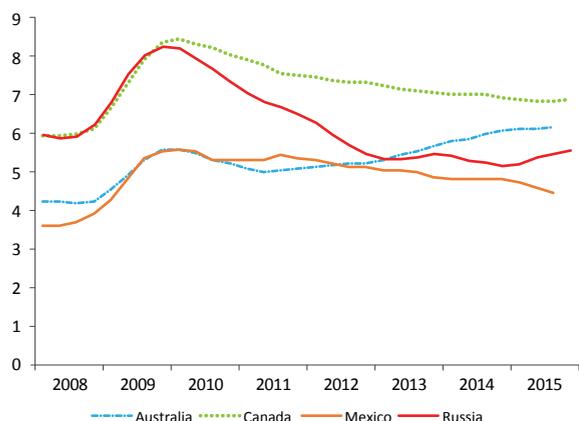
Labor-market indicators have begun to weaken, and the unemployment rate is slowly rising. However, falling wages remain the primary mechanism through which the labor market is adjusting to the recession. Nonwage income declined due to the limited indexation of public transfers, which, along with rising food prices, was responsible for a significant increase in the poverty rate.

**The recession began to weaken labor demand during the second half of 2015.** Falling real wages, large and stable public employment and a steady outflow of migrant workers have largely mitigated the recession’s effect on domestic employment, but since mid-2015 employment data have begun to reflect the worsening economic downturn. While the overall employment rate remained at 65.7 percent, unchanged from the previous year, the number of employed workers decreased by 300,000, year-on-year, in the second half of 2015.

**The number of unemployed workers rose from 3.8 million in the second half of 2014 to 4.1 million in the second half of 2015, as the unemployment rate increased from 5.0 to 5.5 percent.** However, the increase in unemployment remained moderate compared to the trends observed during the global financial crisis, when the unemployment rate soared from 6.2

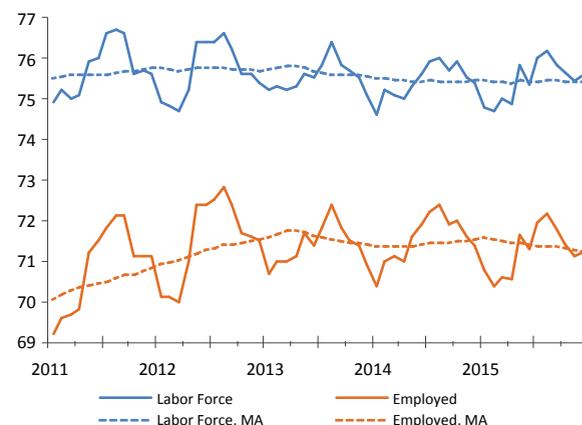
percent in 2008 to 8.2 percent in 2009 (Figure 31). The structure of unemployment remained unchanged in 2015. A significant gap persists between the unemployment rates for male and female workers, but women were slightly more likely to become unemployed in 2015. Male unemployment rose from 5.5 percent in 2014 to 5.8 percent in 2015, while female unemployment rose from 4.8 percent to 5.3 percent. The gap between urban and rural unemployment narrowed as urban unemployment rose faster than rural unemployment. Urban unemployment increased from 4.3 percent in 2014 to 4.8 percent in 2015, while rural unemployment only inched up to 8.0 percent from 7.9 percent in 2014. The large share of long-term unemployed, defined as workers who had been searching for a job for more than a year, is troublingly high at 30 percent. Moreover, regional unemployment rates remain very unequal, reflecting the limited mobility of labor (Figure 37).

Figure 31: Unemployment rates in resource-rich countries, one-year moving average, percent



Source: ILO, Rosstat, Haver Analytics and World Bank calculations.

Figure 32: Labor force participation and employment, million



Source: Rosstat, Haver Analytics and World Bank staff estimates. Note: 2015 data does not include Crimea.

**Russia's aging population has affected its labor market since 2012, but in 2015 the total labor supply remained stable.** Labor force participation rose slightly to 69.5 percent in the second half of 2015, a year-on-year increase of 0.3 percentage points, offsetting the decline in the working age population due to aging and leaving the total size of the economically active population unchanged at 75.5 million (Figure 32).<sup>21</sup> Labor-force participation increased primarily among workers over the age of 40, while declining among young adults. Underemployment is also on the rise, with the number of part-time workers growing by a third (from 100,000 to 133,000) between 2014 and January-October 2015. Yet the increase in part-time workers remains far below the peak of 500,000 during the global financial crisis (Box 10). The significant increase in part-time

workers also corresponds with a slight decrease in the average number of weekly hours worked, which fell from 38.1 in the first three quarters of 2014 to 37.9 in the first three quarters of 2015. Taken together, these data indicate that a rising number of workers are struggling to find and retain full-time employment. At the same time, the sharp drop in real wages may require people to work longer hours or hold multiple part-time jobs.

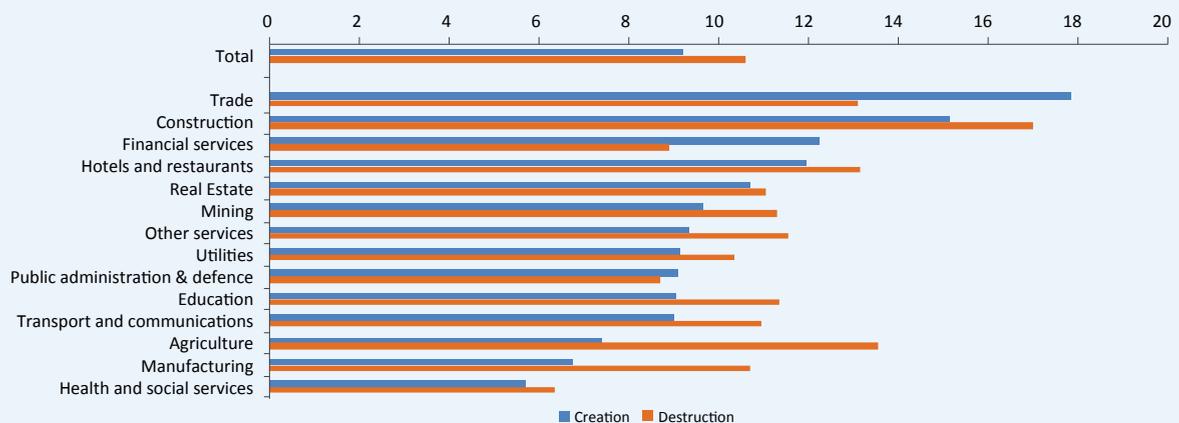
**The erosion of real wages has enabled the labor market to adjust to a deepening recession with only a modest impact on employment dynamics.** After rising by 1.2 percent in 2014, real wages fell by 9.5 percent in 2015, with declines recorded across all sectors as inflation remained in double digits (Figure 34). The deterioration of real wages accelerated in the second half of the year, rising

#### Box 10 Trends in job creation and job destruction

**Job destruction has outpaced job creation since 2008.** On average, the rate of job destruction in large and medium-sized enterprises has outpaced the rate of job creation by 2 percentage points, corresponding to 500,000 jobs annually. This trend reflects the growing informality in the Russian economy, as the share of jobs in large and medium-sized enterprises (which are mostly formal) is falling relative to the number of jobs in small enterprises (which are more likely to be informal). Average job turnover in the nontradable sectors outpaced turnover in the tradable sectors. The highest rates of newly created jobs were in the trade (17.8 percent), construction (15.2 percent) and financial services sectors (12.2 percent), all of which are nontradables. Construction had the highest rate of job destruction (17 percent), followed by agriculture (13.5 percent) (Figure 33).

**Only the trade and financial services sectors registered significantly positive rates of net job creation. The number of jobs in these sectors increased by 4.8 and 3.3 percent, respectively.** Far more modest rates of net job creation were also observed in public administration and defence (0.4 percent). Net job creation rates were negative in all other sectors. The highest rates of net job destruction were in agriculture (6.1 percent) and manufacturing (3.9 percent).

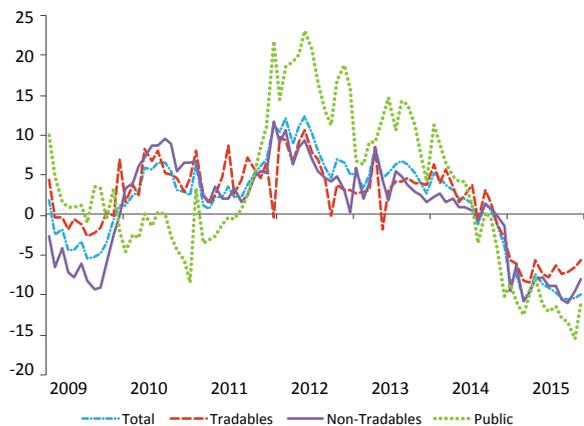
Figure 33: Net job creation and destruction rates by sector, 2008-2014 average, percent



Source: Rosstat and World Bank staff calculations.

<sup>21</sup> These figures are in seasonally adjusted terms. Crimea is excluded to maintain comparability with previous years.

**Figure 34: Real wage growth by sector, year-on-year, percent**

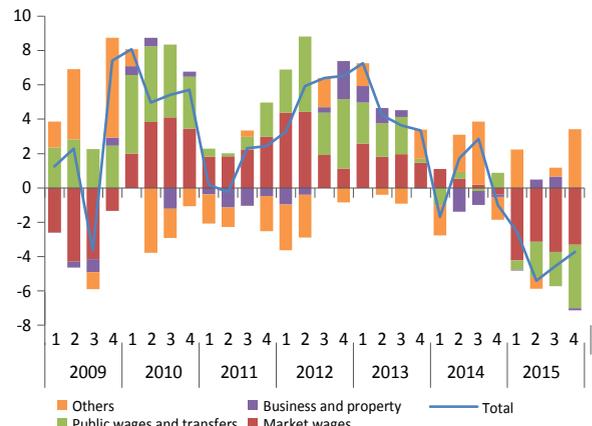


Source: Rosstat and World Bank staff estimates.

from 8.7 percent year-on-year during the first six months to 10.1 percent during the second half. Not only did wages decline, all components of disposable income continued to decrease in real terms, weighing heavily on household consumption. Nonwage income sources such as pensions and other transfers also declined, as they were indexed below headline inflation. Real pensions contracted by 4 percent in 2015, compared to an increase of 0.9 percent in 2014 (Figure 35). The overall decline in real disposable income was a key factor behind the steep drop in consumption observed during 2015.

**The decline in real income has had a significant impact on poverty.** In 2015, the number of poor people rose from 16.1 million, or 11.2 percent of the population, to 19.2 million, or 13.4 percent of the population (Table 8). The increase in poverty was driven by the erosion of real income combined with rising prices for food and services, which pushed many people back below the poverty line. Since the fourth quarter of 2014 the average real income of the bottom 40 percent of the population has grown at exactly the same rate

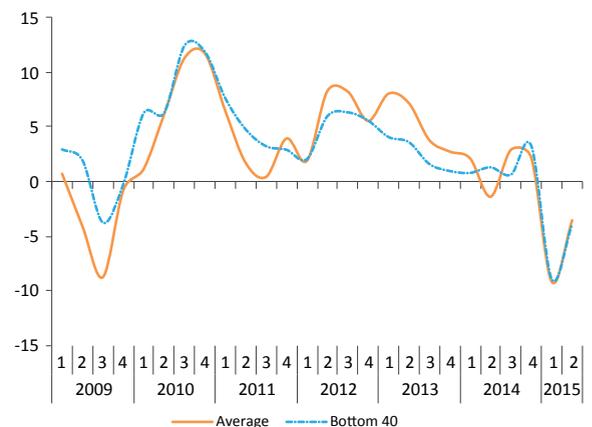
**Figure 35: Contribution to real income growth, total population, year-on-year, percent**



Source: Rosstat and World Bank staff estimates.

as the average income of the total population. This means that the incomes of the poorest 40 percent of the population were not converging with the average. For that the income growth of the poorest 40 percent of the population would need to outpace average income growth. As lower-income households also tend to have less in savings, the pressure to reduce consumption was likely most intense among the country's most vulnerable households (Figure 36).

**Figure 36: Real income growth, all income levels and bottom 40 percent, year-on-year, percent**



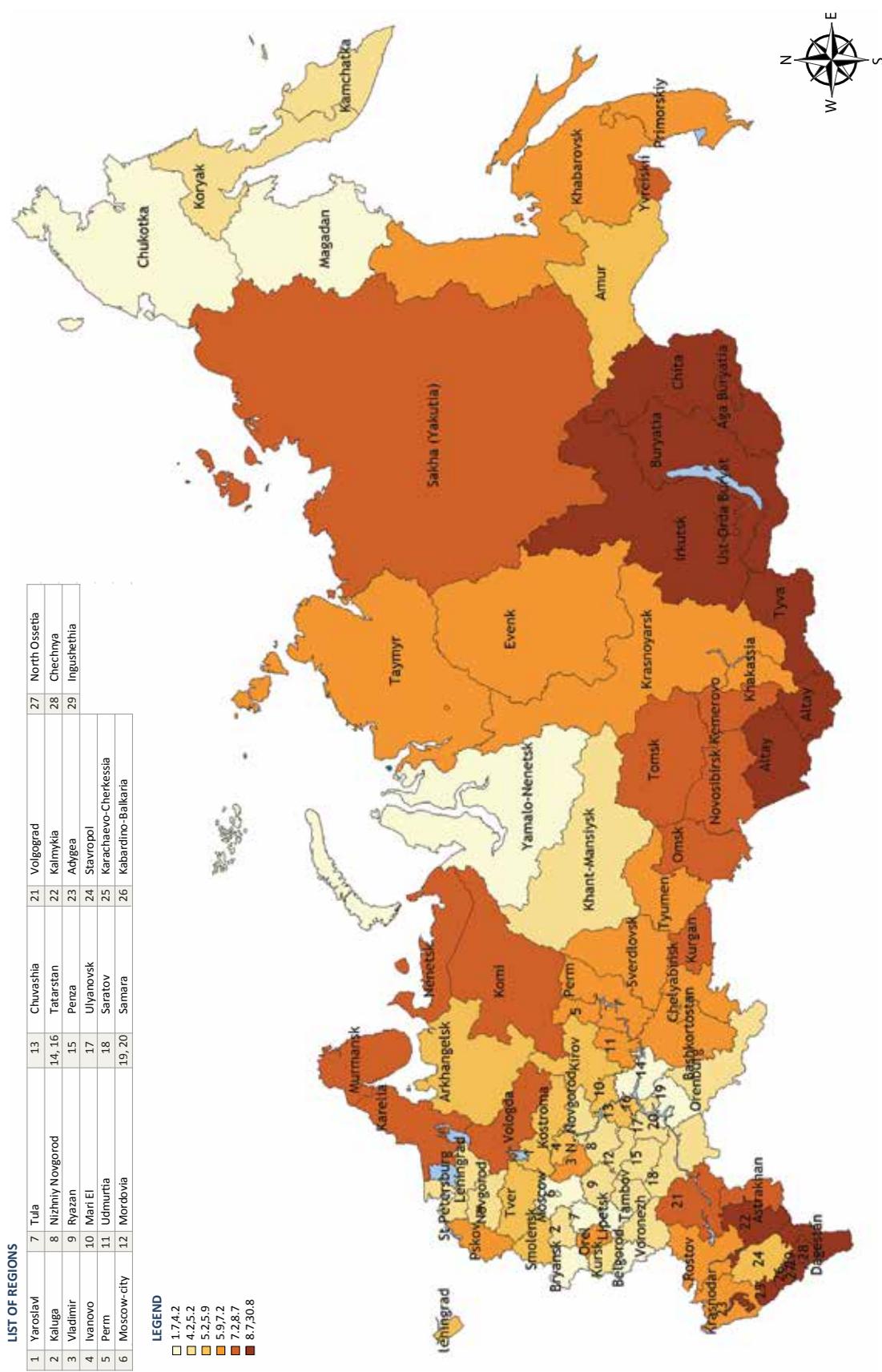
Source: Rosstat and World Bank staff estimates.

**Table 8: Poverty trends**

	2010	2011	2012	2013	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015	Q3 2015	Q4 2015
Poverty rate, cumulative	12.5	12.7	10.7	10.8	13.8	13.1	12.6	11.2	15.9	15.1	14.1	13.4
Number of poor, million people	17.7	17.9	15.4	15.5	19.8	18.9	18.0	16.1	22.9	21.7	20.3	19.2

Source: Rosstat.

Figure 37: Unemployment rates by region, Q4 2015, percent



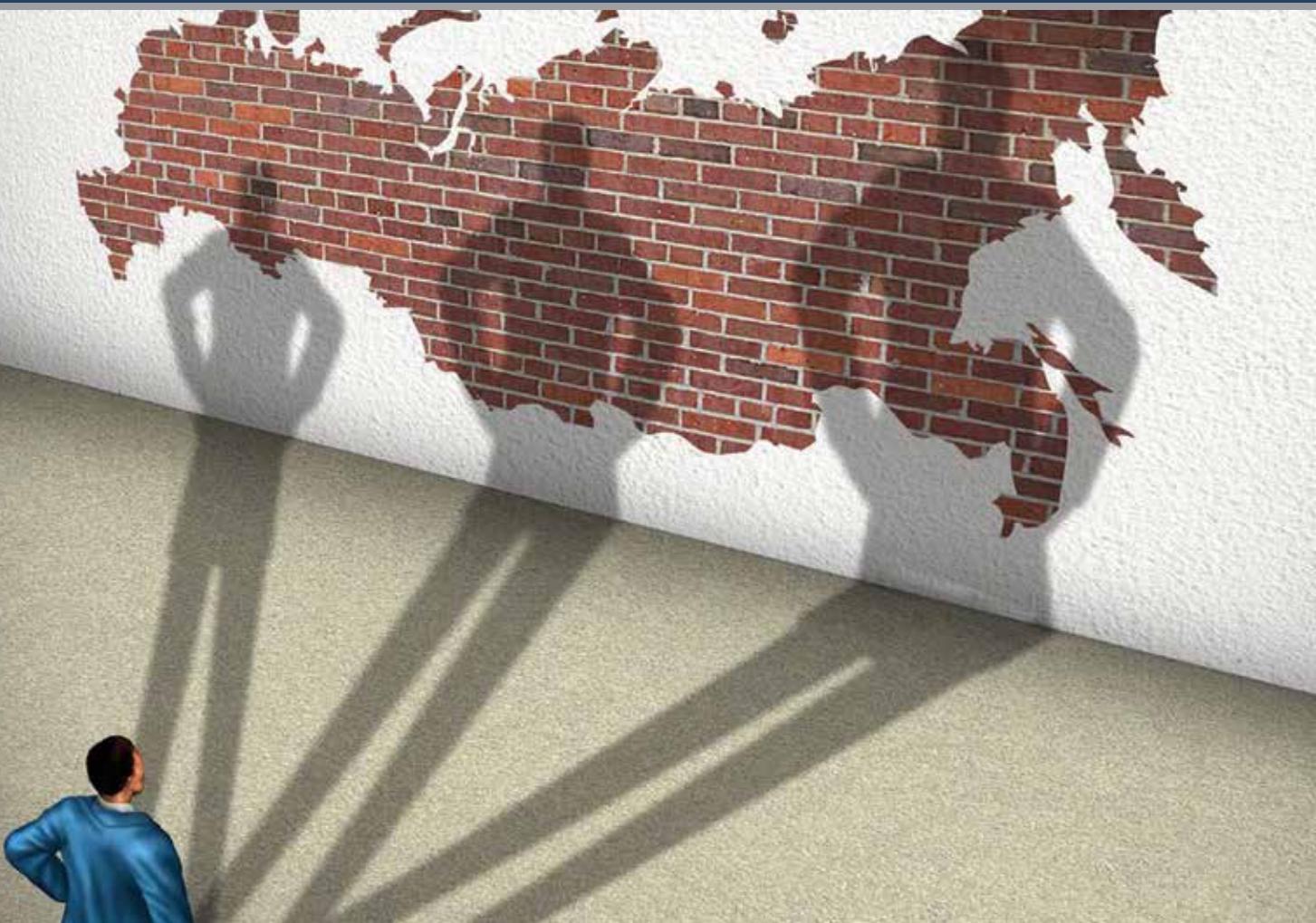
Source: Rosstat and World Bank staff calculations.

## PART II

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# ECONOMIC OUTLOOK: *An Uncertain Path Ahead*

*The Russian economy faces a long journey to recovery. While the conditions that pushed Russia's economy into recession may be gradually abating, the World Bank's current baseline scenario anticipates a further contraction of 1.9 percent in 2016 before growth is expected to resume at a modest rate of 1.1 percent in 2017. Commodity prices will continue to dominate Russia's medium-term outlook, and in addition to the baseline projections both a lower-bound and an upper-bound oil-price scenario are presented. Poverty projections are bleak; under all scenarios poverty rates are expected to rise, and indicators of shared prosperity are expected to worsen. As the Russian economy gradually adapts to an adverse external environment marked by lower oil prices and ongoing economic sanctions, the focus of its economic adjustment challenges is now shifting to fiscal and financial sector restructuring. The government's attempts to consolidate its fiscal balances to reflect the drop in oil revenue have thus far remained largely tentative and ad hoc. A return to a credible medium-term fiscal framework is paramount and would boost consumer and business confidence by reducing fiscal uncertainty. A massive recapitalization program and other supportive measures shored up the country's banking system, but risks to the financial sector will require continued vigilance through 2017. Russia's medium-term economic outlook is modest, as the economy's underlying growth potential is low, but new long-term opportunities are emerging. Over the longer term, the government's key challenge will be to enhance economy-wide competitiveness and promote sustainable diversification beyond the natural resource sector.*



## 2.1 Growth Outlook – A Shift in Adjustment Challenges

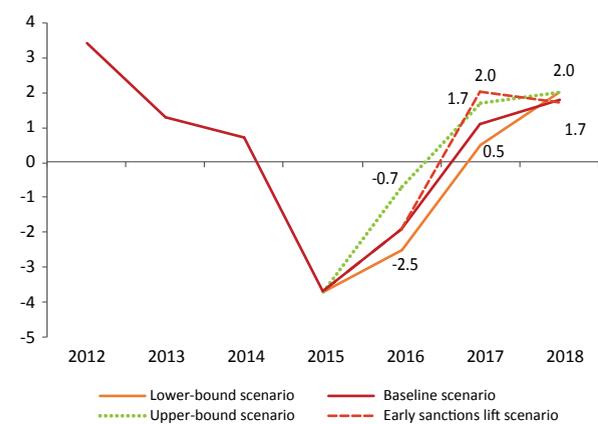
Russia's medium-term growth will remain heavily dependent on oil prices. The World Bank projections reflect three oil-price scenarios: the baseline, an upper-bound scenario and a lower-bound scenario. An alternative baseline scenario combines the baseline oil-price forecast with the projection assumption that economic sanctions would be lifted as early as 2017, while all other scenarios assume that economic sanctions would remain in place until 2018.

**D**uring 2016, the Russian economy is expected to continue its difficult adjustment to a context of low global commodity prices and ongoing economic sanctions. Russia's economy contracted by 3.7 percent in 2015, and economic activity is expected to fall further in 2016, though at a slower pace. The World Bank's baseline growth outlook anticipates a contraction of 1.9 percent in 2016 (Figure 38), which would cause real GDP to remain below its 2012 level (Figure 39). GDP growth is projected to return to a positive rate of around 1.1 percent in 2017. Oil prices are projected to remain at an average of US\$37 per barrel in 2016, far below the US\$53 per barrel forecast used in the previous edition of the Russia Economic Report (September 2015), before recovering to around US\$50 per barrel in subsequent years.<sup>22</sup> As the current baseline forecast for 2016 has now fallen below even the lower-bound projection of US\$40 per barrel included in the last Russia Economic Report, this

edition presents a new set of oil-price scenarios that reflect the worsening outlook for global oil exporters. The macroeconomic projections include: (i) a baseline scenario; (ii) an upper-bound scenario, in which oil prices exceed baseline assumptions; and (iii) a lower-bound scenario, in which oil prices fall short of current forecasts. Each of these scenarios assumes for projection purposes that economic sanctions will remain in place until 2018, while in an alternative baseline economic sanctions would be lifted in 2017.

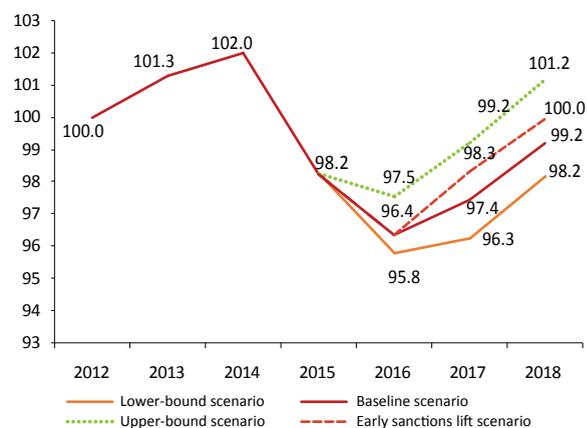
**Due to a continually adverse external environment, Russia's journey to recovery will be long and difficult.** Investment growth is projected to remain weak due to several factors. First, a tepid global recovery in demand for Russian exports, combined with persistently low commodity prices, will limit investment opportunities in the export sector (Box 11).

Figure 38: Real GDP growth projection, year-on-year, percent



Source: Rosstat and World Bank staff estimates.

Figure 39: Real GDP projection, 2012=100



Source: World Bank staff estimates.

<sup>22</sup> The current 2016 budget of December 2015 assumes an oil price of US\$50 per barrel.

Meanwhile, the ongoing erosion of household income will continue to undercut domestic demand, offering little incentive for firms to invest in expanding capacity to produce for the domestic market. Second, the economic sanctions regime will continue to restrict access to capital and limit the inflow of FDI, exacerbating the negative impact of soft demand conditions. Third, a low-level price equilibrium in the global oil market and diminished oil revenues will sharply restrict the fiscal space for increased public investment or other countercyclical policies. As a result, investment is expected to recover slowly, and the overall investment growth rate is not expected to turn positive until 2017. The negative impact on consumption growth resulting from the sharp income adjustment in 2015 is not expected to be offset by significant fiscal stimulus. Consequently, consumption growth is expected to remain negative in 2016 before resuming a modest growth rate of 1 to 2 percent per year.

**The persistent slump in global oil prices and the extension of economic sanctions and counter sanctions is likely to profoundly alter the internal structure of the Russian economy and transform its relationships with its trading partners.** As oil prices fell in 2014-2015, the devaluation of the ruble facilitated the adjustment of Russia's external balances. And as geopolitical tensions and economic sanctions became the norm, capital outflows fell to near their 2012-2013 levels. Russian firms and households are gradually adapting, and the weaker ruble could facilitate the expansion of certain non-resource tradable industries (Box 13). In recent years Russia has tightened its economic integration with China and the members of the Eurasian Customs Union, while sanctions and countersanctions have weakened trade ties with other countries. Overall, Russia's nonfuel exports are increasing as a share of total exports, but they continue to consist largely of nonfuel commodities. Outdated production capacity and

### Box 11 The global economic outlook

**Global growth is projected to accelerate modestly in the coming years, but at a slower pace than previously anticipated** (Table 9). A slowdown in large emerging markets is depressing growth prospects in the developing world and exacerbating an uneven recovery among advanced economies. Nevertheless, global growth is projected to reach 2.9 percent in 2016 and 3.1 percent in 2017-18, while the aggregate growth rate for high-income countries is expected to rise from an estimated 1.6 percent in 2015 to a projected average of 2.1 percent over 2016-2018. However, the anticipated improvement in global economic activity in 2016 and beyond is predicated on an orderly slowdown and rebalancing in China, a steady acceleration among high-income countries, a recovery in global commodity prices, the continuation of accommodative monetary policies in advanced economies and the maintenance of fundamental stability in key financial markets. All of these assumptions are subject to substantial downside risks.

**The protracted slowdown in emerging and developing economies has prompted a negative reassessment of their underlying growth potential.** Faltering demand in emerging markets is contributing to an especially grim outlook for major commodity exporters, which are expected to make a significantly lower contribution to global growth than in the past. While developing countries and emerging markets are both expected to recover somewhat in 2016, further contractions are predicted for Brazil and Russia, with negative implications for their trading partners. The aggregate growth rate among developing countries is expected to remain steady at 4.8 percent in 2016 before accelerating to 5.3 percent in 2017.

Table 9: Global GDP growth, percent

	2009	2010	2011	2012	2013	2014	2015e	2016f	2017f	2018f
World	-1.8	4.3	3.1	2.4	2.4	2.6	2.4	2.9	3.1	3.1
High income	-3.5	3	1.9	1.4	1.2	1.7	1.6	2.1	2.1	2.1
Developing countries	3	7.8	6.3	4.9	5.3	4.9	4.2	4.8	5.3	5.3
Euro area	-4.5	2	1.7	-0.7	-0.2	0.9	1.5	1.7	1.7	1.6
Russia	-7.8	4.5	4.3	3.5	1.3	0.7	-3.7	-1.9	1.1	1.8

Source: World Bank Global Economic Prospects.

other structural rigidities and the high cost of intermediate imports diminish the benefits of the relative price adjustment. In addition, the dearth of new credit underscores the persistent challenges facing the Russian financial sector. Meanwhile, the government's fiscal adjustment to its diminished revenue position has thus far been partial and provisional.

**In 2016, the focus of Russia's economic adjustment will shift to fiscal consolidation and financial sector restructuring.** The government will face difficulty in achieving its 2016 deficit target of 3.0 percent of GDP despite additional spending cuts announced in January. Meanwhile, financing budget overruns will further deplete the already shrinking Reserve Fund. This situation will require bold choices during the 2017 budget-planning process, as the authorities strive to determine the structure and policy priorities of the country's new medium-term fiscal framework. The banking sector benefitted from a massive recapitalization effort in 2015, but the expiration of the central bank's regulatory forbearance scheme on January 1, 2016 has made the health of the financial sector difficult to precisely gauge. Nevertheless, it is clear that the sector will remain highly vulnerable through 2017, requiring the authorities' constant vigilance and readiness to implement further stabilization measures. Challenges related to the further fiscal and financial sector adjustment are discussed in the risk section of this chapter.

**While Russia's medium-term potential is low, it now has a valuable chance to set the foundation for more robust and sustainable long-term growth.** Russia's contribution to global growth is projected to be smaller in the medium-term given its weakened prospects due to low commodity prices. While falling oil prices have exposed serious weaknesses in its current

growth model, the depreciation of the ruble has created an opportunity for Russia to enhance the competitiveness of its non-resource economy. However, a price advantage alone will not enable Russian exporters to overcome the unique historical trends and structural constraints that continue to define its export profile. The special focus chapter included in this edition of the Russia Economic Report explores historic challenges to Russia's export competitiveness and the difficulty of effecting rapid changes in its export profile. Expanding and diversifying Russia's exports will require substantial progress on the structural reform agenda and far-reaching improvements in the business and investment climate. Russia needs large scale investments in its non-resource industries to expand its range of sophisticated manufacturing and service exports and create a more diversified economy. Accomplishing this could boost Russia's long-term growth beyond the moderate expansion of 1-2 percent projected over 2017-2018.

**Commodity prices continue to dominate Russia's medium-term outlook, particularly oil prices.** A combination of abundant supply and weakening demand is driving down oil-price forecasts (Box 12). Inventories in OECD countries remain high, and global output remains robust as OPEC production is not expected to decrease significantly from its three-year high in 2016. Meanwhile, slowing growth in China, the world's second largest oil consumer, is undermining global demand. The World Bank has revised its projections since the previous edition of the Russia Economic Report, including an especially sharp downward revision for 2016. Under the current baseline scenario, oil prices are expected to drop to an average of US\$37.0 per barrel in 2016 before recovering to US\$48.0 in 2017 and US\$51.4 in 2018.

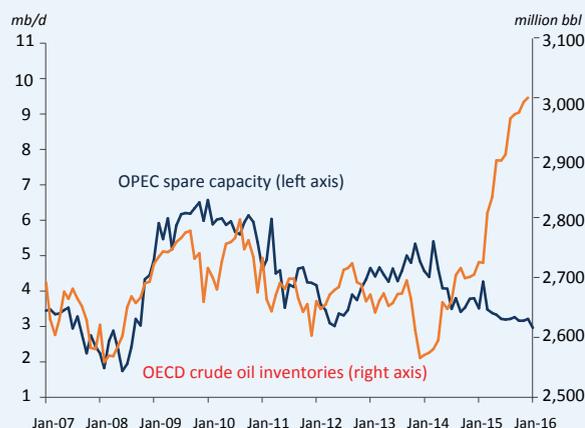
**Box 12 Global oil-price forecast**

**The World Bank’s oil price forecast for 2016 is at US\$37 per barrel.** This represents a 27 percent year-on-year decline in the global price of crude oil. A gradual recovery is expected through 2017, as high-cost oil producers are driven from the market, reducing aggregate supply, while a continuing recovery in global growth strengthens demand. Non-OPEC production is expected to decline by 0.6 million barrels per day in 2016, while US production is projected to decline by 0.7 million. US shale oil production could drop off sharply as existing wells are depleted and low prices delay investment in new wells. While efficiency gains and technical innovation have increased the shale-oil sector’s resilience to falling prices, further cost reductions are unlikely. Non-OPEC production outside the US is expected to fall by 0.1 million barrels per day, as small declines in most regions will be only partially offset by increases in Canada and Brazil. A further appreciation of the US dollar, the currency in which most commodities are traded, could contribute to persistently low prices.

**OPEC is expected to maintain its current policy of defending its market share, while increasing Iranian output will further slow the recovery of global prices.** OPEC will maintain excess production capacity in 2016, and OECD inventories are expected to remain at record highs (Figure 40). Growth in demand is expected to slow to 1.3 percent (1.2 million barrels per day) in 2016, and global consumption is projected to average 95.7 million barrels per day, as the demand boost generated by low oil prices tapers off. OECD oil demand is expected to remain flat, with a modest gain in North America broadly offsetting declines elsewhere. Non-OECD oil demand is projected to rise by 2.4 percent, but slowing consumption growth in Asia, which still accounts for the bulk of non-OECD demand growth worldwide, will dampen the recovery (Figure 41).

**As oil prices continue to fall, all major nominal commodity-price indices are expected to decline in 2016.** Energy prices are projected to drop by 25 percent, metal prices by 10 percent and agricultural commodity prices by 1.4 percent. Large-scale investments made during the decade-long price boom and, in the case of industrial commodities, slowing demand in emerging market economies, will continue to put downward pressure on nonoil commodities over the medium term. 2016 price forecasts for 37 of the 46 commodities monitored by the World Bank have been revised downward.

**Figure 40: Excess global oil production capacity and inventories**



Source: International Energy Agency.

**Figure 41: The recent and projected growth of global oil demand**



Source: World Bank and International Energy Agency.

**Because the global oil market continues to exhibit significant volatility, the projections include both a lower- and an upper-bound scenario.** Although these alternatives are not equally probable, as current oil-price forecasts are especially susceptible to downside risks, both alternatives are presented in order to provide a balanced growth spectrum. The lower-bound scenario envisions an even steeper slide in average oil prices to US\$30 per barrel in 2016, followed by a slower recovery to US\$40 per barrel in 2017 and US\$45 in 2018. The more optimistic

upper-bound scenario projects that oil prices will begin to recover in 2016. However, even under this scenario oil prices are still expected to average just US\$50 per barrel in 2016, US\$53 in 2017 and US\$55 in 2018.

**Persistent geopolitical tensions continue to impact Russia’s medium-term growth prospects.**

The economic sanctions regime imposed against Russia in 2014 and Russian countersanctions have both been extended this year, dampening economic confidence and cutting off Russian

firms and banks from global financial markets. However, for projection purposes it is assumed that geopolitical tensions will gradually subside in 2016 and that economic sanctions would be lifted in 2018. An alternative baseline scenario will illustrate for projection purposes the impact of an earlier lifting of economic sanctions in 2017.

**All forecast scenarios assume accommodative monetary policy and continued fiscal consolidation, but no major structural reforms.**

The central bank is expected to focus primarily on adhering to its inflation-targeting regime, but to relax monetary conditions as inflationary pressures ease. At the time of this report's publication, government fiscal policies were still under discussion and neither the revised 2016 budget nor the 2017 budget proposal had yet been approved. Even in the upper-bound scenario, low oil prices are expected to exert considerable pressure on the fiscal accounts, necessitating a continued drawdown of the Reserve Fund and other fiscal buffers. In late 2015, President Vladimir Putin announced that the government would attempt to eliminate the fiscal deficit by 2019. Achieving this target would require an increasingly sharp fiscal consolidation and would effectively foreclose the possibility of significant stimulus spending, either to boost investment or shore up consumption. All of the scenarios assume that fiscal consolidation will continue through 2017, yet each projects a significant fiscal deficit. Finally, no major structural reforms that might improve Russia's medium-term growth potential are expected before the 2018 presidential election.

**The Baseline Scenario**

**The World Bank baseline scenario projects that Russia's real GDP will contract by 1.9 percent in 2016, before recovering to a modest 1.1 percent growth rate in 2017 (Table 10).** This growth projection has been lowered by 1.3 percentage points since the September edition of the Russia Economic Report, largely due to the downward

revision of oil-price forecasts. A further decline in oil prices is expected to negatively impact the Russian economy through higher-than-expected inflation, which continues to erode the purchasing power of consumers while keeping credit costs elevated. This would compound the negative carryover effect from the deep contraction in 2015, which greatly depressed consumer demand, and could further delay the recovery of business confidence and investment activity. As a result, aggregate domestic demand is not projected to rebound until 2017. Meanwhile, net exports are expected to make a smaller contribution to growth in 2016 than in 2015 due to the slowing pace of import contraction coupled with more modest export growth.

**The baseline scenario includes the following monetary and fiscal policy assumptions.**

The CBR is expected to maintain its adherence to the free-floating exchange rate and to keep monetary policy aligned with its medium-term inflation target of 4 percent. The ruble's renewed depreciation in early 2016 following another drop in oil prices is likely to keep inflation elevated. The ongoing effects of nonmonetary factors are expected to slow the deceleration of the headline inflation rate, which is projected to average 7.6 percent in 2016 before slowing to an average of 4.8 percent in 2017 and reaching the CBR inflation target by the end of 2017. A resumption of the CBR's monetary easing cycle is unlikely until the second half of 2016. Fiscal consolidation is expected to continue in 2016 and 2017, including the limited indexation of public wages and transfers. While lower oil revenues are projected to widen the consolidated budget deficit to 4.6 percent in 2016, an anticipated recovery in oil prices is expected to narrow the deficit to 2.3 percent in 2017 and 2.2 percent in 2018. Financing the deficit is expected to fully deplete the Reserve Fund by end-2016, compelling the authorities to either increase borrowing or generate revenues from privatization.

Table 10: Economic indicators, baseline scenario

	2013	2014	2015	2016	2017	2018
Oil price (US\$ per barrel, WB average)	104.0	97.6	51.9	37.0	48.0	51.4
GDP growth, percent	1.3	0.7	-3.7	-1.9	1.1	1.8
Consumption growth, percent	3.1	1.4	-7.9	-2.5	0.1	1.5
Gross capital formation growth, percent	-7.3	-6.1	-18.3	-6.4	6.4	8.0
General government balance, percent of GDP	-1.2	-1.1	-3.5	-4.6	-2.3	-2.2
Current account (US\$ billions)	34.8	58.3	69.5	41.3	36.3	18.4
Current account, percent of GDP	1.6	2.8	5.2	3.5	2.4	1.0
Capital and financial account (US\$ billions)	-56.9	-173.8	-72.9	-41.2	-36.4	-18.4
Capital and financial account, percent of GDP	-2.5	-8.5	-5.5	-3.5	-2.4	-1.0
CPI inflation (average)	6.8	7.8	15.5	7.6	4.8	4.0

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

**Investment dynamics are projected to drive growth trends over the next few years.** In 2016 weak investor confidence and low consumer demand are expected to cause aggregate investment to contract further, while economic sanctions continue to negatively affect foreign investment. As a result, the baseline scenario projects a 6.4 percent contraction in gross capital formation in 2016, largely driven by a decline in fixed investment. A moderate rebound in investment demand is projected to drive the economy's recovery in 2017-2018, supported by higher oil prices (which will boost investment by oil and gas companies), decreasing credit costs and the accelerated implementation of large off-budget infrastructure projects. The financial sector is likely to play a limited role in facilitating credit growth due to its continued need for restructuring. A slowly improving external environment will further bolster investment in export-oriented industries, and gross capital formation is projected to increase by 6.4 percent in 2017. Investment growth is projected to accelerate to 8.0 percent in 2018 due to stronger consumer demand, improving credit conditions and the anticipated end of economic sanctions.

**Consumption is projected to decline in 2016 for the second consecutive year, and no significant consumption growth is expected in 2017.** The recent terms-of-trade shock resulting from the sharp decline in oil prices in December-January is

expected to amplify the negative carryover effect of the 2015 recession on household income. At the same time, the planned fiscal consolidation will limit the government's capacity to bolster consumption through real increases in public transfers or public sector wages, even as inflationary pressures ease. Consequently, real household income is expected to continue falling in 2016, while credit growth to households will remain low due to the delay in monetary easing and high levels of indebtedness. These factors will cause private consumption to contract by 3.0 percent in 2016, leading to a 2.5 percent contraction in aggregate consumption. In 2017, more modest inflation, improved credit conditions and an appreciating ruble are expected to boost household purchasing power. However, due in part to the limited indexation of public transfers and slow growth in real wages, private consumption is expected to recover only marginally in 2017 before stabilizing at a new medium-term growth rate of around 2.0 percent in 2018.

**Oil prices will continue to dominate Russia's external-account and exchange-rate dynamics.**

An anticipated drop in oil prices in 2016 will reduce export revenue. Meanwhile, imports will continue to fall, though more modestly than in 2015 due to the slower depreciation of the REER and the decelerating contraction of real household incomes. As a result, the trade

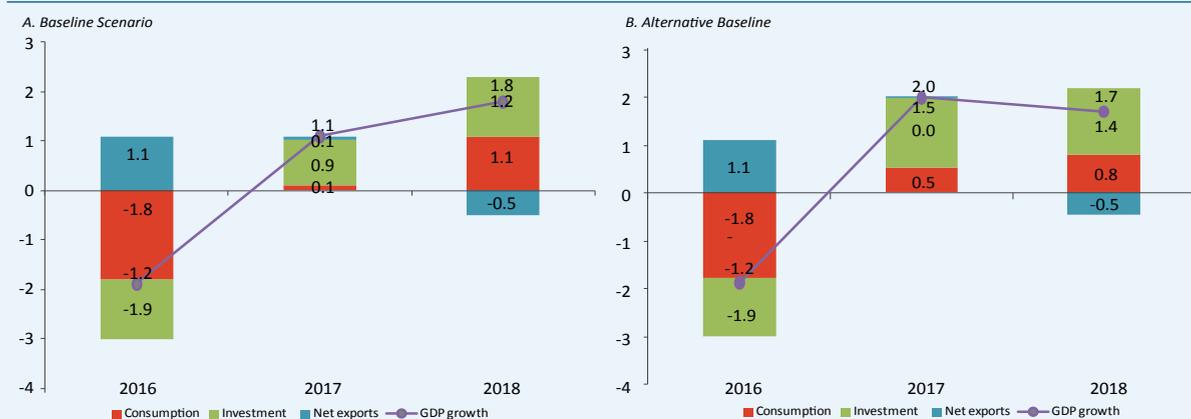
surplus is projected to narrow, reducing the current-account surplus to 3.5 percent of GDP. In 2017-2018 a sustained improvement in domestic demand, combined with an appreciating ruble, is projected to turn import growth positive once again, reducing the current-account surplus to 2.4 percent of GDP in 2017 and 1.0 percent in 2018. Pressure on the capital account is expected to ease over 2016-2017, despite the economic sanctions regime, as the deleveraging by the private sector in 2015 significantly improved the country's debt-service profile. However, capital inflows—including FDI—are expected to remain insignificant through 2017 and are not anticipated to increase until the assumed lifting of economic sanctions in 2018. Thus, the capital and financial accounts are expected to largely mirror changes in the current account, while oil prices will remain the key factor in exchange-rate dynamics. The baseline scenario projects the capital-account deficit to decrease from US\$72.9 billion in 2015 to US\$41.2 billion in 2016 and US\$18.4 billion in 2018.

**For projection purposes, an alternative baseline scenario was formulated to reflect the upside potential of an earlier end to the economic sanctions regime.** Positive changes in the geopolitical environment could increase the probability that economic sanctions against Russia will be lifted. The alternative baseline scenario illustrates for projection purposes the impact of such an early lifting of economic sanctions in 2017 (Box 13). This alternative scenario uses the same oil-price forecasts as the baseline, as well as similar fiscal- and monetary-policy assumptions. While the presumed end of the economic sanctions regime may have a positive effect on economic confidence in 2016, no significant impact on key macroeconomic variables is expected to materialize until the following year. As a result, the 2016 projections are the same as in the standard baseline. While this scenario projects a faster recovery in 2017, its impact would be limited and short-lived, and Russia's medium-term growth potential would remain relatively modest in the absence of other structural policy changes.

**Box 13 Potential impact of the removal of economic sanctions on Russia's medium-term outlook**

**The removal of economic sanctions is projected to boost investment, though this will have a relatively modest impact during the forecast horizon due to Russia's limited growth potential.** Diminished geopolitical risks and expanded access to international financing would lower Russia's capital costs and increase inbound FDI. In the context of Russia's current export profile, rising investment would have the most immediate impact on the production of oil, gas and other export oriented commodities. Greater capital access among Russian banks would reduce the cost of domestic credit, supporting a faster recovery in firm and household lending. In case of a removal of economic sanctions in 2017, increased investment would push the rate of gross capital formation to 10.4 percent in 2017, compared to 6.4 percent in the baseline scenario. Rising consumer confidence would boost the overall consumption growth rate to 0.7 percent in 2017, above the rate of 0.1 percent projected in the baseline. Stronger aggregate demand would accelerate the overall recovery, increasing the real GDP growth rate to 2.0 percent, up from 1.1 percent in the baseline (Figure 42). However, this would not translate into higher growth in 2018 due to structural constraints on Russia's growth potential.

**Figure 42: GDP growth composition with and without economic sanctions in 2017, percent**



Source: World Bank staff estimates.

### The Lower-Bound Scenario

The lower-bound scenario projects that oil prices will fall well below the baseline forecast and that GDP will contract by 2.5 percent in 2016, before recovering modestly in 2017. This scenario assumes that a further oil-price shock in the second part of 2016 would push oil prices to an annual average of just US\$30 per barrel. Prices would then recover gradually to US\$40 per barrel in 2017 and US\$45 per barrel in 2018 (Table 11). This implies that overall global demand would be weaker than in the baseline, which would have negative repercussions for most of Russia's export commodities. In this scenario, lower oil prices would cause the ruble to continue depreciating, which would both increase the relative cost of imports and intensify the pass-through effect on consumer prices, boosting the average inflation rate by 0.9 percentage points over the baseline projection. The CBR would likely postpone the resumption of monetary easing until 2017. Meanwhile, higher inflation would further erode real wages and incomes, depressing consumer demand and keeping consumption growth negative until 2018. These factors, combined with a tighter fiscal stance in response to lower oil revenues, would slow the recovery of investment demand.

In the lower-bound scenario, fiscal risks would intensify. Lower oil prices would directly impact tax revenue, while weakening economic activity would reduce nonoil revenues, and the anticipated depreciation of the ruble would not be sufficient to offset these effects. As a result, the general government deficit would exceed the current target of 3.0 percent of GDP in 2016, widening to 5.6 percent. Assuming that expenditure policies remain the same as in the baseline, the government would need to increase its borrowing, as the Reserve Fund would be insufficient to cover the projected deficit. Heightened budgetary risks would intensify pressure for fiscal restructuring, as the deficit would reach 3.6 percent of GDP in 2017 and 2.7 percent in 2018.

Even in the lower-bound scenario, the current account is projected to remain in surplus. Lower oil prices would cause a sharper contraction in both exports and imports. The 2016 current-account surplus would narrow to 4.6 percent of GDP, slightly smaller than the 2015 surplus, but notably higher than the baseline projection. Rebounding oil prices and improving growth prospects in 2017 and 2018 would further reduce the current-account surplus, especially following the assumed lifting of economic sanctions in

Table 11: Economic indicators, lower-bound scenario

	2013	2014	2015	2016	2017	2018
Oil price (US\$ per barrel, WB average)	104.0	97.6	51.9	30.0	40.0	45.0
GDP growth, percent	1.3	0.7	-3.7	-2.5	0.5	2.0
Consumption growth, percent	3.1	1.4	-7.9	-3.6	-1.0	1.0
Gross capital formation growth, percent	-7.3	-6.1	-18.3	-9.7	3.4	7.9
General government balance, percent of GDP	-1.2	-1.1	-3.5	-5.6	-3.6	-2.7
Current account (US\$ billions)	34.8	58.3	69.5	50.4	45.7	28.8
Current account, percent of GDP	1.6	2.8	5.2	4.6	3.2	1.7
Capital and financial account (US\$ billions)	-56.9	-173.8	-72.9	-50.5	-45.6	-28.8
Capital and financial account, percent of GDP	-2.5	-8.5	-5.5	-4.6	-3.2	-1.7
CPI inflation (average)	6.8	7.8	15.5	8.5	6.0	5.0

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

2018. The prospective decline in oil prices is not expected to directly affect the capital account, and it is assumed that the CBR will refrain from intervening despite rising depreciation pressures. The flexible exchange rate would enable the capital account to improve as the current account deteriorates.

### **The Upper-Bound Scenario**

The upper-bound scenario assumes more favorable external conditions, which would result in a shallower 0.7 percent drop in GDP in 2016, followed by a robust recovery in 2017-2018 (Table 12). As in the lower-bound scenario, these projections are primarily driven by oil prices, while fiscal- and monetary-policy assumptions are similar to the baseline. Under the upper-bound scenario, oil prices would fall to US\$50 per barrel in 2016 before rising to US\$53 per barrel in 2017 and US\$55 per barrel in 2018. Higher, more stable oil prices would put downward pressure on inflation. As a result, the average inflation rate would fall faster than in the baseline scenario, dropping from 7.0 percent in 2016 to 4.5 percent in 2017 and 4.0 percent in 2018 and remaining below the CBR's medium-term target from 2017 on. Real wage and income dynamics would begin to improve by 2017, and lower inflation rates would allow the central bank to accelerate its monetary easing strategy in support of credit growth.

However, the negative carryover effect of the deep recession in 2015 would persist through 2016, and consumption growth would not turn positive until the following year. From 2017 onward, growth is expected to be largely driven by rising investment demand supported by a recovery in household consumption, and overall consumption growth is expected to rebound to a new medium-term average of around 2 percent per year.

Higher oil prices would lessen the fiscal deterioration in 2016 and lead to significant deficit reduction in 2017-2018. The general government budget deficit would rise from 3.5 percent of GDP in 2015 to 3.9 percent in 2016. During 2017-2018, high oil prices and an accelerating recovery would boost both oil and nonoil revenues. The government is expected to only slightly relax its fiscal consolidation efforts under this scenario, and real government consumption is projected to remain constant as the authorities strive to meet their stated target of balancing the budget by 2019. It is assumed that the government will resist pressures to use its additional revenue to ease the fiscal consolidation before the upcoming presidential election. However, the authorities would be expected to resume work on certain high-priority infrastructure projects that were previously suspended, and thus real spending would be somewhat higher than in the baseline.

**Table 12: Economic indicators, upper-bound oil scenario**

	2013	2014	2015	2016	2017	2018
Oil price (US\$ per barrel, WB average)	104.0	97.6	51.9	50.0	53.0	55.0
GDP growth, percent	1.3	0.7	-3.7	-0.7	1.7	2.0
Consumption growth, percent	3.1	1.4	-7.9	-1.2	0.8	1.7
Gross capital formation growth, percent	-7.3	-6.1	-18.3	-2.1	8.6	10.1
General government balance, percent of GDP	-1.2	-1.1	-3.5	-3.9	-0.9	-0.9
Current account (US\$ billions)	34.8	58.3	69.5	49.8	35.4	18.4
Current account, percent of GDP	1.6	2.8	5.2	3.5	2.1	1.0
Capital and financial account (US\$ billions)	-56.9	-173.8	-72.9	-50.0	-35.3	-18.5
Capital and financial account, percent of GDP	-2.5	-8.5	-5.5	-3.5	-2.1	-1.0
CPI inflation (average)	6.8	7.8	15.5	7.0	4.5	4.0

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

Nevertheless, in the upper-bound scenario the fiscal deficit is projected to diminish rapidly, narrowing to 0.9 percent of GDP in 2017 and 0.9 percent in 2018.

**In the upper-bound scenario, the positive impact of higher oil prices on the current account would be offset by accelerating import growth.** The current-account surplus would be somewhat smaller than in the baseline scenario, shrinking from 5.0 percent of GDP in 2015 to 3.5 percent in 2016, 2.1 percent in 2017 and 1.0 percent in 2018. A stronger ruble, more rapid income growth and rising demand for imported

capital goods would cause imports to recover earlier and faster. The decline in external debt payments caused by the massive deleveraging in 2015 would ease pressure on the capital account. Deleveraging is expected to continue in 2016, though on a smaller scale. The debt-rollover capacity of major oil and gas exporters is expected to improve in 2017, and the assumed lifting of economic sanctions in 2018 would expand the private sector's access to international capital markets. As a result, the capital-account deficit would narrow from US\$72.9 billion in 2015 to US\$18.5 billion in 2018 as the current-account surplus shrinks.

## 2.2 Poverty and Shared Prosperity Outlook – Fortunes Reverse

*The continuing recession is projected to partially reverse Russia's recent progress in alleviating poverty and promoting shared prosperity. Poverty levels are expected to rise in 2016 under all three scenarios, even if oil prices swiftly recover. Dim prospects for income growth are likely to continue to negatively impact shared prosperity and poverty trends.*

**The recession is reversing Russia's substantial achievements over the past decade in reducing poverty and promoting shared prosperity.** Russia's poverty rate is expected to rise further in 2016 as the economy continues to contract, unemployment rises, and inflation reduces the real purchasing power of households. Meanwhile, the demands of the fiscal consolidation will sharply limit the government's latitude for countercyclical policies and antipoverty spending. A rising share of the world's poor live in countries with slowing growth rates. There are also growing concerns that poverty will become increasingly concentrated in natural-resource-based economies. For commodity exporters, such as Russia, the gains in poverty reduction made over the past decade are gradually reversing. Poor households in these countries have been hit by higher import prices and sharp currency declines, the disappearance of jobs in construction and other non-tradable sectors, and cutbacks in relief programs because of fiscal pressures (Box 14).

**Weak income dynamics are expected to continue to adversely impact poverty projections.** Under the baseline scenario the headcount poverty rate is expected to increase from 13.4 percent, or 19.2 million people, in 2015 to 14.2 percent, or 20.3 million people, in 2016. The number of people living below the national poverty line already rose by 3.1 million between 2014 and 2015. The projected increase in 2016 would return poverty rates to their 2007 levels, undoing nearly a decade's worth of gains. It would represent the largest increase in the poverty rate since the 1998-1999 crisis, far exceeding the increase observed during the global financial crisis in 2008 (Figure 43). The weakening of the labor market is expected to boost unemployment and put further downward pressure on real wages, thereby contributing to the increase in poverty. Due to the demands of the fiscal consolidation the government is unlikely to reinforce income growth through higher transfers or pensions, further diminishing the prospects for income growth among Russian households.

**Box 14 The impact of fiscal policy on poverty reduction and shared prosperity since 2008**

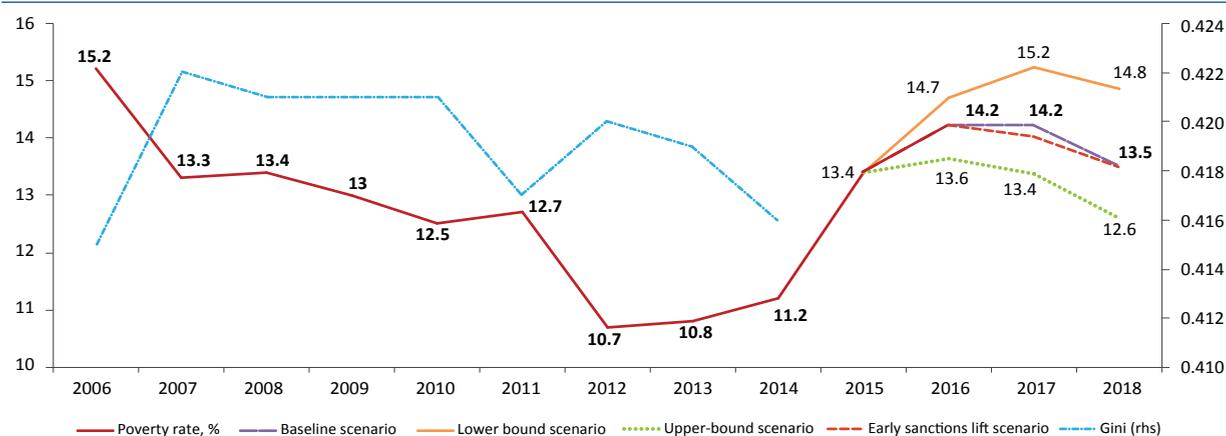
**Russia's progress in reducing poverty and promoting shared prosperity stalled in 2014.** As the economy entered its current recession, poverty rates increased due to a decline in real wages and a rapid increase in inflation, which reduced the real value of social transfers. Income growth among households in the bottom 40 percent of the income distribution fell below the national average, and the middle class stopped expanding for the first time since 2000.<sup>23</sup> Households in the bottom 40 percent of the income distribution depend heavily on public transfers, which account for an average of 60 percent of their total income. As inflation continues to reduce the real value of these transfers, while a shrinking fiscal envelope prevents the government from fully compensating for this effect, the erosion of household purchasing power is reversing past progress in poverty reduction and shared prosperity.

**In the years following the global financial crisis, pensions and public wages played a significant role in increasing the incomes of poorer households in Russia.** On average, households in the bottom 40 percent experienced faster income growth than those in the top 60 percent. However, different factors drove income growth among poorer and richer households. Between 2008 and 2014 private sector wages accounted for 44 percent of real income growth among households in the bottom 40 percent, while public sector wages accounted for 36 percent and pensions accounted for 13 percent. The cumulative growth of public wages for the bottom 40 percent reached 39 percent in 2008-2014. Meanwhile, middle-class and high-income households benefited from the massive growth of pensions. During 2008-2009 pension indexation reached 10-20 percent in real terms, and a valorization increase in 2010 increased real pension payments by 35 percent while also expanding their coverage. Rising real pension payments were responsible for almost all of the income growth among households in the top 60 percent between 2008 and 2014. Private sector wages and other income had a far more modest effect, and was even negative among households in the richest deciles. Public sector wage growth had a mixed impact on the middle class and a slightly positive effect on households in the top three deciles.

**In 2016, poverty is projected to increase further in all scenarios.** The projected increase in the poverty rate under all three scenarios is due in part to the deeply negative carryover effect of the sharp contraction in real income in 2015 combined with the continued deterioration of employment indicators. Elevated inflation, together with the continued zero indexation of public wages, and below inflation indexed pensions will keep real wages and income growth negative in 2016. Labor markets are expected to be impacted by lower demand and the unemployment rate is projected to increase from 5.6 percent in 2015 to 6.0 percent in 2016, further increasing wage pressures. During the 2008 global financial crisis

the government launched a large-scale fiscal stimulus program that reinforced household consumption and prevented an increase in poverty. However, the recent collapse of oil revenues has largely exhausted the government's capacity for countercyclical spending, and the projected fiscal consolidation will greatly limit its ability to shield vulnerable households from the impact of the recession. Under the baseline scenario the poverty rate is projected to increase to 14.2 percent in 2016, or 20.3 million people. The poverty rate is projected to rise to 14.7 percent (21 million people) in the lower-bound scenario and to 13.6 percent (19.5 million people) in the upper-bound scenario.

**Figure 43: Poverty rate projections, percent**



Source: Rosstat and World Bank.

<sup>23</sup> With the exception of a brief pause during the global financial crisis in 2009.

**Better growth prospects in 2017 could translate into a stabilization of poverty rates.** However, even the improvement in economic conditions projected in the baseline scenario would be unlikely to stop the erosion of household incomes in 2017, as nominal increases in public sector wages and transfers are unlikely to keep pace with inflation. As a result, under the baseline scenario the poverty rate would remain elevated in 2017 at close to its 2016 rate of 14.2 percent. Under the lower-bound scenario the poverty rate would rise further, from 14.7 percent in 2016 to a peak of 15.2 percent in 2017. Only the upper-bound scenario would allow for a modest increase in real wages in 2017, though lower-income households would be less

likely to benefit from rising wages due to their disproportionate reliance on public transfers. Under the upper-bound scenario the poverty rate is expected to remain at 13.4 percent in 2017, similar to its 2015 level, but lower than the peak of 13.6 percent observed in 2016. In 2018, pressures related to the presidential election are expected to result in the full indexation of pensions, public wages and social transfers. At the same time labor markets are expected to recover somewhat. Thus, poverty dynamics are expected to improve significantly in 2018. The poverty rate is projected to fall to 13.5 percent under the baseline scenario, 12.6 percent under the upper-bound scenario, and 14.8 percent under the lower-bound scenario.

## 2.3 Risks and Policy Challenges – Prevailing Headwinds

*Risks to Russia's outlook are tilted to the downside as it faces strong headwinds from an uncertain recovery in global demand, especially for oil and other commodities. At the same time, the policy space for Russia's second phase of adjustment to increase medium-term fiscal and financial sector stability has shrunk in light of depleting buffers. Russia's longer-term growth potential will depend on the strength of its structural reforms.*

**Global economic growth and commodity-price projections are subject to substantial downside risk.** Emerging markets and developing economies continue to face serious challenges due to slumping commodity prices and diminished capital inflows. The broad weakness in commodity prices is expected to persist in 2016, maintaining pressure on commodity exporters such as Russia. The sharp drop in oil prices in January underscored the continued instability of both supply and demand in the global oil market. This includes the possibility of a more rapid resumption of oil exports from Iran, greater resilience in US oil production and slower growth in oil consumption as the impact of lower prices on demand fades. Protracted low oil prices in 2016 could further slow global inflation, keeping policy interest rates low across advanced economies. While low policy interest rates that several central banks have put in

place are supportive of short-term growth, they can also undermine the profitability of financial institutions. In the first few months of 2016 low interest rates have already caused a sharp slide in bank equity prices. The slowdown in emerging markets, combined with rising international financial volatility, could delay the projected recovery in global growth (Box 15).

**Weak growth and sharply lower commodity prices have narrowed the room for Russian policy makers to respond, should risks materialize.** The depletion of Russia's fiscal reserves has increased its vulnerability to further shocks. Similar to the experience of other commodity exporters, the recent collapse of global oil prices has sharply limited the Russian government's capacity for countercyclical measures to support macroeconomic stability in a prolonged downturn. Nevertheless, fiscal policies can still

**Box 15 Risks to the global outlook**

**Global growth is expected to accelerate slightly in 2016, but downside risks are substantial.** This includes a disorderly slowdown in major emerging market economies, financial market turmoil arising from sudden shifts in borrowing costs amid deteriorating fundamentals, lingering vulnerabilities in some countries, and heightened geopolitical tensions. Though it remains relatively unlikely, a disorderly slowdown in the largest emerging markets would have important global spillovers through its negative impact on commodity prices and growth in the developing world. Compounding these risks is the possibility of a protracted decline in potential growth throughout emerging and developing economies. Empirical estimates indicate that a sustained 1 percentage point decline in the aggregate growth rate for Brazil, Russia, India, China and South Africa (the BRICS) would cut growth in other emerging and developing economies by around 0.8 percentage points and reduce global growth by 0.4 percentage points.<sup>24</sup> While China's fiscal buffers may be sufficient to manage the risks associated with its own slowdown, this may not be the case for countries such as Russia, in which low commodity prices have greatly diminished revenues and depleted fiscal reserves.

**Declining global inflation and persistently low policy interest rates in advanced economies are increasing international financial risks.** Headline inflation is expected to be close to zero in a number of advanced economies, due largely to the decline of global oil prices. Key central banks have adopted a more accommodative monetary policy stance. Following a modest increase in interest rates in December 2015 the US Federal Reserve indicated in February 2016 that it was closely monitoring external risks and the impact of global turbulence on US growth, and a sudden readjustment of expectations regarding the future trajectory of US interest rates could increase financial stress in developing economies. As low oil prices continue to reduce inflationary expectations, policy rates are projected to remain at their current levels well into 2017. Several central banks in advanced economies have introduced negative policy rates, including the European Central Bank. Though these policies are intended to support growth, the combination of negative rates, large excess reserves, and low long-term yields could undermine the profitability of banks by narrowing net interest margins and reducing revenues from traditional maturity-transformation activities. Amid growing concerns about credit risks, these factors contributed to a significant sell-off in bank shares in early 2016.

play an important role in mitigating risks and supporting growth, and a combination of cyclical and structural policies could prove mutually reinforcing. Near-term policy actions should focus on building resilience to withstand global financial market turbulence and reinforcing financial sector stability. The authorities should design policies to support a smooth fiscal adjustment that equitably distributes the burden across the economy and promotes long-term productivity growth. These cyclical policies should be complemented by structural reforms intended to bolster investor confidence in the short term and enhance growth prospects in the long term.

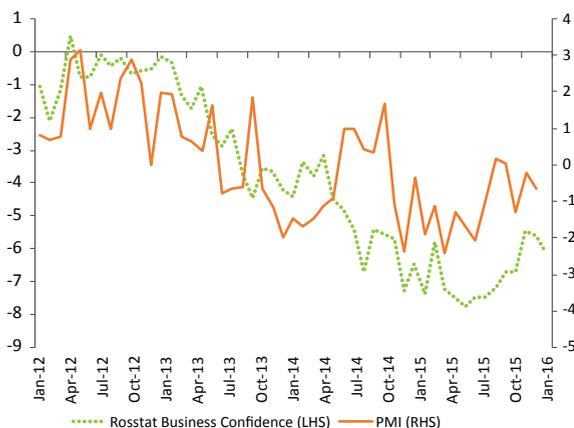
**Policy uncertainty has become the most important obstacle to investment and consumption decisions.** Recent trends in business and consumer sentiments show that

confidence has not yet been restored. Consumer confidence deteriorated in the last quarter of 2015 and is likely to have weakened further in the first quarter of 2016. Business confidence slightly improved in the first quarter of 2016, yet remained low overall (Figure 44). Weak investor confidence is not due solely to the continued softness of domestic demand. However, policy uncertainty became the single most important constraint reported by businesses (Figure 45). This refers to uncertainty about medium-term fiscal policy choices and priorities in economic policy which should address structural inefficiencies in the allocation of factors of production and rethink the footprint of the state in the economy. It also includes the unpredictability in the application of laws and regulations, which prevent the development of a level economic playing field. These policy uncertainties now stifle private investment and limit Russia's growth potential.<sup>25</sup>

<sup>24</sup> World Bank Global Economic Prospects, January 2016.

<sup>25</sup> The output gap turned negative in 2015 from a positive 2-3 percent in 2014, and it is expected to widen further in the next two years to about 6 percent, which could justify further countercyclical policies. However, given the existing structural constraints, projected growth is unlikely to exceed its estimated long-run potential. As a result, aggressive countercyclical policies may boost inflation rather than supporting domestic demand.

Figure 44: Business confidence surveys in manufacturing

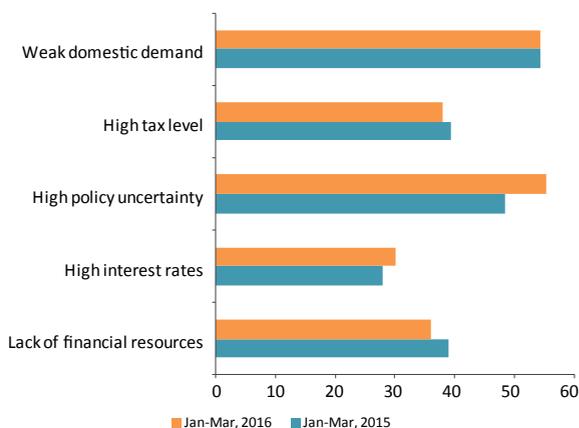


Source: Rosstat and HSBC.

### Financial Sector Stability

**Financial sector stability will be essential to the recovery of private investment, yet financial stability in the near term will be tested by a number of factors.** First, both private and public banks are likely to experience increased capitalization pressures due to the rising share of NPLs on bank balance sheets and the expiration of temporary regulatory forbearance measures by the central bank. Russian banks exhibited weak financial indicators in 2015, and the recession has slowed new business growth.<sup>26</sup> Second, banks are becoming increasingly reliant on central banks and government funding support, due to restrictions on access to international capital and the shallowness of domestic capital markets. Finally, despite significant improvements in recent years, weaknesses in financial sector oversight and the uneven enforcement of banking regulations persist.

Figure 45: Key constraints to manufacturing, rosstat business survey, percent



Source: Rosstat.

**The rising share of NPLs is increasing pressure on bank capital.**<sup>27</sup> Russian banks have been obliged to increase their loan-loss provisioning, which is eroding profits, depleting capital assets, and undermining their ability to attract new investment. Further loan-loss provisioning is likely in the near term as a consequence of weak economic conditions for households and firms, which cumulatively present the authorities with a near ‘perfect storm’ as they continue to adapt measures to sustain financial stability. Russian banks appear to be adequately capitalized overall; at end-2015 almost all banks met the 10 percent capital-adequacy requirement, and average capital ratios were generally sound thanks to a massive state recapitalization effort and CBR forbearance policies.<sup>28</sup> However, the end of forbearance at the beginning of 2016 is expected to increase pressure on bank capital, and the capital-adequacy ratios of affected banks are likely to decline.

<sup>26</sup> The growth of corporate loans is expected to remain in the low single digits, driven by the refinancing needs of large companies and the obligation of recapitalized banks to increase their exposure by 1 percent per month in certain strategic sectors, such as small-business loans mortgage lending. Loans to households are not expected to grow, as banks are less willing to offer consumer credit and auto loans.

<sup>27</sup> The aggregate share of NPLs may be underreported, as more than half of the banking system’s total assets are held by public banks. The CBR’s specific methodology for determining NPLs may also result in underreporting.

<sup>28</sup> The CBR introduced forbearance in 2015 to ease pressure on banks’ prudential ratios. In particular, it allowed banks to convert foreign-currency assets into rubles at more favorable exchange rates beginning in 2014.

**Many of Russia's largest state-owned or state-controlled banks continue to provide support to the economy despite the increase in NPLs.**

The CBR's efforts notwithstanding, high interest rates continue to exert upward pressure on funding costs, while credit levels are in decline and defaults are increasing. This threatens to create a vicious cycle in which tight credit constraints further discourage investment. To maintain the viability of the sector, banks need to resolve their stock of NPLs, which would lead to stronger balance sheets and encourage more sustainable lending.

**Banks have become increasingly dependent on central bank funding as the Russian banking system has remained cutoff from international capital markets since 2014.**

As of end-2015 the CBR had provided bank funding equivalent to 6.5 percent of total banking sector liabilities. Foreign-exchange exposure poses a serious risk for certain banks, especially corporate borrowers with foreign-currency-denominated loans in non-tradable sectors such as real estate and construction. Foreign-exchange exposure is often the single greatest risk to banks whose clients have little or no foreign-currency earnings and have been hard hit by currency depreciation and the economic downturn. Given that foreign-currency-denominated assets represent about 30 percent of corporate-banking assets, this risk is being closely monitored by the CBR as it strives to reduce banks' foreign-exchange exposure in terms of both assets and liabilities.

**Government and central bank policies implemented as part of the 2015 anti-crisis plan have provided important short-term relief to banks, but these measures are straining the capacity of financial sector authorities.**

The CBR has provided immediate liquidity, in some cases accepting the underlying portfolio as collateral despite the significant risks involved. CBR liquidity support and the collateral requirements for central bank loans could expose the central bank to the

declining market value of assets on bank balance sheets. The CBR has responded by intensifying bank supervision, and it continues to close weaker financial institutions. More than 100 banks were closed during the past year, and the consolidation of the banking sector is expected to continue as the CBR tightens regulatory compliance. In the near-term, the resolution of troubled banks should be encouraged, including the merger and/or takeover of smaller banks, possibly by raising the minimum capital requirements. Bank closures have depleted the reserves of the Deposit Insurance Agency (DIA), and the CBR has already provided liquidity to sustain DIA operations. Achieving and maintaining a sustainable level of reserves would allow further banking sector consolidation while still protecting depositors. The DIA would require a premia top-up from industry, a raise in its deposit-insurance premia assessment amount and extended coverage to legal entities.

### **Fiscal Adjustment**

**Fiscal policy uncertainty represents a significant risk to Russia's growth prospects.**

Russia has a disproportionately large public sector. As a significant share of the workforce is employed by the public administration or by state-owned enterprises and banks, many households are directly dependent on public employment and wages. Russia also has a relatively generous social welfare system, and transfers and pensions constitute a substantial share of household income in the form of social transfers and pensions. Given the state's prominent role in the economy, many private firms rely on public contracts. The state's major role in the economy increases risks for households and firms when fiscal constraints tighten or when uncertainty regarding fiscal priorities or the fiscal planning horizon is high. As a result, the manner in which fiscal policy is carried out contributes profoundly to economic sentiments and it has strong implications for employment, income and economic growth.

<sup>29</sup> A new CBR regulation, which is currently pending approval, would introduce higher risk weights on foreign-currency-denominated loans and securities as of April 1<sup>st</sup>, 2016: <http://www.cbr.ru/analytics/?PrId=project&ch=732#CheckedItem>

**As the collapse of global oil prices put increasing pressure on public revenues, Russia launched a fiscal consolidation effort to address rising fiscal imbalances.** Russia's large fiscal reserves facilitated the first phase of the adjustment by buffering the impact of terms-of-trade shocks. However, as low oil prices persisted, these reserves were progressively depleted. Moreover, the volatility of oil revenues made medium-term fiscal planning difficult, and policymakers shortened the budget horizon to one year in 2015. Despite a new round of spending cuts announced in January, Russia is unlikely to meet its 2016 deficit target of 3 percent of GDP, and the country's Reserve Fund is expected to be exhausted by the end of the year. The president's recently announced target of a balanced budget by 2019 effectively constitutes a new fiscal rule, yet the government lacks a mechanism for implementing it.

**Going forward, two key fiscal policy challenges remain.** The first will be to embark on a strategic expenditure restructuring process going well beyond general budget cuts, while also strengthening the nonoil revenue base to adjust to a protracted downturn in oil and gas revenues. Budget cuts can be effective as an emergency response to shocks, but more sophisticated reforms extending to both sides of the budget will be necessary to adjust to a protracted downturn in oil and gas revenues. The second challenge will be to manage expenditure uncertainty in the absence of medium-term budgeting, which was suspended in August 2015. A return to a credible medium-term fiscal framework is paramount and would boost consumer and business confidence by reducing fiscal uncertainty.

**Formulating medium-term policies that support a smooth fiscal adjustment is among the government's most pressing challenges.** A clear, well-sequenced plan for eliminating the deficit over the next several years would allow firms and households to make more efficient

investment and consumption decisions. Such a plan should provide for continued spending on strategic public investments while shielding poor and vulnerable households from the brunt of the fiscal adjustment. Ensuring that the burden of the adjustment is equitably distributed and that the fiscal consolidation is consistent with long-term productivity growth will likely require a comprehensive review of expenditure priorities focusing on key sectors, such as national defense, economic subsidies, and social programs and pensions. Improvements in expenditure efficiency could help the government maximize the value of its existing resources, but such gains may not be sufficient to compensate for increasing structural imbalances. This would require a review of tax policies, which would serve as the basis for developing a strategy to increase nonoil revenues and sustainably lower the nonoil deficit.

**Sizable fiscal deficits are projected over the medium-term, and maintaining fiscal stability will require a new medium-term budget financing strategy as well as a renewed discussion on borrowing limits.** The government's current plan includes only temporary financing measures, such as using the remainder of the Reserve Fund or privatizing public assets. The government is considering an ambitious privatization effort, which could begin as early as the second half of 2016 (section 1.4). The privatization process would need to guarantee transparency and that investors are sourced competitively to ensure that public assets are not undersold. While the Reserve Fund is used to finance recurrent expenditures, the National Welfare Fund is used for infrastructure investment financing. Investment decisions should follow a transparent vetting process based on financial viability assessments to ensure that scarce capital resources generate adequate long-run returns. Strengthening public investment management would help to ensure that projects generate value for money.

## **Structural Reforms to Accelerate Long-Term Growth**

**The shift in relative prices caused by the ruble's depreciation could enable a broad-based improvement in Russia's international competitiveness.** The depreciation has presented Russia with an opportunity to transform its export profile by diversifying away from primary commodities. However, relative prices are not the only dimension of competitiveness, and Russian firms will face considerable challenges in improving the quality of exports, increasing their technological content and ensuring compliance with international standards. Achieving these objectives will require substantial investment, especially FDI, which is associated with the strongest technological spillovers. The price advantage generated by the depreciation might not be sufficient to attract investors, particularly in the context of the economic sanctions regime, unless it is accompanied by sustained improvements in the investment climate and deep structural reforms.

**Structural reform measures could boost investor confidence in the short term and enhance Russia's growth prospects over the long term.** Investors face a range of economy-wide constraints, including administrative barriers to doing business, corruption, high transportation and logistics costs, and unequal access to factors of production and markets due to the lack of competition. Especially if Russia wants

to diversify its export profile, the authorities will need to enact structural reforms designed to facilitate the reallocation of labor and capital between sectors and firms and to create a level playing field for private investors. Private investment remains constrained by regulatory uncertainty and variations in how the rule of law is applied. The government should shift its focus to providing highly effective regulatory institutions that promote robust competition and curtail opportunities for corruption.

**The government's new anti-crisis plan does not focus exclusively on emergency measures, but also includes a number of medium-term economic development initiatives.** This includes reforms designed to improve the investment climate, reduce the frequency of business audits, diminish regulatory uncertainty, and strengthen judicial processes and law-enforcement systems (Box 16). The swift and comprehensive implementation of these measures would provide a clear signal to international capital markets that the Russian government is committed to improving the investment climate. Without rapid and sustained investment in new industries, Russia may miss the opportunity afforded by its current price advantage, and promoting sufficient productivity growth to accelerate the country's long-term economic trajectory would prove far more challenging. These issues are examined in greater detail in the special focus chapter of this report.

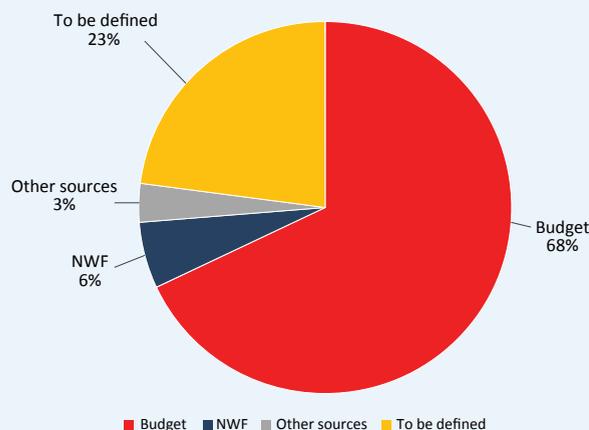
**Box 16 The Government’s 2016 anti-crisis plan**

**On March 1, 2016 the government approved the Plan of Government Action for Stable Socioeconomic Development in 2016.** This new anti-crisis plan calls for RUB684.8 billion (US\$9.5 billion), or 0.8 percent of GDP, in new spending, focused primarily on supporting selected industries and regional governments. In 2015, the authorities had developed an anti-crisis plan in the amount of RUB2.4 trillion, about 70 percent of which was devoted to financial sector support. The government did not originally intend to have a second 2016 plan and instead expected to work on a more routine basis. However, the sharp decline in oil prices in January 2016 caused the government to reconsider its decision.

**The plan focuses on short- and medium-term economic development measures.** It includes transfers to regional governments (RUB310 billion), support to selected sectors (RUB340.8 billion), enhanced social protection (RUB38.3 billion), and reforms designed to improve the investment climate (Figure 46). Transfers to regional governments will consist of credits from the federal budget in place of more expensive commercial debt. In 2015, the net increase in budget credits totalled RUB161.2 billion. Short-term support to selected sectors will encompass the automobile industry (RUB137.7 billion), the state-owned railway company (RUB39.8 billion) and the construction sector (including RUB25 billion for building new schools and RUB16.5 billion for mortgage subsidies). RUB33.5 billion will go to support small and medium enterprises, and RUB21.1 billion will be devoted to promoting non-resource exports. Social protection spending is primarily designed to shore up employment. Finally, measures to improve the investment climate include reducing business audits, increasing the predictability of legislation, improving the judicial and law enforcement systems, decreasing the costs of doing business, privatizing certain state-owned companies and enhancing the efficiency of others.

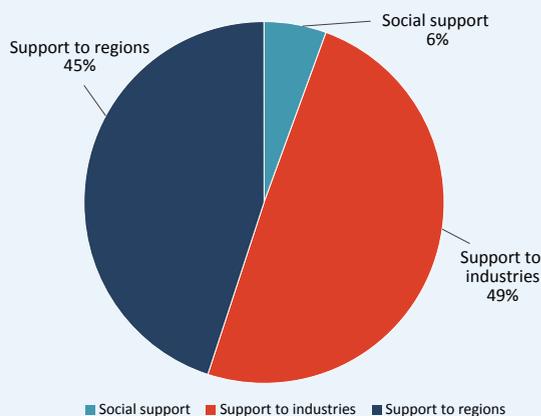
**The bulk of the plan’s financing, RUB468 billion, has already been accounted for in the 2016 budget.** Expenditures to support the economy increased by 11.6 percent in nominal terms, though this may be altered during the upcoming budget revisions. The government’s plan guarantees that support to certain industries will be allocated before amendments to the federal budget are introduced (Figure 47). Support to Russian Railways will come from the National Welfare Fund. The allocation of the remaining RUB158 billion in financing will be determined based on budget execution during the first half of 2016. This includes support to the ailing state-owned development bank, VEB, and a possible second round of pension indexation in addition to the one included in the current budget proposal. Potential sources of financing could include the government’s anti-crisis fund (RUB120 billion, mainly consisting of undisbursed resources from the 2015 anti-crisis plan), the president’s special fund (RUB342 billion, consisting of the frozen second-pillar pension contributions), privatization proceeds, or expenditure reallocations.

**Figure 46: The anti-crisis plan by expenditure area**



Source: Ministry of Finance.

**Figure 47: The anti-crisis plan by financing source**



Source: Ministry of Finance.



## PART III

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# EXPORT COMPETITIVENESS AND FOREIGN DIRECT INVESTMENT: *The Complex Puzzle of Diversification*<sup>30</sup>

*The combined effects of economic sanctions and falling oil prices have brought renewed attention to Russia's longstanding policy discussion on trade diversification and export competitiveness. This focus note explores historic challenges to Russia's export competitiveness and why it might be difficult to expect quick changes in the country's export-profile. For decades the growing dominance of the natural resource sector has undermined economy-wide competitiveness, as high commodity prices have skewed the country's economic and export structure in favor of oil, gas and mining. Russia's export pattern narrowed on both the extensive and intensive margins, becoming increasingly concentrated in terms of both products and markets as the high rate of return offered by primary commodities discouraged value addition and stifled the development of new export sectors. While the depreciation of the ruble has enhanced the competitiveness of Russia's non-resource exports, leveraging this opportunity to develop a broader and more sophisticated export mix will require a substantial and sustained increase in private investment. The price advantage generated by the depreciation might not be sufficient to attract investors, especially foreign investors, unless it is accompanied by deep and sustained improvements in the investment climate. Russia's profound regional disparities underscore the critical role of private investment in the country's development, and empirical evidence reveals that the ability to attract FDI at the regional level is among the single strongest predictors of per-capita income growth.*

<sup>30</sup> This section was prepared by Birgit Hansl, Michael Ferrantino and Gabriela Schmidt based on the findings of a background report entitled *Export Performance and FDI Performance across Russia's Regions*. The original report was part of a suite of papers prepared for the World Bank's Trade and FDI Competitiveness across Russia's Regions in the post-WTO Accession and Eurasian Customs Union Environment research project under the guidance of Birgit Hansl. The team would like to thank peer reviewers Jean-Pierre Chauffour and Borko Handjinski for their comments and suggestions. The team is also grateful for the additional support provided by Karlygash Dairabayeva and Patrick Ibay, as well as Olga Emelyanova, who supplied the data used in the analysis.

### 3.1 Introduction

**Expanding and diversifying Russian exports could reinforce macroeconomic stability, accelerate economy-wide growth and alleviate regional disparities.** Diversifying export products and destinations can mitigate external macroeconomic risks. As the recent experiences with oil price volatility and economic sanctions highlight, broadening the export profile beyond the natural-resource sector can lessen Russia's vulnerability to commodity-price volatility by diluting Russia's fiscal and economic reliance on oil and gas. Second, export industries and export-oriented FDI are believed to generate vital technological spillovers that accelerate innovation and facilitate the production of more sophisticated goods and services which boost economic growth in the long-term. Finally, encouraging investment in regions with a competitive advantage in sectors other than natural resource production and related industries can boost interregional convergence in wage rates and living standards.

**While export competitiveness has always been a prominent element of Russia's discussions on trade diversification, the collapse of global oil prices and the imposition of economic sanctions have brought renewed attention to the importance of expanding production and exports beyond the resource sector.** Repeated oil-price shocks and a grim medium-term outlook for global commodity markets have exposed serious weaknesses in Russia's resource-driven growth model. However, the weaker ruble could also help Russia transform its export profile by diversifying away from primary commodities in general and from the oil and gas subsectors in particular. The weakened ruble has given Russian firms a comparative edge in global markets, and exchange-rate projections indicate that this advantage is likely to endure long enough to justify medium-term investments. However,

relative prices are not the only dimension of competitiveness, and Russian firms face challenges in product quality, innovation capacity and compliance with international standards, as well as economy-wide structural constraints.

**In order for firms to capitalize on their current relative price advantage in international markets they would need to expand and change their output capacity and invest in both their products and production processes.** Efforts to boost output, improve quality, introduce innovative technologies and/or comply with international standards will require a large and sustained influx of new capital. But attracting international investors will require more than a price advantage: in order to become competitive as an exporter and as a destination for global FDI, Russia would need to establish a more hospitable investment climate.<sup>31</sup> Accomplishing this goal will require eliminating administrative barriers to doing business, reducing transportation and logistics costs, lowering corruption and regulatory uncertainty, and ensuring equitable access to productive factors and markets.

**Over the past several decades high commodity prices have skewed Russia's economic and export structure towards oil, gas and mineral products.** Russia has gradually developed a two-tiered export structure, in which the bulk of its export revenue is derived from a "one-product-one-market" pattern of oil and gas exports to the European Union, while a more stable and diverse range of non-commodity goods is exported almost exclusively to markets in the former Soviet Union. Russia has had considerable difficulty introducing and sustaining new non-commodity exports beyond markets in the Eurasian Customs Union (ECU) and former Soviet Union, which are by far its most reliable and enduring export partners. Russia's exports are also less

<sup>31</sup> See also: <http://www.brookings.edu/blogs/future-development/posts/2015/11/03-ruble-depreciation-russia-hansl>

sophisticated than those of Brazil, India, China and South Africa—the other BRICS countries—and their average level of sophistication has declined over time.

**Russia has historically attracted foreign investment at rates comparable to those of the other BRICS countries, but the establishment of economic sanctions in 2014 drastically curtailed inbound FDI.**<sup>32</sup> Russian mining and quarrying firms (including oil and gas companies) are the most likely to have foreign investors, followed by financial and insurance firms. While the resource sector has traditionally been the main target of foreign investment, the sectoral distribution of FDI has become more diverse over time. Over 2005–2012 FDI in the secondary sector (manufacturing, utilities and construction) grew four times faster than FDI in the resource sector, while FDI in the service sector grew three times faster.<sup>33</sup>

**Russia suffers from vast and persistent regional disparities in export performance and FDI attractiveness, and empirical analysis reveals a strong link between FDI, export performance and regional growth.** Gross regional product (GRP) per capita varies enormously across Russia's regions, the wealthiest of which are comparable to high-income OECD members, while the poorest are comparable to low-income developing countries.<sup>34</sup> Beyond the historical economic centers of Moscow and St. Petersburg, most of Russia's more developed regions are spread across the north of the country, while the poorest are concentrated in the south and southwest. The uneven distribution of oil and other natural resources largely explain this pattern: Russia's wealthiest regions tend to have relatively large commodity exports per capita,

relatively high FDI inflows per capita, or both. Higher-income regions also tend to have larger non-commodity exports per capita, but those that have been most successful in attracting FDI have enjoyed the most robust economic growth rates and exhibit the highest average income levels.

**In order to improve export performance, accelerate growth and enable poorer regions to converge with their wealthier counterparts, Russia would need to become more attractive to FDI despite the inherent challenges of the economic sanctions regime.** Even before economic sanctions were imposed, the prevalence of round-tripping FDI—i.e. channeling domestic capital through offshore tax havens so that it is treated as foreign investment—indicated serious deficiencies in Russia's business climate. External shocks exacerbated these weaknesses, particularly restricted access to global financial markets. Falling commodity prices have compounded the impact of the sanctions regime on oil, gas and mining exports. However, the current challenges for the resource sector also presents an opportunity to reinvigorate growth in the non-resource economy—provided that the authorities can establish an adequately supportive investment climate. Moreover, depressed commodity prices are diminishing the advantages of wealthier, resource-rich regions, potentially facilitating long-term interregional convergence in export performance, growth and ultimately living standards. However, many of Russia's poorer regions also suffer from serious deficiencies in economic connectivity, institutional capacity and the quality of the local business environment. Addressing these disparities should be a key priority of the government's FDI strategy.

<sup>32</sup> After adjusting for FDI outflows to tax havens (e.g., Cyprus, Bermuda and various Caribbean countries), Russia's inbound FDI-to-GDP ratio for 2007–2013 was at 2.4 percent, but since the imposition of economic sanctions in 2014 FDI inflows have been negligible.

<sup>33</sup> This was due in part to the reduced value of oil and gas investments following the 2008–09 drop in global oil prices.

<sup>34</sup> Russia's regions are collectively referred to as federal subjects. These include a number of different administrative entities: oblasts, federal republics, krais, autonomous okrugs, federal cities, and one autonomous oblast. Each federal subject has a unique constitutional and historical relationship with the Russian Federation, and many have significant populations of ethnic minorities. The number of federal subjects has varied over time, and the data used here refer to the 83 federal subjects that existed in 2012.

## 3.2 Russia's Export Profile and the Challenge of Diversification

### Trade Orientation and Growth

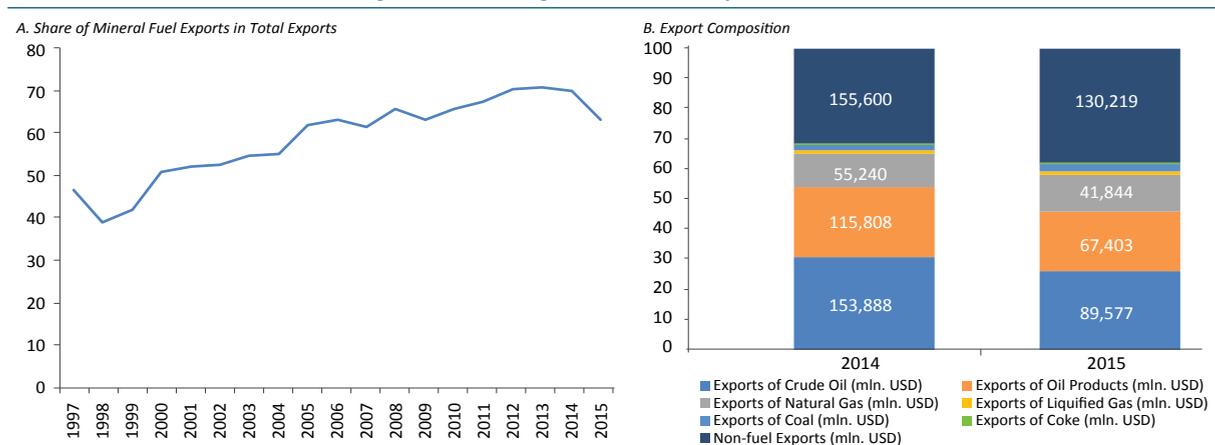
**The Russian economy is well integrated into global markets, but over time oil and gas exports have dominated the growth of its global export share.** The most basic indicator of trade openness and economic integration is the trade-to-GDP ratio.<sup>35</sup> This indicator is slightly lower for Russia than for most BRICS countries, with the exception of Brazil. Russia's actual trade is below its potential.<sup>36</sup> While Russia successfully expanded its export share in global exports to 3 percent during the 2000s, this was due entirely to increases in oil and gas exports.<sup>37</sup>

**The current slump in global commodity prices is not the first time that the overwhelming share of natural resources in Russia's export basket has posed a major threat to macroeconomic stability.** A steep drop in oil prices in 2009 in the wake of the global financial crisis adversely impacted Russia in much the same way as in

2014. Oil and gas exports peaked in 2013 at 71 percent of total exports (Figure 48). Yet even in 2014 and 2015, as global oil prices collapsed, oil and gas continued to account for 66 percent and 62 percent of Russian exports, respectively. Crude oil represented more than one-third of oil and gas exports.

**Russia's dependence on oil and gas exports is exacerbated by its focus on a single export market, the European Union.** In 2014, 46 percent of Russia's total exports went to EU countries, down from 55 percent in 2013, of which oil and gas represented by far the largest share. This "one product-one market" export pattern has heightened Russia's vulnerability to shocks, as either falling global oil prices or decelerating EU growth can negatively affect Russian exports. Since 2013, Russian exports have been continuously impacted by one or both of these dynamics.

Figure 48: Oil and gas and nonfuel exports, 1997-2015



Source: COMTRADE and Haver Analytics.

<sup>35</sup> Dairabayeva, Ferrantino, Portugal-Perez and Schmidt, 2015. The ratio gives an indication of the dependence of domestic producers to foreign demand and of domestic consumers and producers on foreign supply.

<sup>36</sup> Russia's trade potential is estimated through a regression analysis comparing actual trade to GDP per capita.

<sup>37</sup> World Bank 2013: Export Diversification through Competition and Innovation: A Policy Agenda.

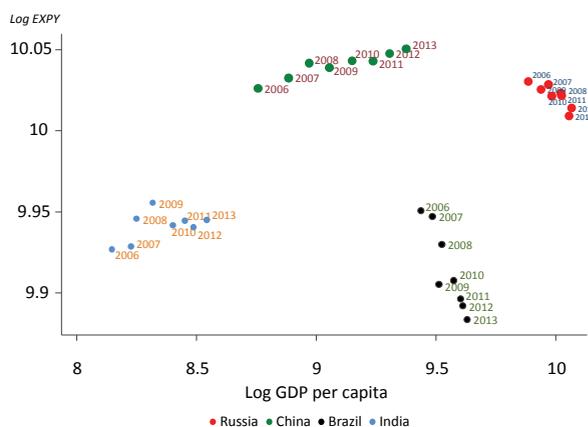
**The dominance of oil and gas in its export profile has decreased Russia’s revealed comparative advantage (RCA) over time.** Russia’s RCA<sup>38</sup> is primarily in oil and gas, minerals, metals, and wood due to the key role of primary commodities in total exports. Moreover, during the 2000s the number of Russian products with a positive RCA declined from 139 to around 100. This means that in the short-to-medium term Russia can generate the most revenue by increasing output within its relatively narrow range of traditional exports, while over the longer term export diversification—in terms of both products and markets—could increase its resilience to external shocks and accelerate the transfer of new productive technologies. In recent years some nontraditional exports have grown at above-average rates, expanding Russia’s export mix. However, most of these are still primary commodities and intermediate goods, such as nonfuel minerals, agricultural products and foodstuffs, and more sophisticated, higher-value-added goods and services remain conspicuously absent from the export profile.

**Export Sophistication, Value Addition and New Export Survival**

**Russian exports tend to be relatively unsophisticated compared with those of the other BRICS countries.** Indicators of aggregate export sophistication have declined in recent

years, notwithstanding a modest and temporary improvement between 2012 and 2013 (Figure 49). A variety of factors contribute to Russia’s focus on primary commodities, agricultural goods and simple manufactures. While the large share of oil and gas exports itself tends to drive down the sophistication index, Russia’s domestic economy also lags many of its peers in terms of service intensity.<sup>39</sup> Accelerating the growth of modern business services could enhance innovation and boost economy-wide competitiveness. In addition, Russian product standards often differ significantly from international norms, which can make it difficult for Russian exports to fully access international markets, especially markets for complex and sophisticated goods.<sup>40</sup>

**Figure 49: The sophistication of BRICS exports, 2006-2013**



Source: Real GDP per capita in purchasing power parity (PPP) is compiled from the World Bank’s World Development Indicators, the proxy for export sophistication (EXPY) is derived from COMTRADE data.

<sup>38</sup> The RCA reflects a given country’s relative advantage in terms of a group of goods or services as evidenced by trade flows. It provides information about the trade potential of new partners and nontraditional products. Countries with similar RCA profiles are unlikely to have high bilateral trade potential. The RCA index of country i for product j is measured by the product’s share in the country’s exports relative to its share in world trade:  $RCA_{ij} = (x_{ij}/X_{it}) / (x_{wj}/X_{wt})$ , where  $x_{ij}$  and  $x_{wj}$  are the values of country i’s exports of product j and global exports of product j, and where  $X_{it}$  and  $X_{wt}$  refer to the country’s exports and total global exports. A value of less than unity implies that the country has a revealed comparative disadvantage in the product, and a value above unity indicates a revealed comparative advantage.

<sup>39</sup> Sáez and van der Marel, 2015.

<sup>40</sup> Ferrantino, Gillson and Schmidt, 2015. Core ideological differences between Russia’s product standard regime and those of its trading partners outside the former Soviet Union have caused tensions with other WTO members, as Russian product standards also govern non-tariff measures on imports. Russian standards cover product characteristics, production techniques, and packaging and are designed to ensure that different firms produce goods with a high degree of compatibility and interchangeability. By contrast, international standards are more often focused on basic requirements for public safety and health, allowing firms considerable latitude to produce highly differentiated products. Under international standards the private sector ensures product quality throughout the supply chain, while in Russia the state ensures quality through “end-of-pipe” inspections. The specificity and rigidity of Russian standards may stifle innovation by relegating scientific health and safety testing to a subordinate role and creating both compliance problems for firms and monitoring problems for the government.

A statistical technique known as **product-space analysis** explores the complex relationships between different products, revealing important information about a country's underlying economic structure. A product-space analysis of the Russian economy indicates that its comparative advantages tend to be skewed toward products with limited connectivity to other sectors and little potential for positive spillover effects. While Russia's product-space map illuminates the roughly 100 products in which the country has an RCA, most of these are located at the periphery of the product space. This focus on economically isolated products makes it more difficult to build comparative advantages in other sectors. Strikingly, most new products in which Russia has developed an RCA tend to be commodities and intermediate goods, including raw materials, forestry products, cereal grains, and oil and gas products. While there are some exceptions, such as chemicals, Russia has largely failed to develop an RCA in complex manufactures and sophisticated services, reflecting the slow pace of structural transformation over the past decade.

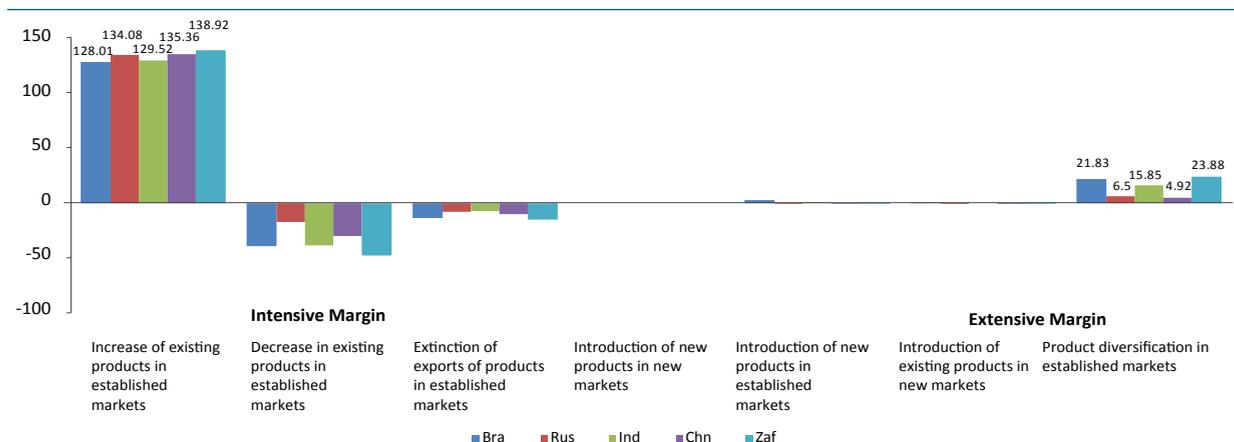
**While Russia has periodically launched new export products and entered nontraditional markets, it has struggled to sustain non-resource exports to countries outside its geographic region.** Exports to countries outside the former

Soviet Union have an especially low survival rate as do products outside the country's dominant resource and commodity sectors. Indeed, many new exports to nontraditional partners survived for just a few years. Conversely, exports to the ECU and other former Soviet Union countries have enjoyed above-average survival rates. Over time, this has generated a dual export structure, in which a relatively diverse and enduring mix of exports to traditional regional trading partners exists alongside a highly concentrated and vulnerable set of mostly resource-based exports bound for partners outside of Russia's historical sphere of influence. Export survival depends on many factors. In Russia, exchange-rate volatility has significantly increased the likelihood that exports will be terminated.

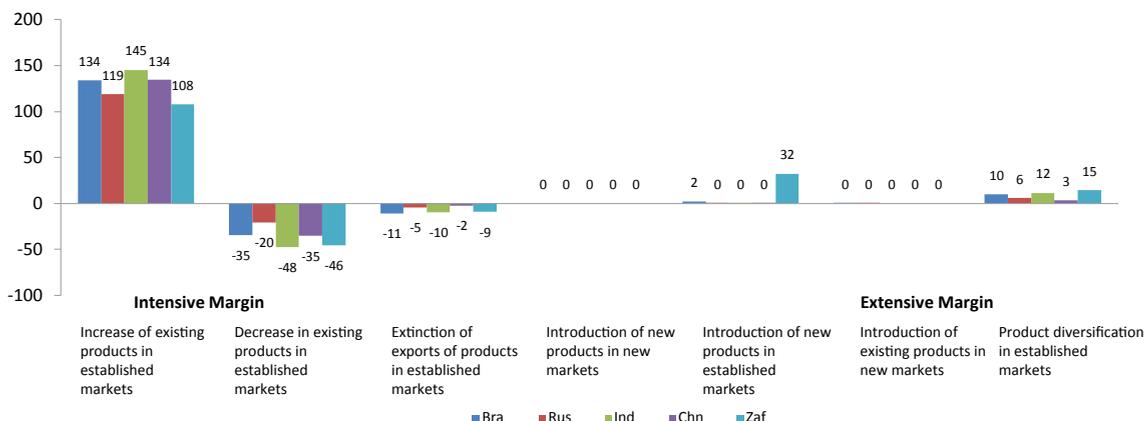
**Compared to its peers, Russia's ability to expand into new markets has been limited, and its trade profile has become increasingly concentrated since 2008.** In recent years, Russia has recorded no growth in exports of new products, either to existing markets or to new markets. Russia's sales of existing products to new markets accounted for only 7 percent of its export gains in 2006–2008 (Figure 50 A), and for 6 percent in 2011–2012 (Figure 50 B). These exports are mainly oil and gas, and growth on the extensive margin is negligible when fuel products are excluded.

Figure 50: Export growth in BRICS countries, 2006–2008 and 2011–2012

A. 2006–2008



B. 2011-2013



Source: COMTRADE.

Note: The analysis excludes 2009, the year of the trade crisis, in order to focus on periods of trade growth.

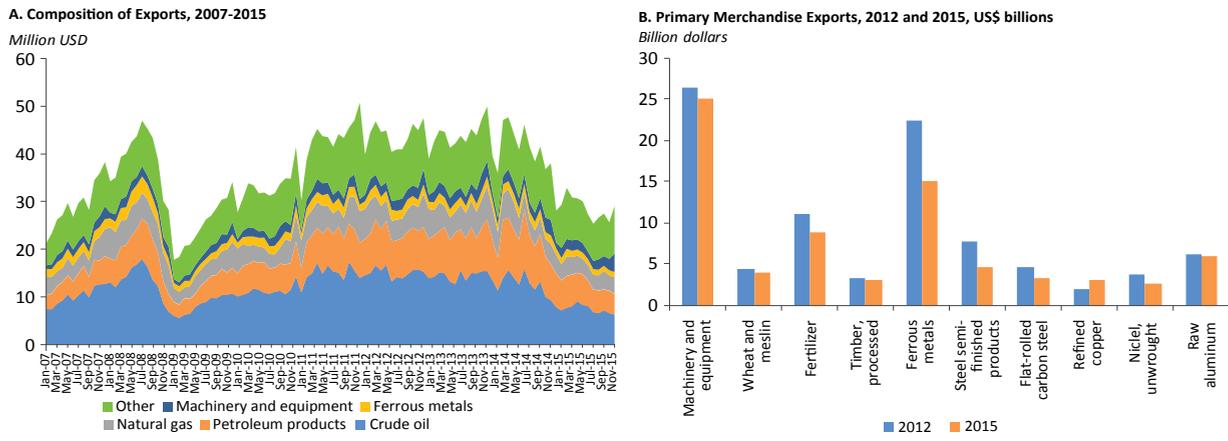
**Export Diversification in an Adverse External Environment**

In 2014 a combination of economic sanctions and the collapse of global oil prices brought renewed attention to Russia’s longstanding policy dialogue on diversification and export competitiveness. While none of the economic sanctions targets Russia’s exports, Russia itself imposed a number of import bans from Western countries, mostly for food items. Also, economic sanctions prohibit the export of some technology and dual-use goods to Russia, which could be used for military purposes. Finally, economic sanctions also prohibit the export of goods, services and technology that could be used for the exploration or production of deep-water, Arctic offshore and shale-oil projects. Most importantly, the rapid devaluation of the ruble created a relative price advantage for Russian exporters, giving rise to considerable optimism regarding Russia’s potential to expand into new products and nontraditional export markets. Yet higher import prices might prevent Russia from importing important intermediate inputs necessary for high-value exports. In addition, Russia faces structural and historical constraints on its export competitiveness and without addressing them the relative price

advantage might be not be sufficient to generate a commensurate increase in the scope, scale and sophistication of Russian exports.

The drop in commodity prices and the establishment of the economic sanctions regime significantly decreased export values in 2014-2015. Fluctuations in the price of crude oil, Russia’s main export, have influenced the prices of Russia’s other commodity exports (Figure 51 A). Economic sanctions, which were phased in from March to December of 2014, inhibited cross-border financial transactions, and their impact on foreign investment may affect future oil-production capacity. The value of Russia’s exports declined by 52 percent between 2012 and 2014, with oil declining twice as fast as other exports. As a result, the share of oil and gas in total exports shrank from 67.2 percent in 2012 to 61.6 percent in 2015. Meanwhile, non-resource exports also contracted by about 30 percent. The value of primary merchandise exports (such as ferrous metals, steel and nickel) also declined over that period, but this drop was less pronounced for machinery and equipment, processed timber and aluminum (Figure 51 B). However, economic sanctions have likely had an even stronger impact on investment than on trade.

Figure 51: Trends in key export goods

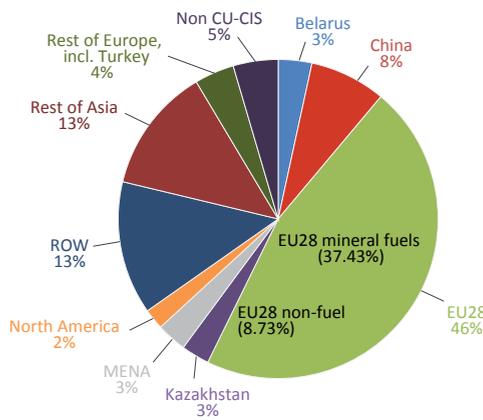


Source: Haver Analytics

While Russia’s recent diversification strategy has focused on expanding exports to the EU beyond oil and gas, China has become an increasingly important export market. In 2014 exports to China accounted for 8 percent of Russia’s total exports, and exports to the rest of Asia represented 13 percent (Figure 52). Exports to ECU partners made up 6 percent, down 2 percentage points from 2013, whereas exports to other CIS countries accounted for 5 percent, down 1 percentage point from 2013. These declines were offset by an increase in the share of exports to the rest of the world.

toward China and the rest of Asia, and the economic sanctions regime is likely to accelerate this trend. Figure 53 shows the evolution of exports to non-EU destinations between 2007-2008 and 2013-2014. Oil and gas exports to China and the rest of Asia more than doubled during this period. Other exports to Asia also increased, though at a much slower pace. After oil and gas, metals and chemicals are Russia’s most important exports. In 2015 metals accounted for 29 percent of nonfuel exports, while chemicals accounted for 19 percent (Figure 55).

Figure 52: Russian exports by destination, 2014

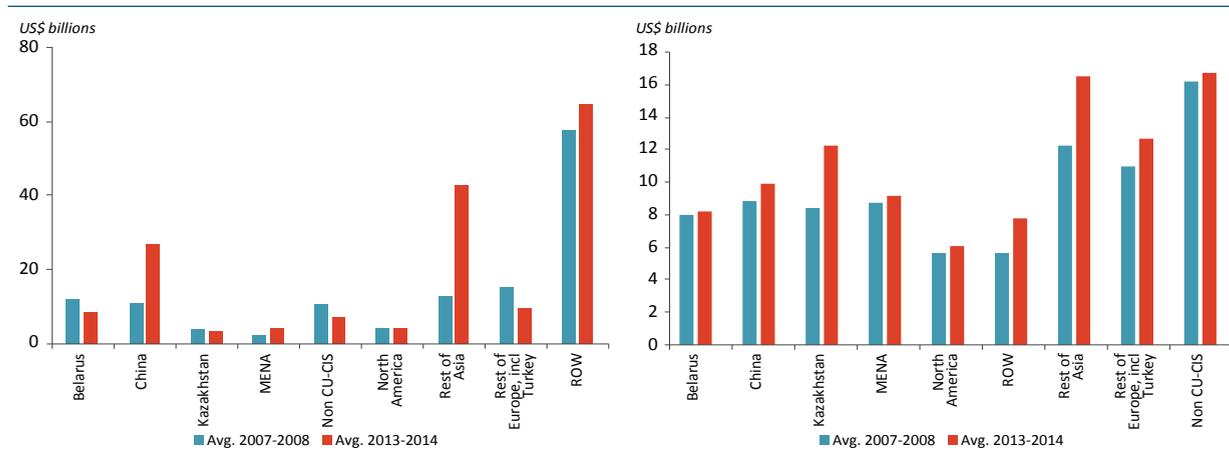


Source: COMTRADE data.  
 Note: “Fuel exports” refer to Chapter 27 of the Harmonized System.

Russian exports, especially oil and gas, have been gradually shifting away from Europe and

Russia has long struggled to diversify both its export products and destination markets, and the rise of the natural resource sector has increased the concentration of the export basket. The Herfindahl-Hirschman Index (HHI) measures the concentration of export shares by product and destination. A score of 0 indicates infinite diversification, while a score of 1 reflects complete concentration. Russia has one of the highest HHI scores for export products among comparable countries, but a relatively low score for export markets. Exports to China and the EU are the most concentrated, while exports to Kazakhstan are the least (Figure 54). This pattern reflects the dual structure of Russian exports to major international markets, which are dominated by oil and gas, and exports to traditional regional trading partners, which are far more diverse.

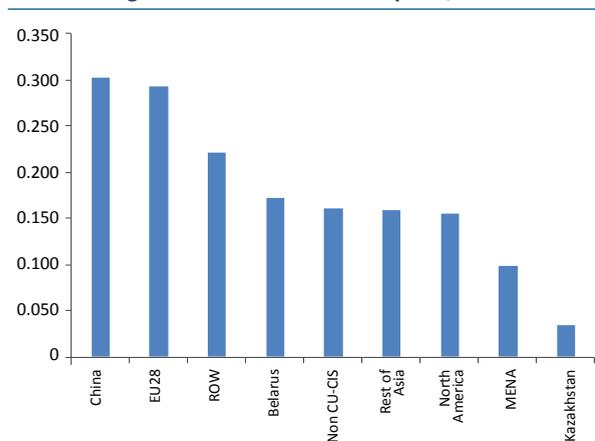
Figure 53: Russian exports to non-EU countries, 2007-08 and 2013-14



Source: COMTRADE.

Note: MENA refers to the Middle East and North Africa. Non-ECU CIS is former members of the Commonwealth of Independent States (CIS) excluding Belarus and Kazakhstan, ROW is the rest of world, and EU is the European Union. Belarus's values for 2007-08 are derived from mirror data.

Figure 54: HHI for Russian exports, 2012



Source: COMTRADE data. The index is calculated based on the three-digit standard international trade categories

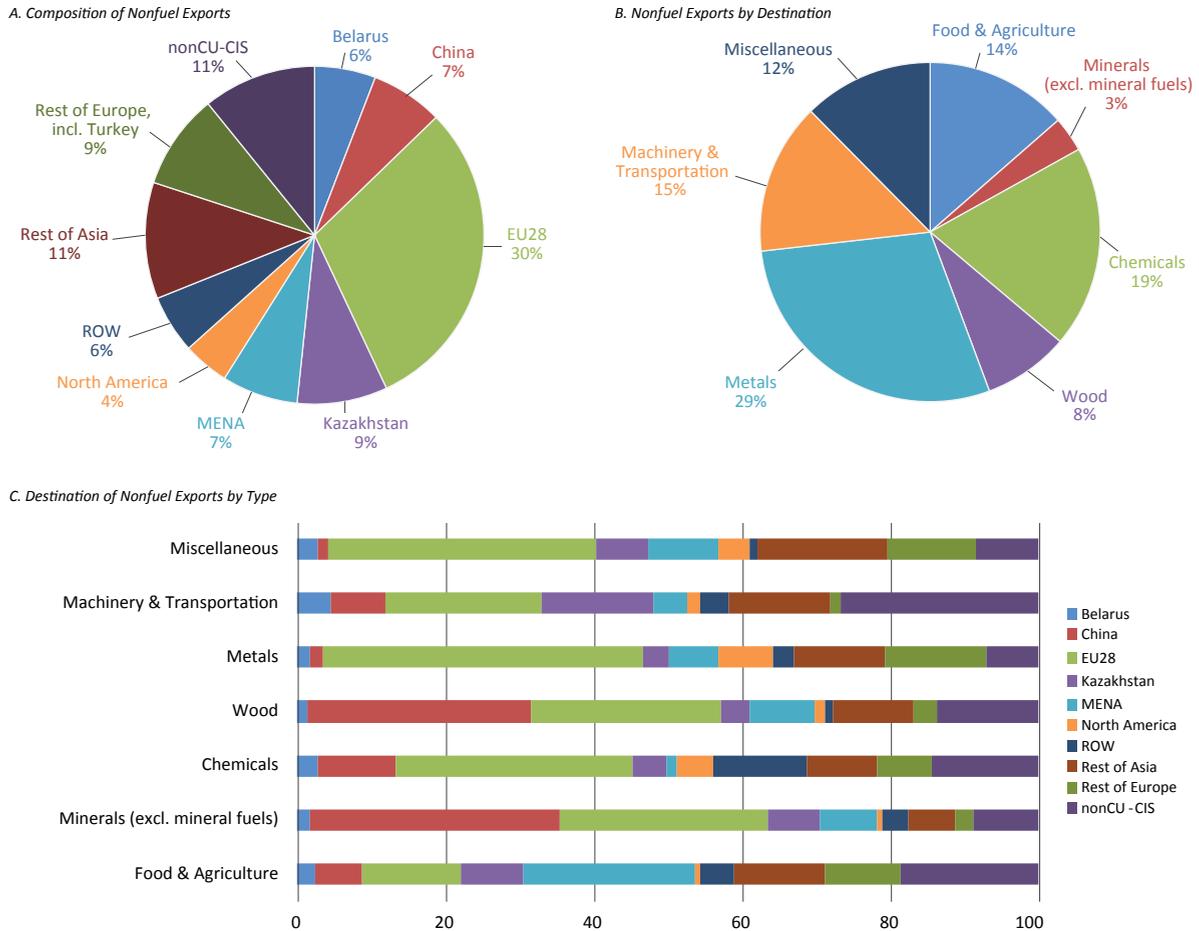
Despite the recent depreciation of the ruble, Russia has had little success in introducing new non-resource exports, especially in markets outside the former Soviet Union, though the experience of different regions has varied substantially (Figure 55 and Box 3-1). Metals and chemicals remain Russia's most important nonfuel exports. Nonfuel exports to ECU and other former Soviet Union countries tend to be significantly more sophisticated than those to other destinations, and they include complex manufactures such as machinery and transportation equipment. Most nonfuel exports to Europe are metals, and the same is true for much of Asia and North America. In addition to

metals, Russia's main nonfuel exports to China include wood and chemicals. Importantly, a third of nonfuel exports to the Middle-East and North Africa are agricultural and food products, which could indicate further export potential. Chemicals dominate Russia's nonfuel exports to other regions, such as Latin America and Africa. Despite the overall concentration of Russia's exports, the EU remains the primary destination for nonfuel products, followed by the CIS countries, China and the rest of Asia.

**While the ruble's depreciation has created an important price advantage for non-resource exports, yet well-known obstacles are inhibiting investment in sectors with high growth potential.** Export volumes rose in the wake of the depreciation, especially to countries outside the former Soviet Union countries. However, the improvement in relative prices did not significantly impact exports for most of Russia's manufacturing sector, and many of the country's industrial products remain uncompetitive on international markets.

**Experienced exporters appear to be benefitting from the weaker ruble, while firms that have traditionally produced for the domestic market have been less able to take advantage of the shift in relative prices.** Adjusting product profiles and

Figure 55: Russian nonfuel exports by product and destination, 2014



Source: COMTRADE. MENA refers to the Middle East and North Africa, Non-ECU CIS refers to CIS members excluding Belarus and Kazakhstan, the EU is the European Union, and ROW is the rest of world.

achieving compliance with international quality standards will require both time and investment. This process already appears to be underway, and investment in certain sectors has increased substantially in recent years (see Box 1.3).

**Diversification policies tend to focus on increasing returns to investment by supporting the growth of specific sectors and even individual firms.** In principle, this type of intervention could accelerate productivity growth and enable firms to achieve international competitiveness more quickly. In practice, however, there is limited evidence for the success of targeted industrial policies once all other factors affecting export

diversification have been taken into account.<sup>41</sup> Other government measures attempt to assist firms in overcoming challenges related to specific export cycles and exploiting emerging export opportunities, often by reducing the cost and risks involved in entering new markets. Export-promotion strategies have achieved mixed results, and their success or failure largely depends on the specifics of each policy. The robust involvement of the private sector is a common element among more effective export-promotion efforts. However, even successful export-promotion measures may prove unsustainable once public sector support is withdrawn.

<sup>41</sup> World Bank, 2014.

**Box 17 Regional differences in export composition and export destinations**

**Russia's regions vary substantially in both the composition of their nonfuel exports and their major destination markets.** The Central Federal Region focuses on machinery and transportation equipment. The Ural Mountains and Siberia primarily export metals. The North Caucasus and the Volga Federal Region have the largest shares of chemical exports, and the Northwest and Far East regions concentrate on wood and agricultural products. Export destinations are largely determined by geography: the Far East region exports primarily to Japan and the rest of Asia, the provinces bordering China export to China, and the southwestern provinces export to the Middle East and North Africa. The major exception is oil-rich Siberia, which joins the western provinces in exporting primarily to Europe (Figure 56).

**Figure 56: Primary non-ECU destinations for Russia's regional exports by value**



Source: GTIS data. MENA refers to the Middle East and North Africa, Non-ECU CIS includes all members of the Commonwealth of Independent States except for Belarus and Kazakhstan, EU is the European Union, and ROW is the rest of the world. Numbered regions: 1 Yaroslavl, 2 Kaluga, 3 Vladimir, 4 Ivanovo, 5 Perm, 6 Moscow City, 7 Tula, 8 Nizhniy Novgorod, 9 Ryazan, 10 Mari El, 11 Udmurtia, 12 Mordovia, 13 Chuvashia, 14 Tatarstan, 15 Penza, 17 Ulyanovsk, 18 Saratov, 20 Samara, 21 Volgograd, 22 Kalmykia, 23 Adygea, 24 Stavropol, 25 Karachevo-Chercheskia, 26 Kabardino-Balkaria, 27 North Ossetia, 28 Chechnya, 29 Ingushethia

**Most investment decisions are driven by enduring improvements in the investment climate rather than relative price adjustments or government support to certain sectors.** In Russia, confidence remains weak among both foreign and domestic investors, discouraging long-term investment (Section 2.3). Securing adequate capital to restructure and expand the non-resource export sector will hinge on the success of Russia's structural reform agenda. Attracting long-term capital investment

will require substantial improvements in the efficiency of factor markets, along with a regulatory environment that fosters competition, innovation and quality. Previous analytical work has demonstrated the particular importance of FDI in increasing productivity, fostering innovation and boosting the export capacity of Russian firms,<sup>42</sup> and recent developments in the external environment will have key implications for the future of FDI in Russia.

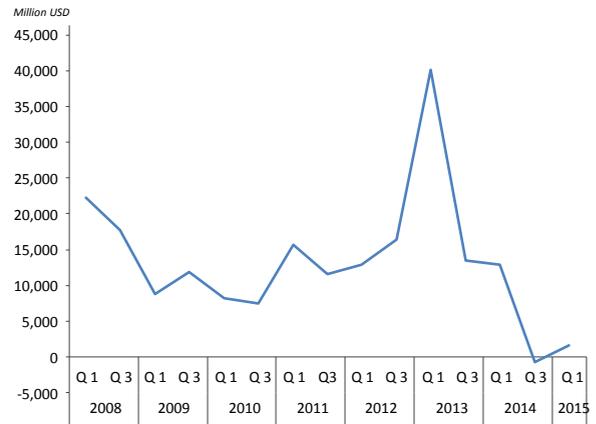
<sup>42</sup> Lee and Liu, 2005; World Bank, 2013. FDI is strongly associated with productivity growth and technology transfer, as foreign firms tend to have ownership-specific advantages in productive systems and management techniques.

### 3.3 Attracting FDI in a Challenging External Environment

Prior to 2014 Russia’s inbound FDI levels were comparable to those of the other BRICS countries, though “round-tripping” was especially common. Between 2007 and 2012 as much as one-third of Russia’s inbound FDI was in fact Russian capital channeled through offshore tax havens. Correcting for round-tripping, inbound FDI hit its post-2008 peak during the first quarter of 2013, when net inflows reached US\$69 billion.<sup>43</sup> However, net FDI plunged by two-thirds during 2014. The most severe declines were observed in the third and fourth quarters, when aggregate net inbound FDI turned negative across all sectors of the economy, indicating widespread capital flight (Figure 57). A tenuous recovery began during the first half of 2015, though net FDI inflows remained far lower than in previous years. Round-tripping, which was always more prevalent in Russia than in other BRICS countries, has intensified since 2014 (Figure 58).

**The increasing prevalence of round-tripping is cause for concern.** Russian firms likely favor

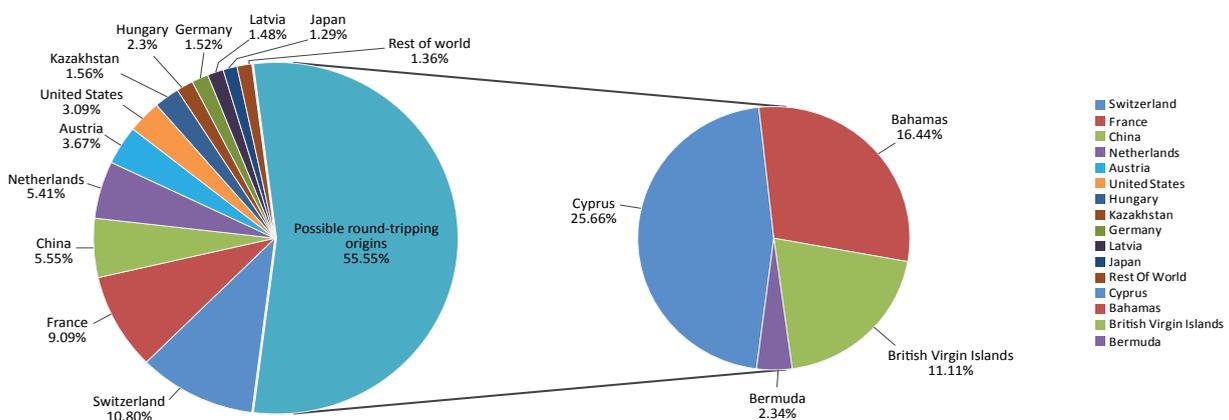
Figure 57: Net FDI inflows to Russia, 2008-2015



Source: CBR.

round-tripping due to the weak enforcement of financial laws and property rights in the domestic market, as well as the tax advantages offered by offshore financial centers. Since round-tripped FDI is not authentically foreign capital, but rather domestic capital reentering the country, it is less likely to generate the same gains in technology transfer and productivity growth associated with genuine FDI.

Figure 58: Sources of Russian net incoming FDI, 2014



Source: CBR.

<sup>43</sup> The large spike in 2013 was due to a historically large single investment in the oil-refinery sector (Table 13) by the British Petroleum Company. It acquired a 20 percent share in Rosneft, using cash arising from BP’s sale of its 50 percent stake in the vertically integrated TNK-British Petroleum consortium to Rosneft.

**The economic sanctions regime established in 2014 restricts FDI by targeting both financial transactions in general and investments in the oil sector in particular.** The economic sanctions regime has inhibited the international operations of Russia's largest banks, preventing Russian firms from acquiring international debt or making cross-border financial transactions. They have also partially blocked the oil sector from acquiring new technology and equipment, and some prospective FDI projects have been frozen. Russia's oil sector is the country's primary destination for inbound FDI, and by targeting the oil sector the economic sanctions regime has had an immediate and deeply negative impact on FDI inflows.<sup>44</sup>

**Prior to 2012 FDI rates were increasing fastest in high-tech manufacturing, utilities, construction and financial intermediation, sectors that are strongly associated with positive technological spillovers.**<sup>45</sup> Foreign auto manufacturers broadened the range of affordable and high-quality cars in the domestic market. Rising FDI in the chemicals sector leveraged Russia's absolute advantage in fossil fuels, and foreign chemical

firms expanded into the domestic pharmaceutical subsector. Foreign firms also diversified the range of available construction services. The minority participation of foreign investors in Russia's telecommunications subsector accelerated technology transfer despite an especially large share of round-tripped FDI.

**Net outflows of foreign capital since 2014 affected all sectors of the Russian economy simultaneously, particularly during the third quarter of 2014** (Table 13). A modest rebound in FDI, focused largely on the oil and gas sectors, began in the first half of 2015. Unless FDI inflows continue to recover, the government is unlikely to achieve its ambitious medium-to-long-term plans to enhance the export competitiveness of Russian firms. Constrained FDI inflows are not only slowing Russia's overall growth, but also have significant negative implications for regional development. Russia's regions have benefitted differently from FDI, and regional development patterns illustrate the important links between foreign investment, export performance and economic growth.

Table 13: Net inbound FDI by sector, 2013-2015

	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015
<b>All sectors/industries</b>	40,140	6,900	13,515	8,664	12,907	11,751	-709	-1,059	1,704	2,640
<b>Primary</b>	<b>3,361</b>	<b>6,083</b>	<b>-1,329</b>	<b>-394</b>	<b>2,036</b>	<b>2,789</b>	<b>-442</b>	<b>344</b>	<b>2,373</b>	<b>2,551</b>
<b>AGRICULTURE, FORESTRY AND FISHING</b>	<b>294</b>	<b>150</b>	<b>32</b>	<b>143</b>	<b>-53</b>	<b>148</b>	<b>39</b>	<b>-164</b>	<b>28</b>	<b>151</b>
<b>MINING AND QUARRYING</b>	<b>3,067</b>	<b>5,933</b>	<b>-1,361</b>	<b>-537</b>	<b>2089</b>	<b>2641</b>	<b>-481</b>	<b>508</b>	<b>2345</b>	<b>2400</b>
<b>including:</b>					<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Mining and quarrying of fuel and energy materials</b>	<b>3,366</b>	<b>3,943</b>	<b>-700</b>	<b>-75</b>	<b>1999</b>	<b>2388</b>	<b>24</b>	<b>1286</b>	<b>2038</b>	<b>1941</b>
<b>Mining and quarrying except fuel and energy materials</b>	<b>-300</b>	<b>1,990</b>	<b>-662</b>	<b>-462</b>	<b>89</b>	<b>252</b>	<b>-505</b>	<b>-778</b>	<b>307</b>	<b>459</b>
<b>Secondary</b>	<b>21,172</b>	<b>-5,722</b>	<b>1,686</b>	<b>4,046</b>	<b>2,201</b>	<b>2,883</b>	<b>-27</b>	<b>-272</b>	<b>1,339</b>	<b>1,721</b>
<b>MANUFACTURING</b>	<b>19,635</b>	<b>-7,494</b>	<b>1,023</b>	<b>3,330</b>	<b>758</b>	<b>1524</b>	<b>-453</b>	<b>-662</b>	<b>1195</b>	<b>1943</b>
<b>including:</b>										
<b>Food products, beverages, and tobacco products</b>	<b>-151</b>	<b>215</b>	<b>-507</b>	<b>348</b>	<b>-365</b>	<b>520</b>	<b>-584</b>	<b>462</b>	<b>-45</b>	<b>805</b>

<sup>44</sup> Participants in the economic sanctions regime include Australia, the European Union, Japan, Norway, Switzerland, Ukraine, and the United States. The particular nature and timing of the economic sanctions has varied by participant.

<sup>45</sup> Kuznetsov, 2010.

	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015
Wood and products of wood and cork	9	6	-21	10	1	62	124	75	21	153
Pulp and paper production; publishing and printing	60	-139	60	71	158	-268	-17	177	11	-1
Refined petroleum products and coke	17,001	767	1,062	1,877	95	549	-2012	-130	-1245	-268
Chemicals and chemical products	272	249	170	456	147	52	346	956	412	542
Rubber and plastic products	95	31	-2	125	108	197	-30	59	193	136
Other non-metallic mineral products	298	144	29	102	194	45	19	-226	273	102
Basic metals and fabricated metal products	1,383	-9,238	-725	212	336	645	1524	-1837	1162	-13
Machinery and equipment	148	162	317	-148	138	-418	51	195	60	101
Computer, electronic and optical products	364	220	154	85	1	83	42	65	14	16
Manufacture of motor vehicles, trailers and semi-trailers and other transport equipment	145	80	474	171	17	5	92	-480	327	365
Other manufacturing	11	11	13	21	-70	53	-8	23	12	6
UTILITIES (electricity, steam, gas and water supply)	542	299	485	468	313	636	-48	-1	39	-285
CONSTRUCTION	995	1,474	178	248	1129	723	475	391	105	62
Services	14,114	6,198	12,788	5,603	8,244	6,054	-134	-1,145	-2,490	-1,717
WHOLESALE AND RETAIL TRADE; REPAIR OF MOTOR VEHICLES AND MOTORCYCLES	7,412	2,811	8,049	2,270	3682	2904	898	-4218	342	-517
TRANSPORT AND COMMUNICATION	1,316	734	-729	-2,265	-187	624	-2,231	-1,310	-1,554	-83
FINANCIAL AND INSURANCE ACTIVITIES	5,232	2,928	2,103	4,192	3832	1445	2117	1668	-345	253
OTHER	154	-275	3,365	1,405	916	1,081	-919	2,717	-933	-1,369
Unallocated	1,411	194	325	-666	370	-19	-119	-28	507	81

Notes: "Other manufacturing" includes textiles and apparel, leather and miscellaneous manufacturing. "Other services" includes real estate and rentals, business activities, education, health and social work.

### 3.4 Foreign Investment, Export Performance and Regional Development

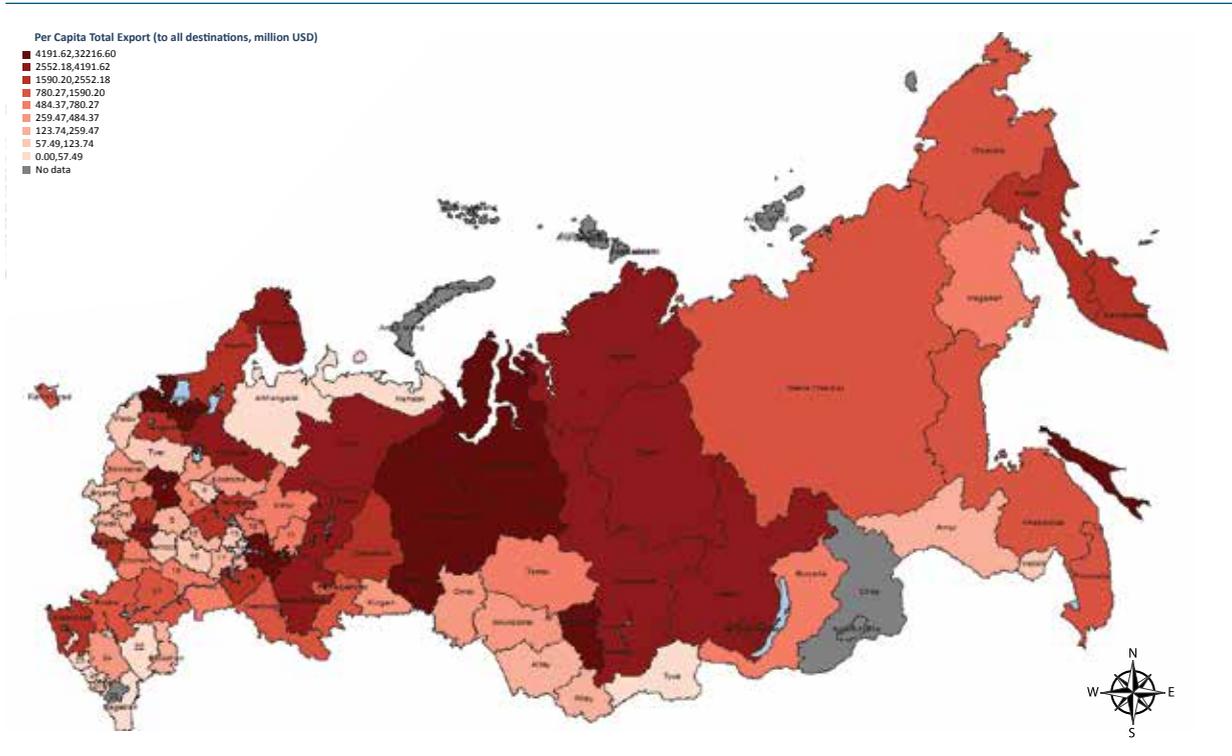
#### Regional Export Dynamics and FDI Trends

**Export performance varies significantly across regions.** Oil, gas and other natural resources have a major influence on regional exports. Russia's wealthiest regions tend to have very high exports and/or FDI inflows per capita, while moderately wealthy regions often have relatively high non-resource exports per capita. Seven

of the country's 12 wealthiest regions are also among the top export performers (Figure 59), and 7 have rates of per capita FDI that are in the top 15 percent of the distribution.<sup>46</sup> Conversely, the North Caucasus include 6 of the 11 poorest regions in the Russian Federation. In 2011 the export performance of these 6 regions was far below the national average, and 4 reported receiving no FDI at all.

<sup>46</sup> As of 2012, the most recent year for which regional export data are available.

Figure 59: Total exports per capita by region, US\$ Million



Source: GTIS data. Numbered regions: 1 Yaroslavl, 2 Kaluga, 3 Vladimir, 4 Ivanovo, 5 Perm, 6 Moscow City, 7 Tula, 8 Nizhniy Novgorod, 9 Ryazan, 10 Mari El, 11 Udmurtia, 12 Mordovia, 13 Chuvashia, 15 Penza, 16 Tatarstan, 17 Ulyanovsk, 18 Saratov, 20 Samara, 21 Volgograd, 22 Kalmykia, 23 Adygea, 24 Stavropol, 25 Karachevo-Chercheskia, 26 Kabardino-Balkaria, 27 North Ossetia, 28 Chechnya, 29 Ingushethia.

**High rates of FDI and natural-resource exports relative to GRP are both positively correlated with regional per capita income** (Figure 60 A and Figure 60 B). Since the global financial crisis the export intensity of GRP—the share of exports in regional economic output—has remained flat or declined in all regions except Moscow.<sup>47</sup> Export intensity has been lower than average in Central Russia and very low in the North Caucasus, which are also the country’s poorest regions (Figure 61 A). The Far East has received the largest share of FDI in the country, and it has the highest FDI-to-GDP ratio (Figure 62 B). FDI has increased fastest in the chemical and pharmaceutical products, machinery, electronics and transport equipment, and financial intermediation subsectors. As noted above, mining and quarrying firms are most likely to have foreign investors, followed by financial and insurance firms. However, an estimated 50 percent of FDI in the financial services subsector

has been round-tripped, suggesting that the rapid growth of investment in financial services may be driven more by policy weaknesses than by economic opportunity.

**Regional competitive advantages affect the type of FDI each region attracts, and investment may drive the transformation of comparative advantage over time.** The largest share of foreign-owned mining and quarrying firms is in the Far East, followed by Siberia and the Urals. Oil and gas dominate exports from the Far East and Ural regions, though not from Siberia. However, FDI may ultimately drive Siberia to specialize in oil and gas. Agriculture, forestry, and fishing also are attracting FDI in the relatively wealthy Far East, as well as in Southern Russia and in the relatively poor North Caucasus. These three regions also have the highest concentration of food and agriculture exports. The Volga

<sup>47</sup> As of 2012, the most recent year for which regional export data are available.

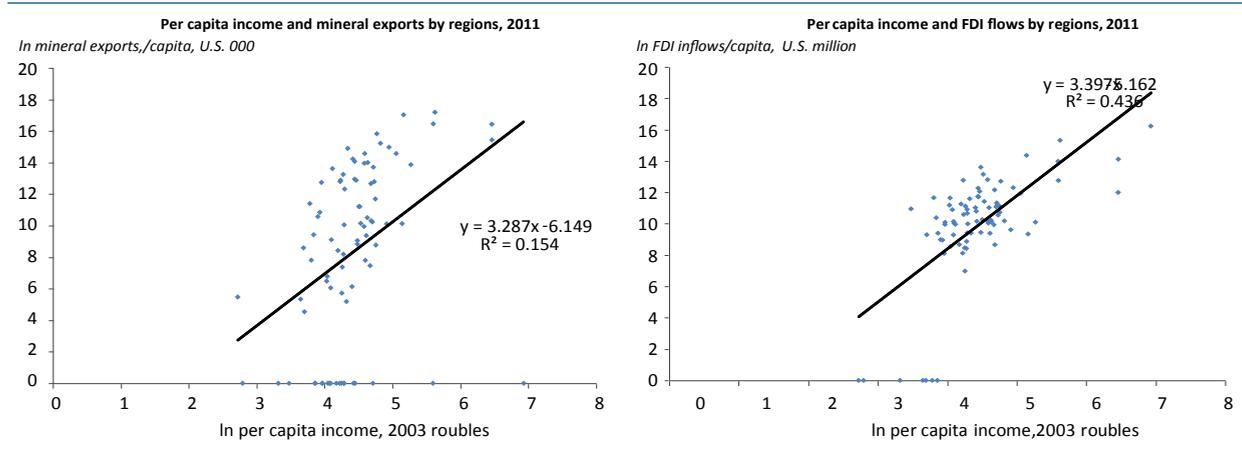
region is a major destination for manufacturing investment, which has enabled it to build an export base comprising chemicals, machinery and transportation equipment.

**FDI as a Predictor of Regional Growth**

**Regional FDI inflows are among the strongest predictors of per capita income growth.** A cross-sectional model of regional income

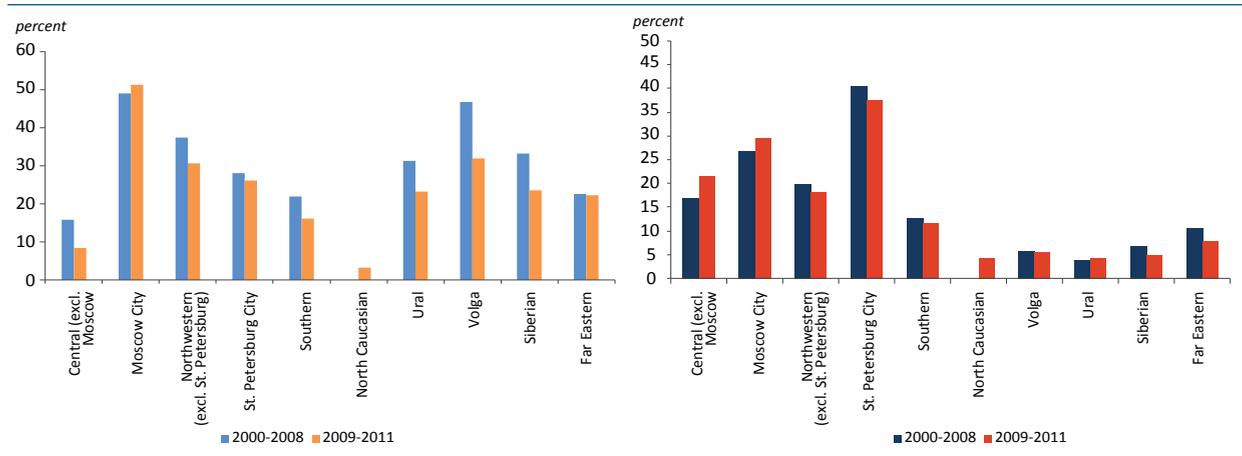
growth over the period 2001–2011 illustrates this relationship.<sup>48</sup> Along with attracting more FDI, rapidly growing regions are more likely to have better business-climate indicators. Ceteris paribus, poorer regions grow faster than wealthier regions.<sup>49</sup> However, despite the accelerated growth of poor regions, large disparities persist and convergence rates are slow and uneven.

**Figure 60: Intensity of resource exports, FDI and GDP per capita by region, 2012**



Source: Rosstat.

**Figure 61: Average export intensity and FDI inflows, percent of nominal GRP**



Source: Rosstat.

Note: "Location" refers to the firm's headquarters, not necessarily the site of production.

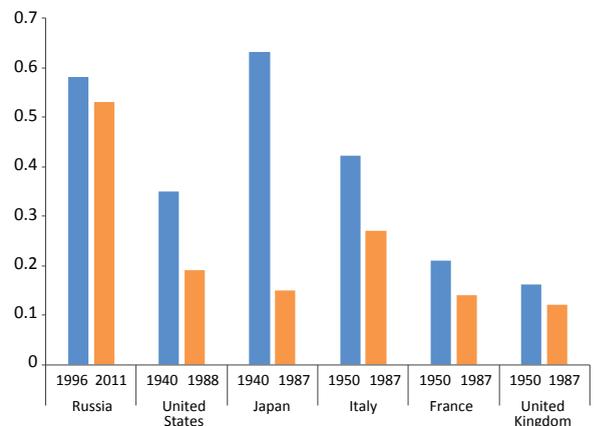
<sup>48</sup> The model is adapted from Mankiw, Romer and Weil (1992). The determinants of income growth in the model are  $p$ , in which variables are measured as period averages, either in per capita terms or in shares, and are expressed as follows:  $y_{i,t} - y_{i,t-1} = \beta_0 + \beta_1 y_{i,t-1} + \beta_2 \text{human\_capital}_{i,t-1} + \beta_3 \text{exports}_{i,t-1} + \beta_4 \text{FDI}_{i,t-1} + \beta_5 \text{business\_climate}_{i,t-1} + \beta_6 \text{share\_mineral}_{i,t-1} + \beta_7 \text{share\_urbani}_{i,t-1} + e_{i,t}$  In this model,  $y$  denotes real per capita income in each region  $i$ ,  $y_{i,t-1}$  represents 2001, the initial year, human capital is measured by the percentage of the population enrolled in secondary school, FDI is measured in U.S. dollars per capita, the business climate is based on 2003 scores from the consulting firm Expert RA, resource exports are expressed as a share of total merchandise exports and the urban population as a share of the total population. For non-income dependent variables,  $t-1$  denotes the period averages.

<sup>49</sup> Barro and Sala-i-Martin, 1995. Beta convergence, which has been found for subnational regions in the EU, Japan, and the US, is necessary but not sufficient for sigma convergence. These countries have less regional income inequality than Russia, and regional incomes have become more equal over time.

**Despite the tendency towards convergence in income by regions, Russia’s poorest regions have not narrowed the gap with their wealthier counterparts.**<sup>50</sup> Russia’s regions vary greatly in terms of their resource endowments, governance quality, institutional capacity, and ability to attract FDI. The dispersion of levels of income across regions—the standard deviation of log per capita income across regions—fell from 1996 to 2001, but rose in 2011, indicating that regional inequality has actually increased in recent years.<sup>51</sup> Regional income inequality is more pronounced in Russia than in most comparable countries (Figure 62). While Russia’s poorer regions are converging with wealthier regions that have similar characteristics, the divergent influence of resource endowments, governance quality and FDI inflows currently outweighs the factors favoring convergence.<sup>52</sup>

**Sustained improvements in the business climate will be critical to promoting Russia’s overall growth and alleviating its profound regional disparities.** Russia’s poor regions have much more tenuous international engagements than the rest of Russia in terms of both exports

Figure 62: Standard deviation of log per capita income by region



Source: World Bank staff calculations drawing on data from Barro and Sala-i-Martin (1995).

and FDI. Thus, increasing exports and attracting FDI are central to efforts to enhance living standards and promote development in these regions. The long-term economic convergence of Russia’s regions will require a level playing field for attracting FDI. In the current context of low oil prices and economic sanctions, accelerating progress on the structural reform agenda will be especially critical.

### 3.5 Conclusion

**In the short-to-medium term Russia could expand exports by focusing on sectors in which it already enjoys a competitive advantage and working to expand its range of export partners.** These include natural resources and resource-based goods such as oil and gas, petroleum products, chemicals, metals and wood products. Oil and gas, including both unrefined and processed products, accounted for about 66 percent of Russia’s exports in 2014 and 62 percent in the first half of 2015. However, these exports

are overwhelmingly bound for Europe, and the heavy concentration of destination markets intensifies Russia’s external vulnerabilities. Oil and gas exports to the EU represent close to half of Russia’s total goods exports, and this “one product-one market” model comprises the foundation of the country’s export income. China and the rest of Asia receive a large share of commodity exports, but there is considerable scope to broaden Russia’s range of trading partners for resource-related exports.

<sup>50</sup> In the economic growth literature convergence can be twofold: sigma-convergence refers to a reduction in the dispersion of levels of income across economies while beta-convergence occurs when poor economies grow faster than rich ones.

<sup>51</sup> This calculation is made for 83 federal subjects for which complete data from 1996-2011 are available. Since the federal subjects with partial data are at the extreme ends of the income distribution, actual regional inequality is likely greater than reported here.

<sup>52</sup> Guriev and Vakulenko (2012) also found that interregional income inequality in Russia was high during the 1985-2005 period, even by the standards of emerging markets. They also found a lack of convergence in per capita income across Russia’s regions during the 2000s, though other measures (such as wages and unemployment rates) have tended to converge. Guriev and Vakulenko (2015) found evidence that lower-income households in the poorest regions of Russia may face particular difficulty in moving to richer regions.

**Russia's non-resource exports are largely confined to trading partners in the former Soviet Union, and non-resource exporters have struggled to maintain an enduring presence beyond regional markets.** While Russia exports complex manufacturing goods to a number of former Soviet Union countries, and these export relationships are durable, many of its non-resource goods are not globally competitive. Moreover, those countries accounted for just 10 percent of Russia's total exports in 2014. The low survival rates of non-resource exports to nontraditional markets are largely attributable to deficiencies in product quality, innovation capacity and compliance with international standards.

**Investment in the sophisticated productive capabilities necessary to export to advanced economies can boost economy-wide growth.** This is especially important as there is a highly positive association between exports

of technology-intensive goods and firm-level innovation capacity. In order to maximize the potential spillover effects of export-oriented investment, Russia must increase its global competitiveness in technology-intensive sectors. Attracting sufficient FDI to sustainably diversify Russia's export profile will pose an especially serious challenge in the current external context, and meeting this challenge will require a similarly exceptional improvement in the investment climate. Enhancing the quality of the regulatory environment, removing obstacles to accessing productive factors and harmonizing product standards with international norms will be essential to attract increased investment, particularly in poorer regions and new economic sectors. While there is considerable scope for further analysis, Russia's ability to further integrate into global markets will have critical implications for both its regional and national development objectives.



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## Annex 1: Main Macroeconomic Indicators

Output Indicators	2015												2016				
	2012	2013	2014	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2015	2016
	2012	2013	2014	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2015	2016
GDP, % change, y-o-y	3.5	1.3	0.7	-	-	-2.8	-	-	-4.5	-	-	-3.7	-	-	-3.8	-3.7	-
Industrial production, % change, y-o-y	3.4	0.4	1.7	0.9	-1.6	-0.6	-4.5	-5.5	-4.8	-4.7	-4.3	-3.7	-3.6	-3.5	-4.5	-3.4	-2.7
Manufacturing, % change, y-o-y	5.1	0.5	2.1	-0.1	-2.8	-1.9	-7.2	-8.3	-6.6	-7.1	-6.8	-5.4	-5.9	-5.3	-6.1	-5.4	-1.0
Extraction of mineral resources, % change, y-o-y	1.0	1.1	1.4	1.5	0.1	0.4	-0.8	-0.9	-0.9	0.2	0.8	0.8	1.4	-0.1	0.1	0.3	5.8
Fixed capital investment, % change, y-o-y	6.8	0.8	-1.5	-4.1	-5.6	-4.6	-6.2	-9.9	-9.6	-11.7	-13.4	-13.7	-3.7	-6.5	-8.1	-8.4	-
<b>Fiscal and Monetary Indicators</b>																	
Federal government balance, % GDP <sup>1/</sup>	-0.1	-0.5	-0.5	-5.4	-7.4	-4.9	-4.4	-3.7	-2.6	-2.8	-2.1	-1.5	-1.2	-1.3	-18.6	-2.4	-8.1
M2, % change, p-o-p <sup>2/</sup>	17.9	15.4	7.3	-2.1	0.9	-0.3	1.5	0.6	0.6	0.5	1.1	-0.2	-0.3	1.4	7.5	7.2	0.8
Inflation (CPI), % change, p-o-p	5.1	6.8	7.8	3.9	2.2	1.2	0.5	0.4	0.2	0.8	0.4	0.6	0.7	0.8	0.8	15.6	0.6
Producer price index (PPI), % change, p-o-p	6.8	3.4	6.1	1.3	2.1	5.5	2.7	-1.2	0.7	1.5	0.1	-1.1	1.8	-0.7	-2.2	10.7	-1.5
Nominal exchange rate, average, Rb/USD	31.1	31.8	38.4	61.7	64.6	60.2	52.9	50.6	54.5	57.1	65.2	66.8	63.1	65.0	69.7	60.6	77.2
Reserve fund, bln USD e-o-p	62.1	87.4	87.9	85.1	77.1	75.7	76.4	76.3	76.8	72.9	70.7	70.5	65.7	59.4	50.0	46.0	49.9
National wealth fund, bln USD, e-o-p	88.6	88.6	78.0	74.0	74.9	74.4	76.3	75.9	75.7	74.6	73.8	73.7	73.5	72.2	71.7	71.7	71.3
Reserves (including gold) billion \$, end-o-p	537.6	509.6	385.5	376.2	360.2	356.4	356.0	356.8	361.6	357.6	366.3	371.0	370.0	365.0	368.0	368.4	380.0
<b>Balance of Payment Indicators</b>																	
Trade balance, billion \$ (monthly)	191.7	180.6	189.7	15.4	13.7	15.5	14.3	15.2	13.7	10.3	8.6	9.4	10.0	8.8	11.0	148.5	7.9
Current account, billion \$	71.3	33.4	58.3	-	-	30.0	-	-	16.6	-	-	8.0	-	-	15.0	69.6	-
Export of goods, billion \$	527.4	521.8	497.8	27.7	29.2	32.7	30.6	30.6	30.0	27.2	25.0	26.3	27.2	25.2	28.4	341.5	17.6
Import of goods, billion \$	335.8	341.3	308.0	12.3	15.5	17.2	16.3	15.4	16.3	16.9	16.4	16.9	17.2	16.4	17.4	193.0	9.7
<b>Financial Market Indicators</b>																	
Average weighted lending rate for enterprises, % <sup>3/</sup>	9.4	9.4	18.3	19.9	18.1	17.9	17.2	16.0	15.5	14.7	14.2	14.0	13.6	13.8	13.8	15.7	13.4
CBR policy rate, % end-o-p	5.5	5.5	17.0	17.0	15.0	14.0	12.5	12.5	11.5	11.5	11.0	11.0	11.0	11.0	11.0	11.0	11.0
Real average rate for ruble loans, % (deflated by PPI)	3.9	5.5	11.7	12.1	8.1	4.3	1.9	2.3	2.1	1.4	-0.4	1.2	-0.5	-0.1	2.8	2.8	5.7
Stock market index (RTS, ruble term, eop)	1,527	1,443	791	737.4	896.6	880.4	1029.3	968.8	939.9	858.8	833.6	790.0	846.0	847.0	757.0	757.0	769.0
<b>Income, Poverty and Labor Market</b>																	
Real disposable income, (1999 = 100%)	286.2	297.7	294.7	201.3	263.6	254.7	286.6	256.4	279.3	284.8	285.2	261.5	279.1	271.0	395.5	282.9	187.3
Average dollar wage, US \$	859	942	841	448.7	511.3	558.4	664.9	649.0	637.5	574.7	484.0	497.0	518.0	503.0	596.0	553.5	427
Share of people living below subsistence, % <sup>1/</sup>	10.7	10.8	11.2	-	-	15.9	-	-	15.1	-	-	14.1	-	-	13.4	13.4	-
Unemployment (% ILO definition)	5.1	5.6	5.3	5.5	5.8	5.9	5.8	5.6	5.4	5.3	5.3	5.2	5.5	5.8	5.8	5.8	5.8

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

<sup>1/</sup> Cumulative from the year beginning.

<sup>2/</sup> Annual change is calculated for average annual M2.

<sup>3/</sup> All terms up to 1 year.



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