



WORLD BANK GROUP

**PRESERVING STABILITY;
DOUBLING GROWTH;
HALVING POVERTY
— HOW?**

40 RUSSIA ECONOMIC REPORT
NOVEMBER 2018



**Russia Economic Report #40:
Russia's economy: Preserving stability; Doubling growth; Halving
poverty -- How?**

Acknowledgement

This report is produced twice a year by World Bank economists in the Macroeconomics, Trade and Investment (MTI) Global Practice. The team that prepared this edition was led by Apurva Sanghi (Lead Economist for the Russian Federation, asanghi@worldbank.org) and consisted of Olga Emelyanova (Economist, GMTE2), Mikhail Matytsin (Research Analyst, GPV03), Irina Rostovtseva (Research Analyst, GMTE2), Katerina Levitanskaya (Senior Financial Sector Specialist, GFCE1), Eva Gutierrez (Lead Financial Sector Specialist, GFCEE), Yoki Okawa (Economist, DECPG), Peter Stephen Oliver Nagle (Economist, DECPG), Christopher David Miller (Program Leader, ECCRU), Tigran Shmis (Senior Education Specialist, EDU), Maria Ustinova (Consultant, EDU). Peer reviewers included Yaroslav Baklzhansky (Advisor, Macroeconomic Policy Department, Eurasian Economic Commission) and Kevin Carey (Practice Manager, MTI). The report was edited by Christopher Pala (Consultant), and the graphic designer was Robert Waiharo (Consultant). The team would like to thank Andras Horvai (Country Director for Russia) and Sandeep Mahajan (Practice Manager, MTI Global Practice), Donato De Rosa (Lead Economist, GMTE1), and Sergei Ulatov (Director for coordination, Eurasian Development Bank) for their advice and support. The team also would like to express their gratitude to the Department for Research and Forecasting of the Central Bank, Department for Macroeconomic Forecasting of the Ministry of Economic Development, Department for the budget policy and strategic planning of the Ministry of Finance and the IMF for the collaboration. This report went to press on December 4, 2018.

Abbreviations and Acronyms

AE	Advanced Economy
APR	Annual Percentage Rate
Bbl	Oil Barrel
BRICS	Brazil, Russia, India, China, and South Africa (emerging economies)
BP	British Petroleum
BSCF	Banking Sector Consolidation Fund
CBR	Central Bank of the Russian Federation
CPS	Collaborative Problem Solving
CPI	Consumer Price Index
EAEU	Eurasian Economic Union
EM	Emerging Markets
EMDEs	Emerging Markets and Developing Economies
EU	European Union
FAS	Federal Antimonopoly Service
FDI	Foreign Direct Investment
FIFA	Fédération Internationale de Football Association
FX	Foreign Exchange
GDP	Gross Domestic Product
GNFS	General Number Field Sieve
HBS	Household Budget Survey
HSE	Higher School of Economics
HSI	Human Capital Index
ILO	International Labor Organization
IMF	International Monetary Fund
LNG	Liquified natural gas
NPL	Non-Performing Loan
OECD	Organization for Economic Co-operation and Development
OFZ	Federal Loan Bonds
OPEC	Organization of the Petroleum Exporting Countries
PIRLS	Progress in International Reading Literacy Study
PISA	Program for International Student Assessment
PP	Percentage point
PPP	Public–Private Partnership
REER	Real Effective Exchange Rate
RLMS	Russia Longitudinal Monitoring Survey
Rosstat	Russian Federal State Statistics Service
SAR	Special Administrative Region
SMEs	Small and Medium-Sized Enterprises
SOE	State Owned Enterprise
TFP	Total Factor Productivity
TIMSS	Trends in Mathematics and Science Study
VAT	Value-Added Tax
WB	The World Bank
WITS	World Integrated Trade Solution
WTI	West Texas Intermediate
WTO	World Trade Organization
y-o-y	Year-on-year

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Executive Summary

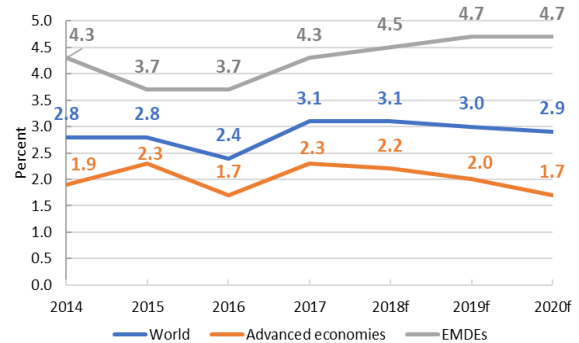
I. The Global economy and oil prices

Global growth is broadly stable but downside risks from rising trade tensions are increasing. A weakening recovery in trade and manufacturing activities is weighing down global growth (Figure 1a). Global goods trade has decelerated more rapidly than expected. U.S. tariffs and the retaliatory responses of its trading partners have affected 2.5 percent of global goods imports. Surveys of companies in the U.S., China and Japan suggest that the risks of a trade war have not yet fully materialized. While the Eurasian Union (excluding Russia) posted strong growth in 2018, Russia's main trading partners – the Euro area and China – experienced a growth slowdown (Box 1).

Financial conditions for Emerging Markets and Developing Economies (EMDEs) are tightening. Divergent monetary policies and growth prospects among the U.S. and other major economies contributed to a significant appreciation of the U.S. dollar in 2018. This, together with intensifying trade tensions, deteriorating growth prospects and renewed attention to external vulnerabilities has contributed to significant depreciations and capital outflows in many EMDEs. EMDE currencies fell – including the Russian ruble – and cumulative portfolio outflows from EMDEs surpassed those seen after the 2013 taper tantrum. Economies with external vulnerabilities, including Argentina, Indonesia, and Turkey, experienced the sharpest currency depreciations. While the spillover from those countries has been limited, the intensification of turmoil could lead investors to reevaluate their exposure to EMDEs and to capital outflows (Figure 2a).

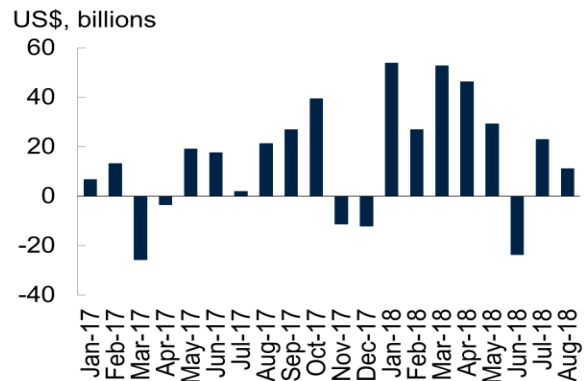
Oil prices have risen this year and remain volatile as Russia's oil production reached an all-time high. Oil prices have averaged USD70/bbl in 2018 so far (up 33 percent from their 2017 average) and are expected to average USD71/bbl over the next three years. They remain volatile, with the price of Brent, the international marker, ranging from USD59/bbl to

Figure 1a: Global growth is broadly stable



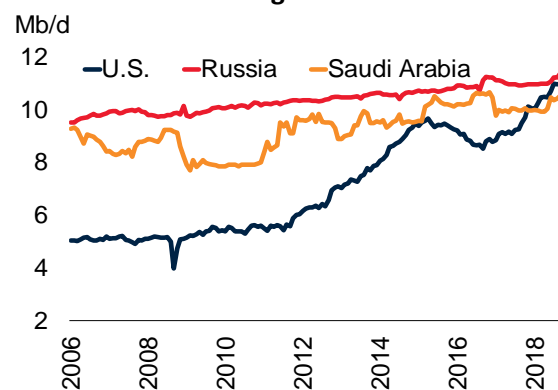
Source: World Bank (current working assumptions).

Figure 2a: Capital flow to EMDEs is declining



Source: Institute of International Finance and World Bank.

Figure 3a: Russian production of hydrocarbons has reached record highs



Source: International Energy Agency.

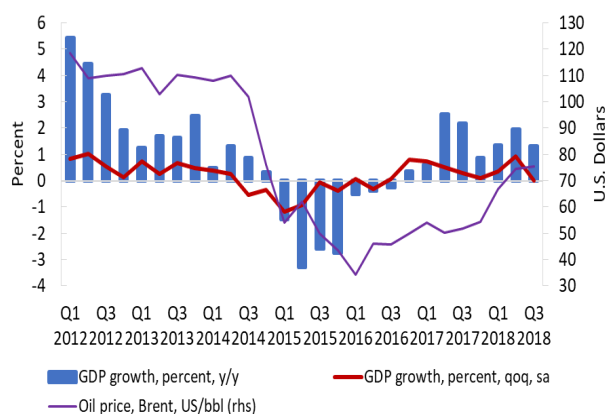
USD86/bbl in 2018. The announcement of U.S. sanctions on Iran and declining production in Venezuela supported prices in September and early October. However, prices fell sharply in early November after the U.S. announced it would grant waivers to its sanctions on Iran to eight countries, including China, and India. This, combined with an upward revision to production in the U.S., and increased production by both OPEC members and their non-OPEC allies, is causing concerns in the markets that a supply shortfall might be followed by an oversupply. Production in Russia reached an all-time high of 11.4 mb/d in October (Figure 3a).

II. Russia's economic performance in 2018

Growth momentum in Russia increased in the first half of 2018, supported by robust global growth, rising oil prices and a macro policy framework that has promoted stability. Real GDP growth totaled 1.3 percent y/y in the first quarter of 2018 and 1.9 percent y/y in the second. It was broad-based and in line with the economy's potential. Non-tradable sectors were the main growth drivers in the first half of 2018. In the tradable sectors, manufacturing was the main driver. Growth in mineral-resource extraction was limited until June 2018 by the OPEC+ agreement, supported by Russia (Box 2).

However, preliminary estimates suggest that growth momentum appears to have weakened in the third quarter of 2018. Third quarter growth is expected to be 1.3 percent, y/y. This slowdown is on the back of a weaker harvest, sluggish performances in manufacturing and construction, and the waning effects from the World Football Cup (Figure 4a).

Figure 4a: Growth momentum has slowed



Source: Rosstat.

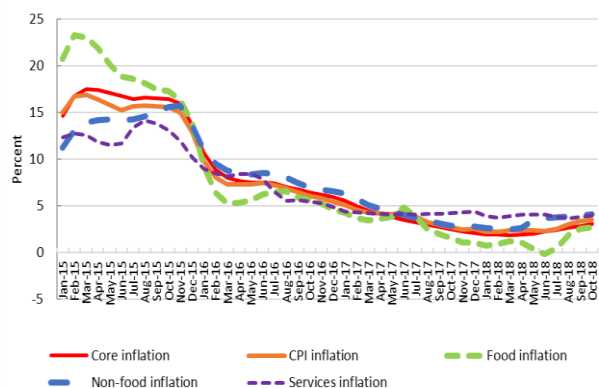
Net capital outflows increased because of turbulence in emerging markets and elevated geopolitical tensions. The recent expansion of sanctions and increased geopolitical tensions, exacerbated by higher risk perception for emerging economies, resulted in increased net capital outflows from 1.1 percent of GDP in January – September 2017 to about 3.4 percent of GDP in the same period this year. These outflows were mainly driven by the sell-off of OFZ bonds and slump in incoming FDI (reflecting reduced interest of foreign investors in Russian assets). Driven largely by increasing oil prices the current account surplus widened to about 6.3 percent of GDP in January – September 2018 (from 1.7 percent in the same period last year). Overall, a sound macroeconomic framework with relatively high levels of international reserves (USD461 billion), low external debt levels (about 29 percent of GDP), and a comfortable import cover (15.9 months) positions Russia well to absorb external shocks.

Monetary policy remained consistent with the inflation-targeting regime. Since July, inflation has been increasing, but stayed below the CBR's target level of 4 percent in annual terms, with non-food products contributing the most to headline inflation (Figure 5a). After a prolonged period of monetary loosening, the Central Bank hiked the policy rate in September from 7.25 percent to 7.5 percent in the face of elevated inflationary risks (ruble depreciation prompted by elevated geopolitical tensions and turbulence in emerging markets and the planned hike in the VAT).

The banking sector is relatively weak but stable, with lending growth resuming across various sectors. Despite recent bailouts and a continuing sector clean-up, Russia's banking sector remains relatively weak with less capital buffer (12.2 percent as of end-September) and a higher NPL ratio (10.8 percent as of end-September, Figure 6a) than other BRICS (15.6 percent and 4.4 percent, respectively). However, credit is expanding, albeit at a differential pace across various segments (by 9.7 percent, y/y in the corporate sector compared to 22.5 percent for households as of end-October). To address the risks linked to accelerated consumer lending growth, predominantly driven by unsecured loans and mortgage loans, CBR tightened its risk-weighting requirements for unsecured consumer loans with an annual percentage rate (APR) in the range of 10-30 percent, with plans to further tighten requirements for mortgage loans with lower down payments.

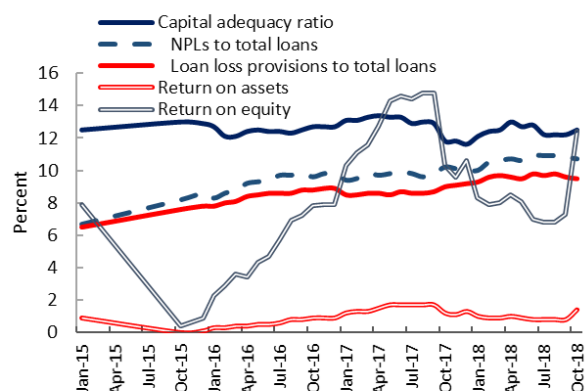
However, concentration and public dominance in the banking sector increased even further. Five large banks control 60 percent of the system's assets – up from 52 percent at the end of 2013. Furthermore, state-owned entities account for nearly 70 percent of Russian bank assets. One reason for this increase was an establishment of the recent Banking Sector Consolidation Fund (BSCF) by the CBR to resolve insolvent financial institutions. The BSCF took control of eight privately owned banks, including systemically important ones. The CBR intends to privatize these banks once recapitalization procedures are complete and market conditions become more favorable. With increasing public dominance in the financial sector, private and smaller banks find it more difficult to compete as public banks often enjoy preferential access to government programs, clients, cheaper funding and large distribution networks. Increasing competition in the financial sector has thus become one of the priorities of the CBR's financial sector development strategy for 2018-2021.

Figure 5a: Inflation rose but remained below the CBR's target (CPI index and its components, percent, y-o-y)



Source: CBR and Haver Analytics.

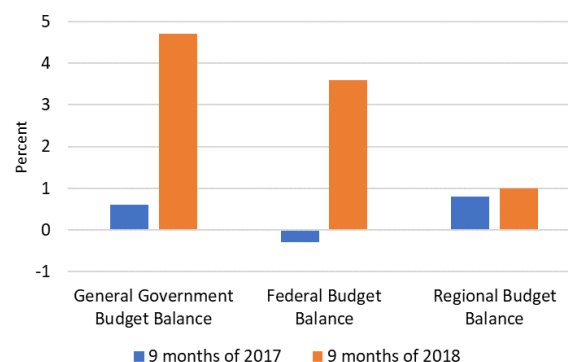
Figure 6a: Overall financial sector indicators remained broadly stable (Key credit and performance indicators, percent)



Source: CBR.

The fiscal balance improved at all levels of the budget system. The general government surplus widened in the first nine months of 2018 (to 4.7 percent of GDP compared to 0.6 percent in the same period last year); the federal budget deficit in 2017 (of 0.3 percent) turned into a surplus of 3.6 percent in the first ten months; and the consolidated regional budget surplus improved to 1.0 percent of GDP from 0.8 percent of GDP in the first nine months of 2018 (Figure 7a). The across-the-board improvement in the fiscal stance was due to higher oil prices, combined with a weaker ruble, a better tax administration and a conservative fiscal policy. The reduction in the non-oil/gas primary deficit is noteworthy, from 5.9 percent of GDP in 2017 to 4.3 percent in the first ten months.

Figure 7a: Budget balance improved at all levels of the budget system (Percent of GDP)



Source: EEG.

Notes: The federal budget balance is for 10 months of 2018.

The funding of the “May Decree” goals put an impetus on revenue mobilization but increases fiscal risks.

To boost growth, in May 2018, the President issued a “May Decree” which introduced a set of goals to be reached by 2024. These goals have already moved the government to increase spending on education, health, infrastructure, social policy, digital economy, support of SME and exports starting in 2019. Twelve national projects and the comprehensive plan for modernization and expansion of infrastructure are included in the federal budget for this purpose. Additional budget spending in these areas is expected to be about 8 trillion rubles over six years (or about 1.1 percent of annual GDP, on average). As a result, overall federal budget spending is expected to total 17.0 percent of GDP in 2019, 17.2 percent of GDP in 2020, and 16.9 percent of GDP in 2021 (compared to previous plans of spending 15.9 percent of GDP in 2019, and 15.6 percent of GDP in 2020). The most important steps to mobilize revenues for the May Decree goals include:

- Increasing the VAT rate from 18 to 20 percent (would mobilize revenues worth 0.5 to 0.6 percent of GDP annually; also see Box 6 for distributional impact of VAT increase);
- Streamlining taxation of the oil sector by 2024 (would mobilize revenues worth 0.2 to 0.4 percent of GDP in 2020 and 2021); and
- Raising the retirement age (would mobilize revenues in the long-term; see Box 7)

The government also plans a temporary relaxation of the fiscal rule in 2019 – 2024. In this period, instead of targeting a zero federal budget primary deficit (at the benchmark oil price of USD 40 per barrel in 2017 prices), the fiscal rule would now target a deficit of 0.5 percent. This expenditure increase (of 0.5 percent of GDP) would be financed mainly via domestic debt issuance.

Prima facie, while fiscal risks would increase with higher debt level, they are contained, given Russia’s sound macro fundamentals. The federal budget is expected to register surpluses of 1.8 percent of GDP, 1.1 percent of GDP, and 0.8 percent of GDP in 2019, 2020 and 2021. The general government budget is expected to register surpluses of about the same scale. A temporary relaxation of the fiscal rule would increase the

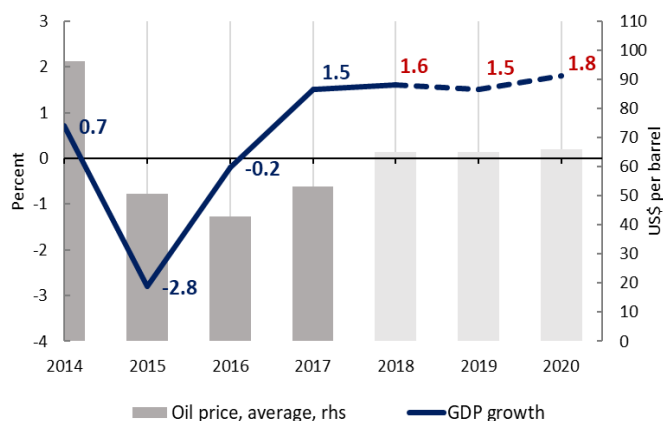
public debt. However, Russia’s public debt is low (15.5 percent of GDP in 2017 compared to the OECD average of 73 percent), and the Russian domestic bond market (of about 19 trillion rubles) is sizable compared to the additional issuance (of about 1.5 trillion).

There is room to mobilize more revenues. To fit in higher spending, other measures such as increasing tobacco taxation and cutting tax expenditures (by reconsidering and reducing preferential tax rates), currently estimated at 2.8 percent of GDP, can help mobilize more revenues.

III. Russia’s medium-term economic prospects: 2018 – 2020

Russia’s growth prospects for 2018-2020 remain modest, forecasted at 1.5 to 1.8 percent (Figure 8a). This suggests that growth rates in Russia will stay below the EMDE average (4.6 percent) and exceed the AE average (1.7 percent) only in 2020. Higher-than-expected oil prices could favorably affect the growth forecast. Unfavorable factors stem from the potential expansion of sanctions and continued elevated geopolitical tensions, which translate into high uncertainty that dampens domestic demand. A marked escalation of trade tensions among major economies could negatively affect growth in Russia and globally. A potential sudden tightening of global financial conditions could negatively affect growth in

Figure 8a: The forecast for Russia suggests modest growth (real GDP growth, percent)



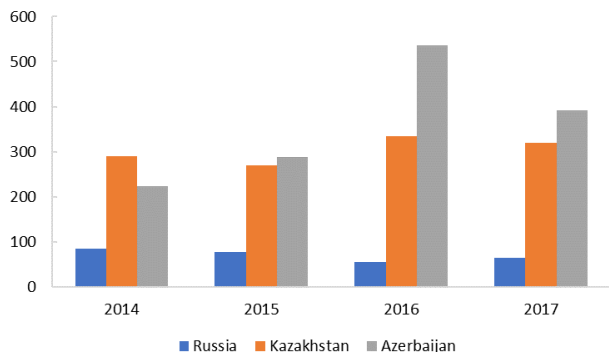
Source: Rosstat, World Bank.

Russia by pressuring the financial account and exchange rate, translating into higher inflation and lower domestic demand. Inflationary risks stem from the VAT rate increase, pass through from the ruble depreciation, a higher-than-expected rise in gasoline prices, a closing of the output gap, elevated inflation expectations and heightened external volatility. And with a large state footprint, the risk of contingent liabilities (in the banking sector, for instance) are elevated. On balance, thus, unfavorable factors outweigh favorable ones, keeping the emphasis on maintaining stability.

Export diversification is limited. Since 2014, Russia’s non-energy export volume growth has been outpacing that of energy and contributing to export diversification. Yet Russia’s progress in export diversification is limited, with the share of oil/gas products still totaling a high 59 percent in exports of goods in 2017; about 25 percent of fiscal revenue; and with diversification happening mainly through active (as opposed to new) lines of products (Figure 9a). Moreover, Russia’s integration into the global economy has not changed much (Figure 10a). In addition to any short-term gains from currency depreciation, it is essential for diversified growth that there are strong institutions capable of managing macroeconomic volatility and delivering public services such as health, education and infrastructure. With flexible exchange rates and a renewed fiscal rule now in place – both measures that rein in macroeconomic volatility – the “May Decree” and other initiatives of the government, aimed at investing in human capital and infrastructure, are steps in the right direction.

In the case of human capital, as Box 8 discusses, Russia performs well and achieves a lot in terms of ensuring the equal access and quality of education for students. Yet problematic areas such as socio-emotional skills or skills of the 21st century need improving.

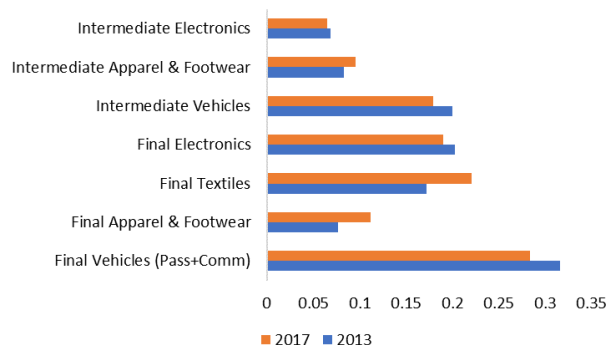
Figure 9a: Azerbaijan succeeded best in introducing new export lines, Russia least (number of new lines)



Source: Comtrade, WB staff calculations.

Note: “New” lines are defined as lines of export becoming active, after two consecutive years of inactivity.

Figure 10a: Russia’s progress in integration into the global economy through global value chains was limited (market share, percent)



Source: WITS.

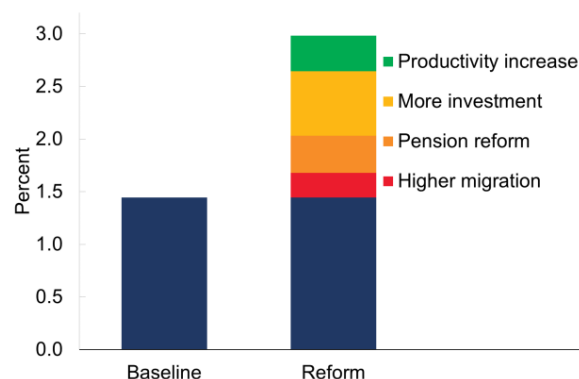
IV. Russia’s longer-term economic prospects: select issues beyond 2020

The May Decree goal of halving poverty by 2024 could be within reach. Driven by a rebound in real wages and disposable incomes on the back of low inflation, the number of poor people decreased by 1.1 million in the first half of 2018. As Box 6 analyzes, the proposed VAT rate increase would also have a relatively neutral effect on the overall income distribution. However, the poverty rate remains over 13 percent and is projected to average 12 percent over the next three years – still above the pre-crisis rate of 10.8 percent in 2013. Specifically, Box 9 discusses what would it take to halve the poverty rate from 13.2 percent to 6.6 percent by 2024. The poverty rate target of 6.6 percent by 2024 *could* be achieved even under a modest growth scenario of 1.5 percent annual growth. Additional redistribution of 0.39 to 0.45 percent of GDP annually, through social assistance and transfers, would achieve this. This estimated additional redistribution assumes improving targeting from the current 20 percent to around 60 to 70 percent (in line with other countries). Efficiency gains from existing programs could partly fund or replace the required additional redistribution. These efficiency gains could be realized by an increase in the targeting accuracy of existing means-tested programs; extension of means-testing to some programs currently not means-tested; consolidation into a single program providing much higher benefits; and a significant increase in child allowances for families with three or more children and for single-parent families.

Taking a longer perspective, various government initiatives could double Russia’s potential growth rate to 3 percent by 2028. As discussed in Part 3, Russia’s potential growth peaked before the 2008 global financial crisis and continued to decline up to 2017. The estimated potential growth rate was 3.8 percent in 2000-09 and 1.7 percent in 2010-17, a 2.1 percentage point decline. The most recent deceleration was due to a

slowdown of productivity growth and a shrinking potential labor force rather than a shortfall in capital accumulation. Regarding its future trajectory, under the baseline scenario, Russia’s potential growth is expected to continue its gradual downward trend from 1.5 percent in 2017 to bottoming out at 1.3 percent in 2022. But it is expected to recover gradually afterwards, primarily driven by a stabilization of the labor force. Simulations of an increase in the retirement age (see Box 7 for a detailed discussion on pension reform measures), more inward migration, higher investment, and gradual acceleration of Total Factor Productivity (TFP) growth could double Russia’s potential growth rate to 3.0 percent by 2028 (Figure 11a). Potential growth is found to be most sensitive to changes in TFP growth.

Figure 11a: Comprehensive reforms can raise Russia’s potential growth



Source: World Bank.

An important element for inclusive and diversified growth is strong micro fundamentals. There has been some progress towards strengthening micro fundamentals. Russia continued its efforts to enhance the regulatory environment for SMEs by carrying out four reforms in the past year. Because of these latest reforms, Russia advanced to 31st place in the global ease of doing business ranking, representing an improvement from the 35th place last year and 40th place two years ago (Russia was ranked 120th seven years ago). However, as Box 11 discusses, there is room for further improvement in several areas, such as Trade Across Borders, Resolving Insolvency and Protecting Minority Investors. And even though the regulatory environment for SME reforms is improving, the overall volume of outstanding SME loans remains below the pre-crisis level (see Box 5). Moreover, competition conditions in Russia have not improved as rapidly as broader investment-climate conditions (see Box 10). Product market regulations remain the most restrictive in the OECD and Russia ranks 95th of 137 countries on the Global Competitiveness Index’s competition perceptions indicator. The continuing presence of high price-cost margins, lower-than-average market entry rates and lower levels of private investment in innovation all point to limits to competition.

The trinity of maintaining stability, doubling growth, and halving poverty can be completed. *Maintaining stability* will require a high level of skill to navigate an increasingly uncertain external environment and mobilizing additional revenues (by increasing tobacco taxation and cutting tax expenditures for example). *Doubling growth* will require, in addition to expanding the labor force through higher retirement age, the implementation of reforms that increase inward migration, boost investment, and increase TFP growth. Increasing competition and targeted interventions in human capital that specifically build socioemotional skills and skills of the 21st century would help boost TFP growth. And *halving poverty* will require additional – but modest – redistribution.

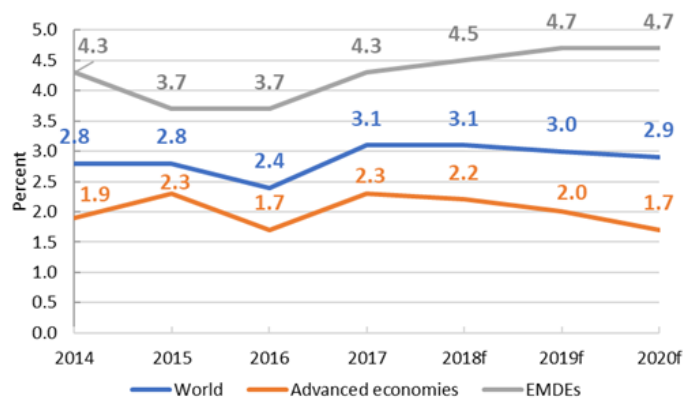
PART 1. Recent Economic Developments

1.1 Global Growth: weighed by weakening recovery in trade and manufacturing

Weakening recovery in trade and manufacturing activities is weighing on global growth. Global goods trade has decelerated more rapidly than expected. EMDE financial conditions are tightening but spillover from the turmoil in major EMDEs has been limited. Crude oil prices have averaged USD70/bbl in 2018 so far. Production in Russia reached an all-time high of 11.4 mb/d in October.

Global growth is broadly stable but risks from rising trade tensions are increasing (Figure 1 and Box 1). A weakening recovery in trade and manufacturing activities is weighing down global growth. Global goods trade has decelerated more rapidly than expected; global capital goods production, which is highly trade-intensive, has also moderated in recent months, and new export orders continue to deteriorate. U.S. tariffs and retaliatory responses of trading partners have affected 2.5 percent of global goods imports. A third of the manufacturing companies surveyed in the United States and Japan said that they would reconsider their investment plans if trade tensions escalated, while a small fraction of companies have already changed their investment plans. In China, less than one-third of exporters surveyed in October expects full-scale trade war and decline in orders. These surveys suggest that the risks of a possible trade war have not yet fully materialized.

Figure 1: Global growth is broadly stable (Percent)

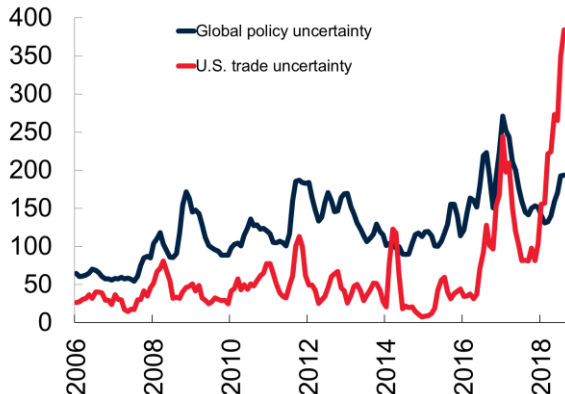


Source: World Bank.

Investment plans if trade tensions escalated, while a small fraction of companies have already changed their investment plans. In China, less than one-third of exporters surveyed in October expects full-scale trade war and decline in orders. These surveys suggest that the risks of a possible trade war have not yet fully materialized.

EMDE financial conditions are tightening but spillover from the turmoil in major EMDEs has been limited. Divergent monetary policy and growth prospects among the United States and other major economies contributed to a significant appreciation of the U.S. dollar in 2018. This, together with intensifying trade tensions, deteriorating growth prospects, and renewed attention to external vulnerabilities, has contributed to significant depreciations and capital outflows in many EMDEs. EMDE currencies – including the Russian ruble – fell and cumulative portfolio outflows from EMDEs surpassed those seen after the 2013 taper tantrum. Economies with external vulnerabilities, including Argentina, Indonesia, and Turkey, experienced sharp currency depreciation. While spillover from those countries has been limited, reflecting weak direct linkage, the intensification of turmoil could lead investors to reevaluate their exposure to EMDEs and to capital outflows.

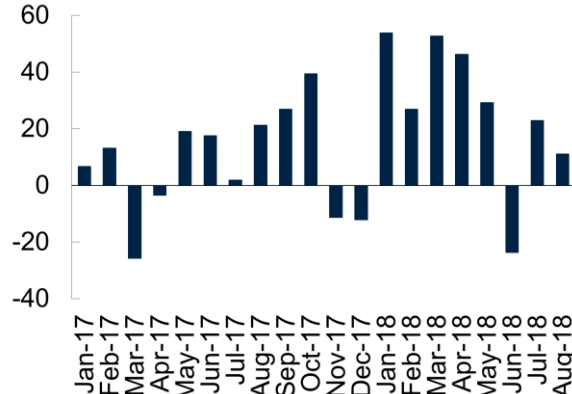
Figure 2: Trade Policy uncertainty is rising
Index, 3-month moving average



Source: Baker, Bloom, and Davis (2016).

Note: Trade policy-related uncertainty in the United States is based on an index presented in Baker, Bloom, and Davis (2016), and computes the frequency of articles in domestic newspapers mentioning terms related to trade policy (e.g., import tariffs, import barriers, WTO, dumping, etc.).

Figure 3: Capital flows to EMDEs are declining
US\$, billions



Source: Institute of International Finance and World Bank.

Note: Capital flows refers to all types of net flows from both residents and non-residents covering portfolio flows, banking flows, direct investment, and other components of the financial account in a nation's balance of payments. Last observation is August 2018.

Box 1: Recent development in major economies.

United States: forecasted robust growth of 2.7 percent in 2018 is amid pro-cyclical fiscal stimulus, solid private investment, and still-accommodative monetary policy. The labor market remains robust with the 50-year low unemployment rate while long term inflation expectations remain contained.

Euro Area: growth slowed notably in 2018. High-frequency indicators suggest possible downward revision from current 2.1 percent growth forecast, dragged by softening net exports. Higher energy prices raised headline inflation to target, and the European Central Bank stopped adding assets to its balance sheet.

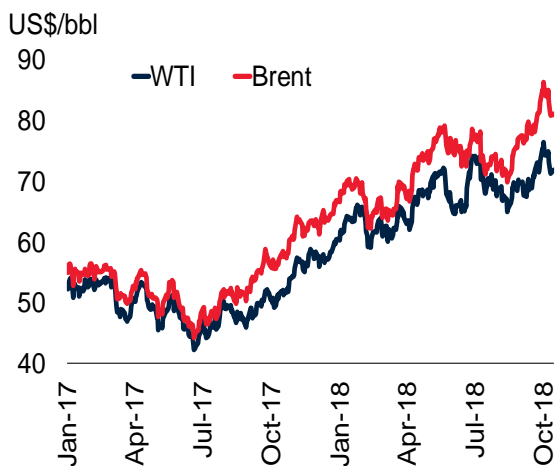
China: resilient consumption and rebound in private investment is supporting growth in 2018, forecasted at a still-robust 6.5 percent. However, export growth has declined, reflecting easing external demand and new U.S. tariffs. Monetary and fiscal policies have become more supportive of growth to offset the weak external demand.

Eurasian Union (excl. Russia): external factors are promoting continued strong 2018 growth in member countries. Recovery in the Russian economy increased exports from Belarus and remittances to the Kyrgyz republic. Elevated commodity and oil prices for Kazakhstan and copper prices for Armenia supported those economies.

Crude oil prices have averaged USD 70/ bbl in 2018 so far, an increase of 33 percent relative to 2017, and are expected to average US 71/bbl over the next three years.¹ Oil prices have been buffeted by an array of geopolitical and macroeconomic factors this year, with the price of Brent, the international marker, ranging from \$59/bbl to \$86/bbl (Figure 4). A key development in oil markets this year was the announcement by the U.S. of its intention to reimpose sanctions on Iran, which led to concerns about oil supply—when sanctions were previously implemented in 2012 they resulted in a reduction in Iranian exports of around 1mb/d. Production has also continued to decline in Venezuela, falling to 1.3mb/d in October, roughly half the level of production in 2016. These factors supported prices in September and early October.

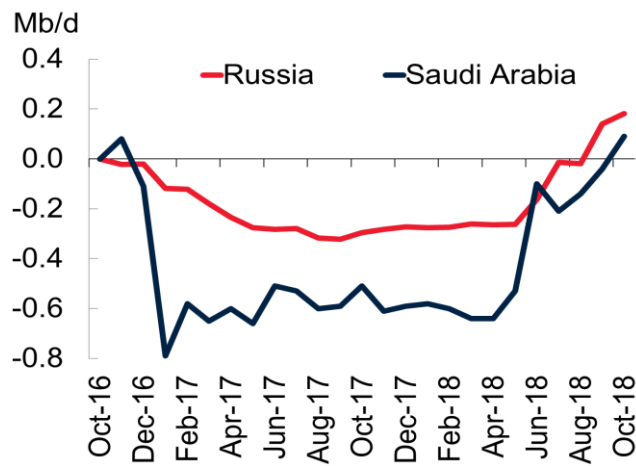
However, prices fell sharply in early November after the United States announced it would grant waivers to its sanctions on Iran to eight countries, including China and India. This development coincided with an upward revision to production in the United States, which is estimated to have reached 11.5mb/d in October. Production by other OPEC members, as well as their non-OPEC allies, has also significantly increased this year, in response to concerns about a shortfall in supply, with the largest increases in Saudi Arabia and Russia (Figure 5). Production in Russia reached an all-time high of 11.4 mb/d in October (see Box 2). The announcement of waivers, together with the increased supply from other countries, shifted market concern away from a supply shortfall towards fears of oversupply.

Figure 4: Crude oil prices have averaged USD 70 / bbl in 2018 so far



Source: Bloomberg.

Figure 5: Production by Russia and Saudi Arabia significantly increased this year, in response to concerns about a shortfall in supply



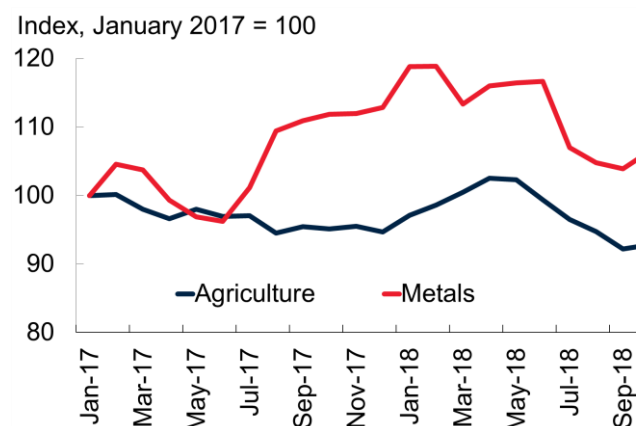
Source: International Energy Agency, World Bank.
 Note: Figure shows the change in oil production since October 2016. Last observation is September 2018.

¹ The World Bank oil price is an average of three prices (Brent, WTI and Dubai oil prices).

Metals and agricultural prices declined in the third quarter of 2018 (Figure 6).

Metals prices fell nearly 10 percent on weaker global demand, as well as concerns about the effects of the U.S.-China trade dispute on global trade and economic activity. For aluminum, these effects were partially offset by supply constraints, including the closure of the world's largest supplier of alumina, and environmentally driven reductions in production in China. While most oilseed and grains prices fell on ample supplies and trade tensions, wheat prices have been supported by poor harvests in Europe and Central Asia, where production has been adversely affected by heat-waves.

Figure 6: Metals and agricultural prices declined in the third quarter of 2018



Source: World Bank.

Box 2: The Russian oil and gas sector: record levels of production.

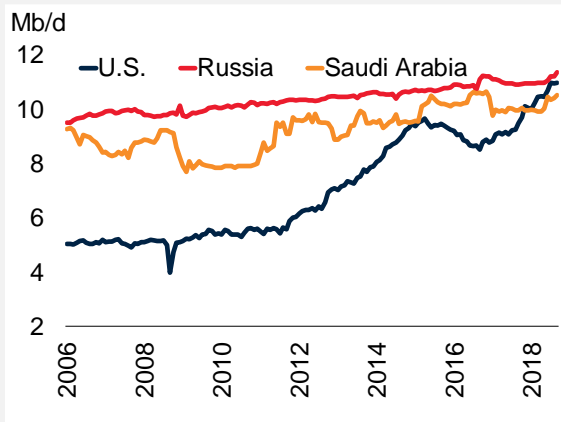
Russian production of hydrocarbons has reached record highs. Crude oil production reached a record level of 11.4 million barrels per day (mb/d) in October (Figure B2-1). Yet in August the U.S. overtook Russia as the largest producer of oil in the world. While production has been rising, consumption of oil has been relatively flat, so exports of oil have continued to rise (Figure B2-2). In 2017, Russia overtook Saudi Arabia to become the world's largest exporter of crude oil and oil products.

Production in Russia had been restricted by an agreement between OPEC and some other non-OPEC producers in late 2016 to cut production in order to ease a supply glut and support prices. Russia agreed to a 0.3mb/d cut starting in January 2017. However, the group decided to allow some increases in production in June this year to offset greater-than-expected falls in production in Venezuela and more recently, Iran. Since the end of this agreement, Russia has more than reversed its cut, with production increasing by around 0.4mb/d. The increase was driven by higher output from Rosneft, as well as increases from production-sharing agreement producers and other smaller players. Gazprom's Neft saw a small fall in production. The International Energy Agency expects oil production in Russia will continue to increase in 2019, by approximately 0.3mb/d.

Russian production of natural gas reached a record high of 640 billion cubic meters in 2017, making it the second-largest producer after the United States (Figure B2-3). However, it is the world's largest exporter of natural gas, as the United States consumes most of its domestic production. Russia exports almost all of its natural gas to Europe via pipelines, although its exports of liquified natural gas (LNG) are increasing, destined primarily for Japan and other Asian countries (Figure B2-4).

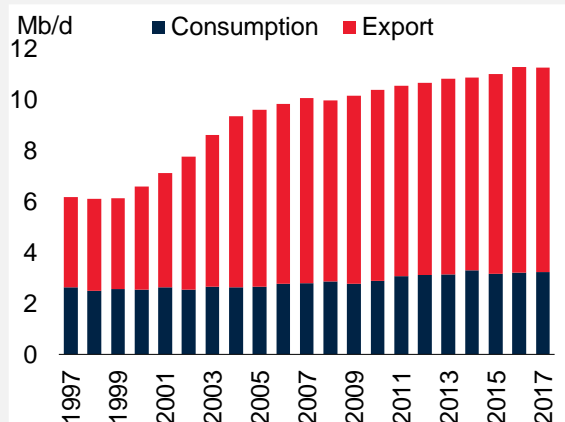
The BP 2018 Energy Outlook expects Russian production of natural gas to continue to rise steadily for the foreseeable future, with further increases in LNG exports.

Figure B2-1: Russian production of hydrocarbons has reached record highs



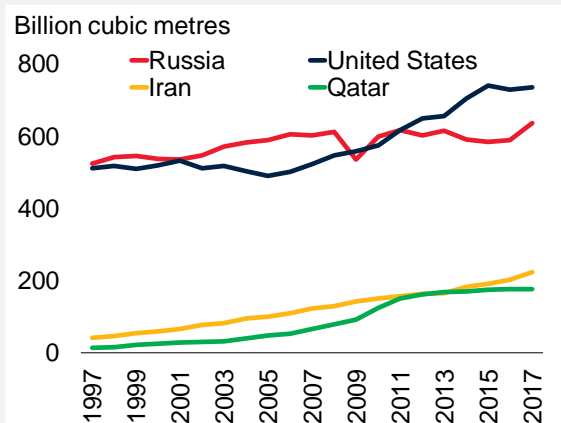
Source: International Energy Agency.

Figure B2-2: Russian crude oil consumption has been relatively flat



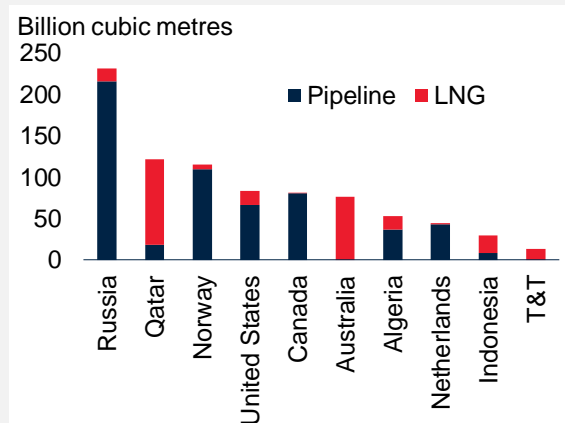
Source: BP Statistical Review.

Figure B2-3: Russian production of natural gas reached a record high in 2017



Source: BP Statistical Review.

Figure B2-4: Russia is the world's largest exporter of natural gas



Source: BP Statistical Review.

Note: LNG stands for liquified natural gas. T&T stands for Trinidad and Tobago.

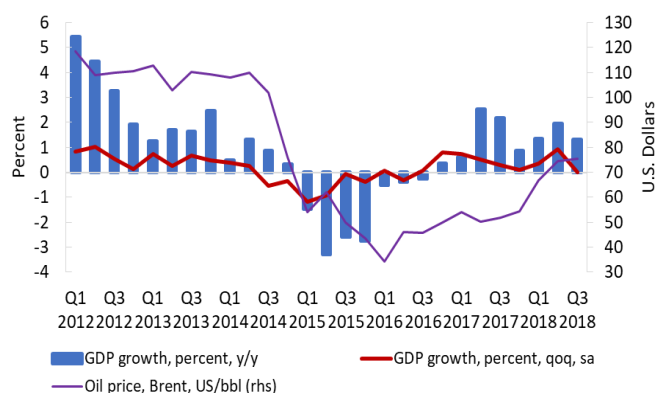
1.2 Russia: growth momentum slowed down in the third quarter.

After relatively robust growth in the first half of 2018, growth momentum stalled in the third quarter. A weaker harvest, sluggish performances in manufacturing and construction, waning effects from the FIFA World Football Cup, led to this stalling. Since 2014, non-energy export volume growth has been outpacing that of energy, contributing to limited export diversification. A more diversified export base will require further strengthening of institutions capable of managing macroeconomic volatility and delivering public services such as health, education and infrastructure. With flexible exchange rates and a new fiscal rule now in place, recent policy initiatives aimed at investing in human capital and infrastructure are steps in the right direction.

Supported by a pick up in global growth, rising oil prices and macroeconomic stability, growth momentum improved in the first half of 2018 (Figure 7). Moreover, GDP growth (1.3 and 1.9 percent, y/y, in Q1 and Q2, respectively) was broad-based and in line with the economy's potential, with non-tradable sectors as its main drivers. In the tradable sectors, manufacturing was the engine of growth, supported by robust global demand, real effective exchange-rate (REER) depreciation, and a recovering domestic demand (Figure 8). Growth in mineral-resource extraction was limited until June 2018 by the OPEC+ agreement, supported by Russia (Box 2).

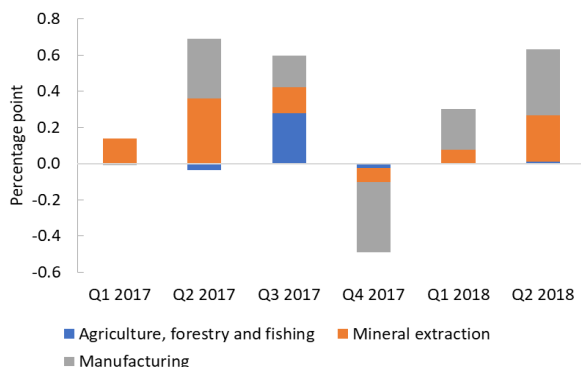
In the second quarter of 2018, GDP growth momentum accelerated to 0.9 percent, q/q, adjusted for seasonal and calendar factors, gaining from the FIFA World Football Cup hosted by Russia, which accelerated growth in the non-tradable sector (Figure 9), and by the relaxation of production limits in the oil sector in June.

Figure 7: Growth continued in 2018



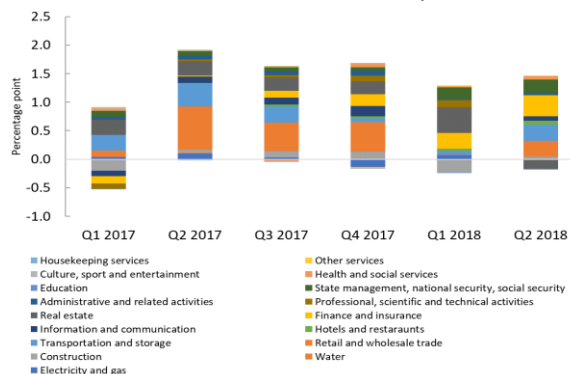
Source: Rosstat.

Figure 8: Within tradeable sectors, manufacturing was the main engine of growth in the first half of 2018



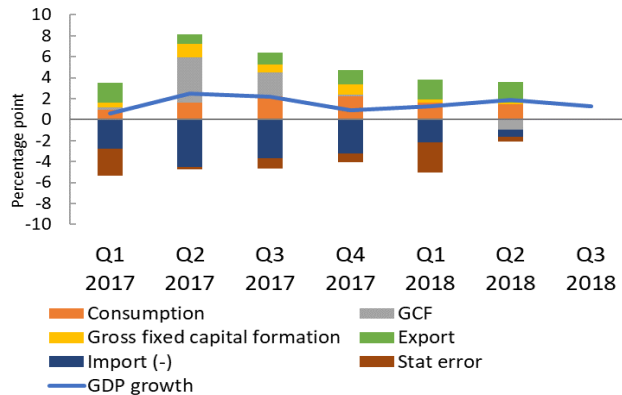
Source: Rosstat.

Figure 9: Contribution to growth from retail and wholesale trade, transportation, and hotels and restaurants increased in the second quarter in view of the FIFA World Football Cup



Domestic demand continued to recover in the first half of 2018, although its growth slowed down in the second quarter of 2018 and net exports, supported by the FIFA World Football Cup, emerged as the main contributor to demand-side growth. (Figure 10). With inflation remaining low, wages and pensions continued to increase in real terms, supporting households' consumption. Historically low interest rates and deferred demand fueled consumer loans. Fixed capital investment growth slowed down in the first quarter of 2018 due to a drop-in investment in mineral-resource extraction (partly due to the high base of last year), and further in in the second quarter. In addition, restocking by firms decelerated in the first half of 2018, which led to negative contribution of gross capital formation to GDP growth, with the effect being especially strong in the second quarter of 2018. The FIFA World Football Cup supported export growth, meanwhile, lower restocking and a weaker ruble in the second quarter of 2018 resulted in the slowdown of import growth, making net exports the main contributor to GDP growth.

Figure 10: Net exports became main growth driver in the second half of 2018

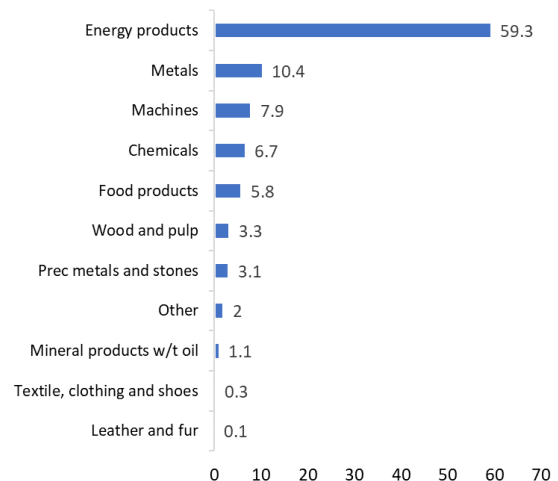


Source: Rosstat.

Growth momentum appears to have weakened in the third quarter of 2018. Rosstat preliminary estimates suggest that GDP growth stalled: 0 percent growth, q/q, adjusted for seasonality (1.3 percent, y/y). This slowdown is on the back of a weaker harvest and sluggish performances in manufacturing and construction, waning effects from the World Football Cup. Demand side has possibly registered some slowdown in export and further restocking deceleration.

Since 2014, non-energy export volume growth has been outpacing that of energy, contributing to export diversification. Yet progress has been limited, with the share of oil/gas products totaling about 59 percent of total export of goods in 2017 (Figure 11). During the period 2014-2017, Russia had made progress in export diversification, which was reflected in a lower share of the top-ten product lines in the total export of goods as well as in a lower value of the Theil index (Figure 12). A similar improvement in diversification of exports was registered in other major carbon-exporters of Europe and Central Asia region: Kazakhstan and Azerbaijan.

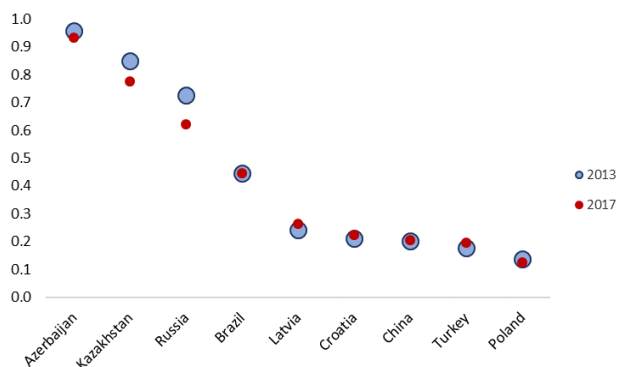
Figure 11: Share of oil/gas products totaled about 59 percent in export of goods in 2017 (Percent)



Source: Russian customs statistics.

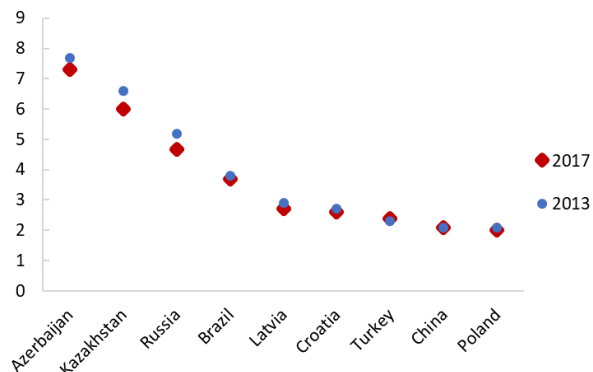
Figure 12: Russia has made some progress in export diversification (2013 - 2017)

Share of top 10 products in total export of goods



Source: Comtrade, WB staff calculations.

Theil index for exported goods (HS 2012 classification, 6 digits)

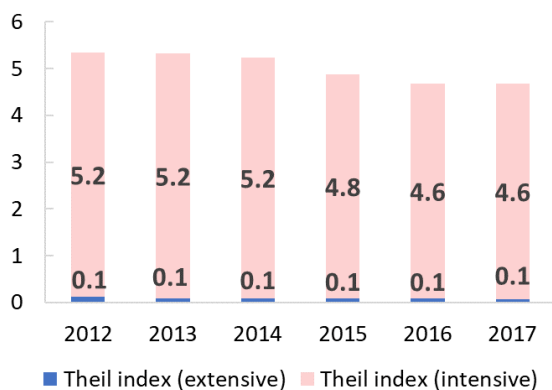


Source: Comtrade, WB staff calculations.

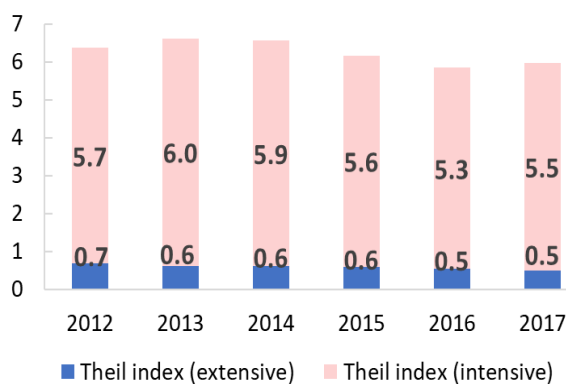
In Russia (as in Kazakhstan), export diversification happened mainly through active (as opposed to new) lines of products:² the share of energy items decreased, while the share of active non-energy items grew (Figure 13 and Figure 14). Lower oil prices (price for Brent oil dropped to US\$54.4 in 2017 from US\$108.9 in 2013) were also important contributing factors. The share of energy products in total goods exports³ fell from 70.2 percent in 2013 to about 65 percent in 2017.

Figure 13: In Russia and Kazakhstan export diversification happened mainly through active (as opposed to new) lines of products

Russia



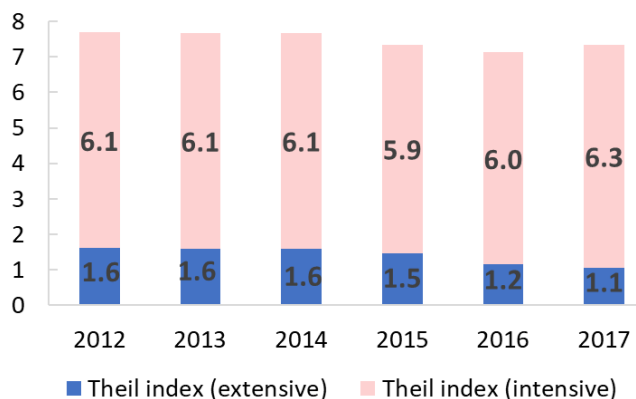
Kazakhstan



² We use decomposition of Theil's index into "between" and "within" group components with a partition of export lines into active and inactive ones. The result is a mapping of changes in the "between" groups component of Theil's index into changes in the extensive margin of exports and of changes in its "within" groups components into changes in the intensive margin of exports. (see "Export diversification: what's behind the hump?" Cadot, et al. 2007).

³ Source: Russian customs data.

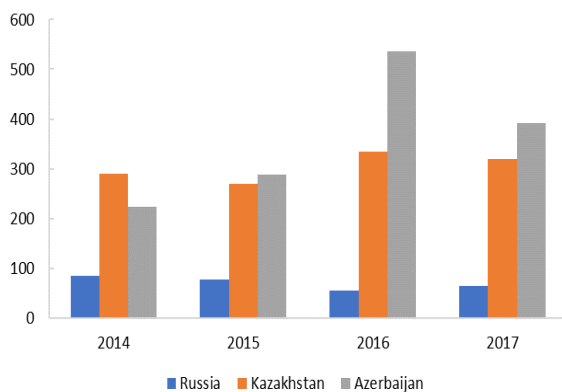
Azerbaijan



Source: Comtrade, WB staff calculations.

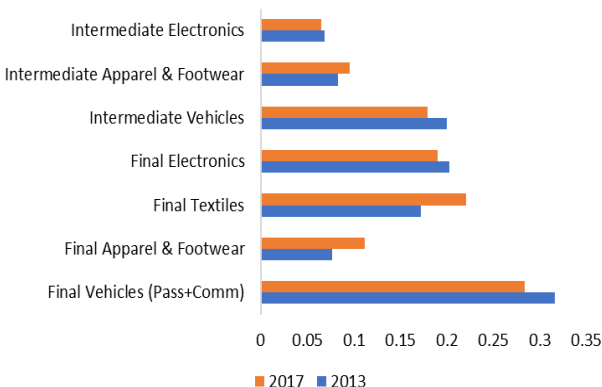
Russia's integration into the global economy has not changed much since 2013. Russia's shares in the world's market of final and intermediate groups of manufacturing products stayed at about the same levels (Figure 15; latest data available for 2016).

Figure 14: Azerbaijan succeeded best in introducing new export lines, Russia least⁴ (number of new lines)



Source: Comtrade, WB staff calculations.

Figure 15: Russia's progress in integration into the global economy was limited



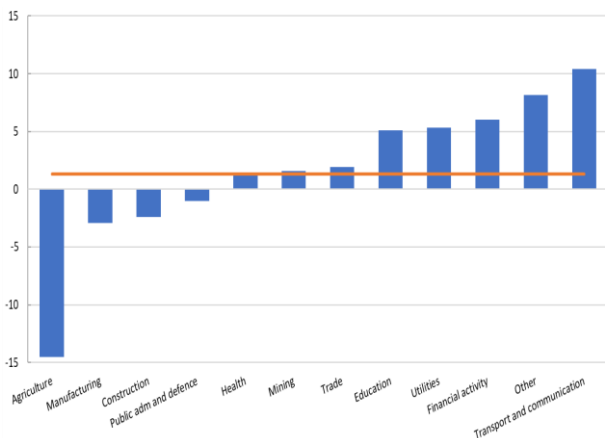
Source: WITS.

Economic diversification in Russia has been limited. The recovery in fixed capital investment in manufacturing only just started in 2018⁵; FDI in oil and gas sector outperformed FDI in manufacturing in 2014-2017; and employment levels (and shares) in manufacturing and agriculture decreased compared to the levels of 2013 (Figure 16 and Figure 17).

⁴ New lines were defined as lines of export becoming active, after two consecutive years of inactivity.

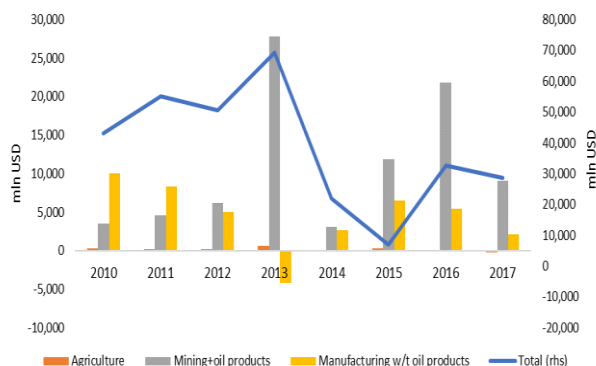
⁵ Data for large and medium enterprises.

Figure 16: Employment in manufacturing decreased (change in employment levels, 2017 vs 2013, percent)



Source: Rosstat.

Figure 17: FDI in oil and gas sector outperformed FDI in manufacturing in 2014-2017



Source: CBR.

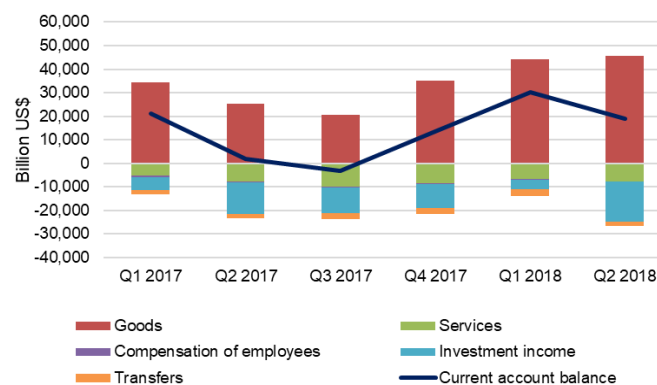
The lack of significant diversification of the Russian economy despite REER depreciation could be partly attributed to a high share of imported goods and tradable raw materials in the costs of manufacturing production. In addition, as the study “Diversified Development” (World Bank, 2014, Indermit Gill et al), states, building strong institutions (the mechanisms to manage resource rents, administer social services, and regulate economic production), which would provide for a level playing field and the rule of law, is a key condition for economic diversification. Recent initiatives of the government aimed at investing in human capital and infrastructure are steps in the right direction. There have also been substantial improvements in Russia’s business climate (see Box 10). However, there is still room for further gains (especially in easing excessively burdensome administrative procedures in external trade). Moreover, worldwide governance indicators reveal that Russia lags behind Upper Middle-Income countries in such categories as “Regulatory quality,” “Rule of law” and “Control of Corruption.”

1.3 Balance of payments: current account surplus widened, capital outflows increased

In January – September 2018, the current account surplus widened, supported by an increase in the terms of trade, robust global growth, and REER depreciation. Net capital outflows increased because of turbulence in emerging markets and elevated geopolitical tensions. To reduce volatility on the financial markets the CBR suspended its daily currency purchases in the fiscal rule framework until end-December 2018.

Supported mostly by rising oil prices, the current account surplus widened to about 6.3 percent of GDP (USD75.8 billion) in January-September of 2018 from 1.7 percent of GDP (USD19.7 billion) in the same period last year (Figure 18). A stronger trade balance supported the current account: both energy and non-energy exports increased (Table 1). Energy exports grew mainly on the back of higher oil prices (+38 percent, y/y). Non-energy exports were supported by growth of both prices and volumes (Figure 19). In the first

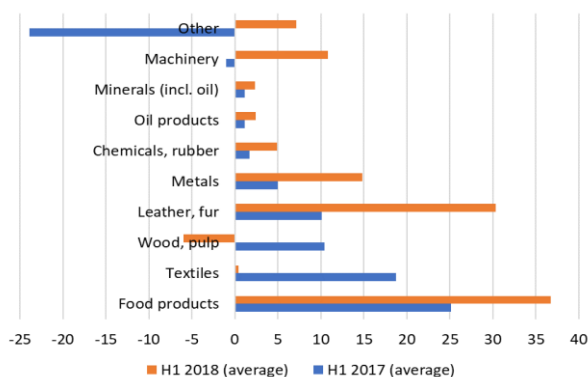
Figure 18: The current account surplus widened



Source: CBR.

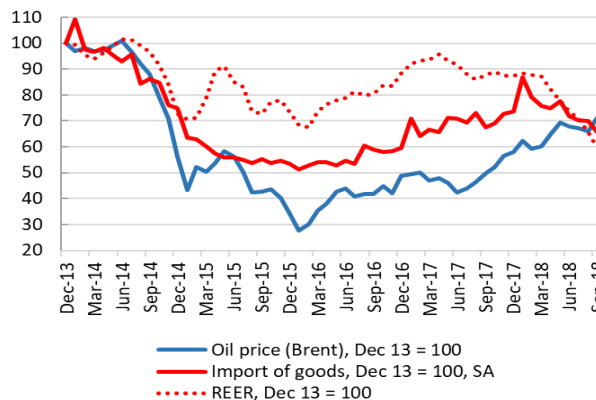
half of 2018, non-energy export volume growth was broad-based, but particularly high in food products (after a good harvest in 2017), leather, metals, and machinery. Import value growth in annual terms was high in the first quarter of 2018 but decelerated in the second quarter and turned negative in the third, as the REER depreciated and domestic demand growth slowed down. In January-August 2018, FX interventions within the fiscal rule framework, conducted by the Central Bank on behalf of the Ministry of Finance, supported the current account by putting downward pressure on the ruble (Figure 20). The balance of services, primary and secondary income balances changed marginally. In January-September 2018, the non-oil/gas current account deficit improved from 9.3 percent of GDP to 10.5 percent of GDP in the same period last year, largely reflecting improvement in the non-oil/gas fiscal balance.

Figure 19: Non-oil/gas export volume growth was robust in the first half of 2018 (Percent)



Source: CBR, Haver Analytics.

Figure 20: Import growth decelerated in 2018 (y/y)



In the second and third quarters of 2018, the expansion of sanctions and increased geopolitical tensions, exacerbated by the changed risk perception of the emerging economies, resulted in increased net capital outflows, pressure for depreciation on the exchange rate and downward pressure on the asset prices. Net capital inflows turned into net capital outflows in the government sector, mainly through the sell-off of OFZ bonds: share of OFZ bonds held by non-residents dropped from 33.1 percent in the year beginning to 25.8 percent in the end of September. Net capital outflow increased in the private sector in the first nine months of 2018 to 3 percent of GDP, compared to 2.2 percent of GDP in the same period last year. Banks continued debt repayments in an environment of limited access to international financial markets. In the non-banking sector, net capital outflows increased largely due to a slump in incoming net FDI in the third quarter, reflecting reduced interest of foreign investors in Russian assets. Foreign-currency purchases within the fiscal rule framework weakened the link between oil price fluctuations and the exchange rate, thus despite growing oil prices, downward pressures on the exchange rate prevailed. The REER depreciated by 8.2 percent, y/y, in the first nine months of 2018.

International reserves gained USD 31.1 billion in the January-September 2018 period compared to an increase of USD 14.4 billion in the same period, last year. The international reserves growth stalled in September when the Central Bank suspended FX interventions in the fiscal rule framework to stabilize financial markets. Reserves amounted to USD 460.6 billion at end-September 2018, compared to USD 432.7 in the end of 2017. The import cover stayed at a comfortable level, and slightly higher than as of end 2017 (15.9 months of goods and services in the end of September 2018, compared to 15.8 months of at the end of 2017). The Central Bank refrained from intervening on its own, in line with its flexible exchange-rate regime. Relatively high levels of international reserves, relatively low external debt levels (about 29 percent of GDP), and the recently established macroeconomic framework would help Russia to limit exposure to external volatility and absorb external shocks.

Table 1: Balance of payments, 2015 – 2018 (US\$ billions)

	2015	2016	2017	Q1 2018	Q2 2018	Q3 2018e	9m 2018e
Current account balance	68.8	25.5	33.3	30.3	19.1	26.4	75.8
<i>Trade balance</i>	111.5	66.4	115.4	44.1	45.6	46.7	136.3
Non-oil current account balance	-134.5	-129.6	-160.2	-31.3	-44.4	-39.9	-115.5
Capital and financial account	-69.4	-11.1	-14.0	-12.8	-9.7	-21.4	-43.8
Errors and omissions	2.9	-4.6	3.8	2.3	2.3	-0.2	4.4
Change in reserves (- = increase)	-1.7	8.2	-22.6	-19.3	-11.3	-5.0	-35.6

Source: CBR.

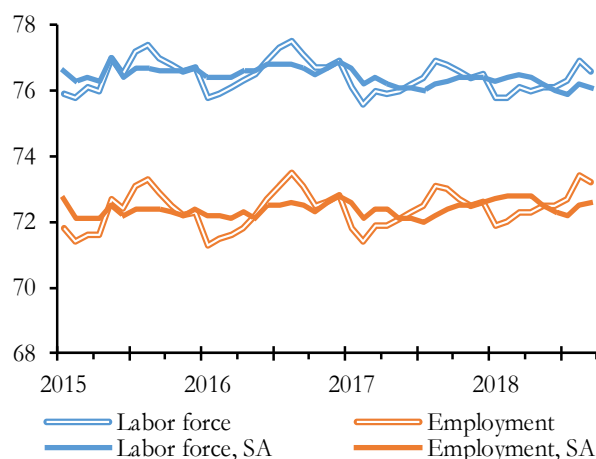
1.4 Labor Market and Poverty Trends: unemployment declines and wages are recovering

Unemployment declined further in the third quarter of 2018 to a current 4.6 percent, while real wages and disposable incomes increased on the back of low inflation. In 2018, wage growth was highest in the public

sector and above the rate of inflation in the non-tradable and tradable sectors. The poverty rate under the national definition decreased in the first half of 2018, driven by a rebound in household incomes. The extreme poverty rate remained marginal, below one percent. Halving poverty over the next 6 years is within reach and will require mobilizing additional – but modest – resources for distribution.

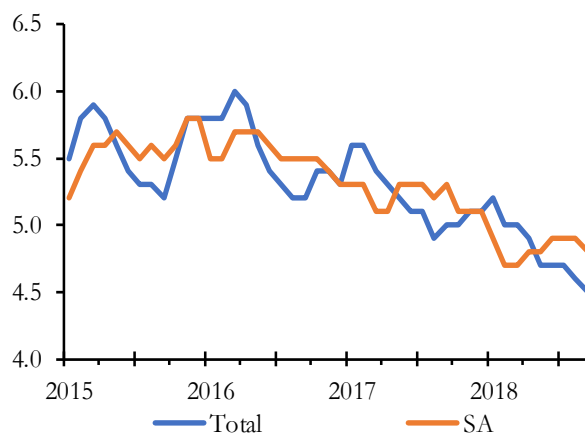
The employment and labor-force participation rates remained at high levels while unemployment was close to minimum. The absolute numbers of employed people increased by 200,000 to 73.2 million in September 2018, compared to the levels of a year earlier (Figure 21). At the same time the measure of the total labor force decreased by the same amount to 76.6 million people in September 2018. The employment rate grew marginally by about 0.3 percentage point to 60.3 percent. The labor force participation rate remained unchanged at the level of 63.2 percent. High employment rates, in combination with the continued decline in the working-age population, led to a further reduction of the unemployment rate. It decreased to 4.6 percent in the third quarter of 2018, compared to 5.2 percent a year earlier (Figure 22). The structure of unemployment remained the same. The gaps between male/female remains stable – unemployment for women is usually around 0.3 percentage points lower than for men (except for June 2018, when this gap reverted). Most of the unemployment is still long-term: 30 percent of the unemployed had been looking for a job for over a year. Unemployment by regions remained unequal and followed the declining national trend.

Figure 21: Labor force and employment, mln people



Source: Rosstat and Haver Analytics.

Figure 22: Unemployment rate, percent



Source: Rosstat and Haver Analytics.

Other labor-market indicators have not been overly affected. The vacancy rate⁶ increased slightly to 3.0 percent in second quarter of 2018, compared to 2.7 percent a year ago, reflecting a gradual recovery in the real sector. The number of part-time employees increased slightly in the first half of 2018 but remained far below the levels of the 2009 crisis period. The average number of hours worked decreased marginally for both genders.

⁶ Ratio of vacancies to the total numbers of jobs.

With inflation low, wages continued to grow in real terms. Real wages growth in January-October of 2018 was 7.6 percent, compared to the same period of 2017 (Figure 24). The fastest real wage growth was in public sector: health (23.3 percent in the first nine months of 2018), education (11.2 percent). Real wage growth in the tradable sector was much lower: 4.2 percent on average (8.3 percent in mining, and only 0.9 percent in manufacturing). Among non-tradables, the highest real wage growth rates were in the sector of hotels and restaurants (8.2 percent), while wages in construction increased only by 1.0 percent in January-September 2018 compared to the same period last year.

Real disposable income dynamics remain volatile. Income started to grow in the beginning of 2018. Its average growth rate in real terms in the first ten months of 2018 was 1.6 percent (Figure 23). Labor pensions were indexed by 3.7 percent in January 2018 and social pensions were indexed by 2.9 percent in April 2018 – slightly above the current rates of inflation. As a result, the real growth of pensions in the first nine months of 2018 in Russia was only 1.2 percent (Figure 23).

Figure 23: Real incomes dynamics, percent, year on year

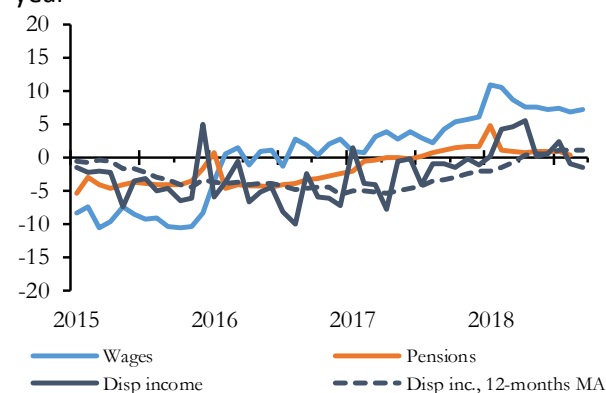
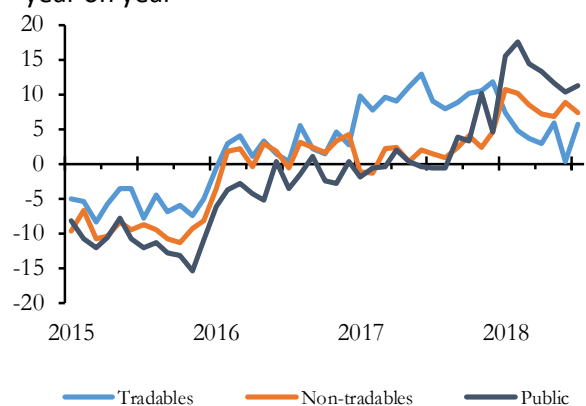


Figure 24: Real wages growth by sector, percent, year on year



Source: Rosstat and World Bank staff estimates.
Note: pension and disposable income dynamics adjusted for January 2017's one-time payment.

Source: Rosstat and World Bank staff estimates.

The official poverty rate continued to decrease slowly in the first half of 2018. Driven by a rebound in real disposable income, the poverty rates in Russia decreased in the first and second quarters of 2018 (Table 2).

Table 2: Poverty (cumulative)

	2010	2011	2012	2013	2014	2015	2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018
Poverty rate, percent	12.5	12.7	10.7	10.8	11.2	13.3	13.3	15.0	14.4	13.8	13.2	14.2	13.6

Source: Rosstat.

The share of the economically secure the population stayed unchanged in 2017. The share of economically secure population decreased by 5 percentage points from 79 percent in 2014 to 74 percent

in 2015 and further to 72 percent in 2017.⁷ This contraction was driven by a massive contraction of disposable incomes and wages in 2015, and a continued decline in incomes in 2016-2017.

One of the May Decree goals is to halve poverty in the next six years. We analyze the feasibility of this goal (Box 3).

Box 3: Halving Poverty in Russia by 2024: What will it take?

We identify the conditions in terms of economic growth and public transfers required to “...reduce poverty in the Russian Federation by half by 2024” as stated in the President Decree of May 17, 2018. The current poverty rate is 13.2 percent and halving it would mean reducing the current rate to 6.6 percent by 2024. We estimate that average annual growth of 1.5 percent would bring down the poverty rate from 13.2 percent to only 10.7 percent by 2024. But even if Russia were to be able to catch up with the rest of the world and grow at 3.2 percent annually, its poverty rate would fall to 8.1 percent – still above the stated goal of 6.6 percent. Consequently, to reach the presidential target of 6.6 percent, we estimate that the annual required growth rate would need to surge to 4.4 percent.

But the poverty rate target of 6.6 percent by 2024 could be achieved even under a scenario of 1.5 percent annual growth. This can be done via additional redistribution, for example, in terms of social assistance and transfers. We estimate such additional redistribution to amount to around 0.27 percent of GDP per year. Of course, accelerating economic growth would make the task of poverty reduction easier. If Russia were to grow at 3.2 percent (slightly above the global growth rate of 3 percent), under perfect targeting, we estimate such additional redistribution to be around 0.10 percent of GDP.

We caution though that this estimate assumes perfect targeting, and as such, should be viewed as a lower bound.⁸ If the assumption of perfect targeting is dropped, under current conditions where only around 20 percent of the allocated budget reaches its intended beneficiaries, Russia would need to mobilize 1.35 percent of GDP to be able to redistribute 0.27 percent of GDP to the poor. However, improving targeting from the current 20 percent to even around 60 to 70 percent, which is in line with other countries, would require mobilizing only **0.39 to 0.45 percent of GDP annually.**

Efficiency gains from existing programs could partly fund these additional transfers. These measures could include better targeting accuracy of the existing means-tested programs, including their consolidation into a single program providing much higher benefits; extension of means-testing to some of the currently not means-tested programs; and a significant increase in child allowances to children in families that have three or more children and children of single parents.

⁷ The World Bank. Towards a New Social Contract.

<https://openknowledge.worldbank.org/bitstream/handle/10986/30393/9781464813535.pdf>. The threshold of 11 US\$ a day or more in 2011 PPP, which corresponds to almost 8,700 Russian rubles per person per month in 2017 prices, is used to define the lower bound for “economically secure population.”

⁸ Perfect targeting assumes that the poor and their income are identified precisely, and they receive the exact amount of social transfers needed to bring them to the level of the poverty line. In other words, no targeting errors are assumed. In reality, both errors of inclusion and exclusion are commonly found in poverty-targeted income

1.5 Monetary Policy: after a prolonged period of loosening, the Central Bank hiked the policy rate in September in the face of elevated inflationary risks

In 2018, monetary policy remained consistent with the inflation-targeting regime. Since July, inflation has been increasing, but stayed below the CBR's target of 4 percent in annual terms. Ruble depreciation on the back of increased geopolitical tensions and turbulence in emerging markets; weak harvest; and higher gasoline prices pushed up consumer inflation to 3.5 percent in October (y/y, annual) from 2.2 percent in January. In order to reduce volatility in the foreign exchange market in August, the CBR suspended FX interventions in the fiscal rule framework. The upcoming increase in VAT rate in 2019; closing of the output gap; and elevated depreciation pressure raises inflationary risks.

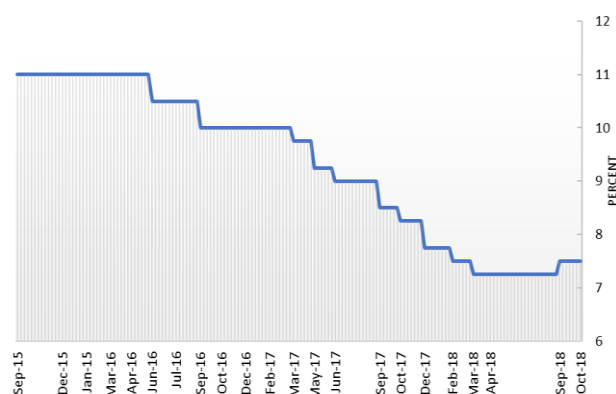
The Central Bank hiked policy rate as inflationary risks increased.

Between January and August 2018, the CBR lowered the key rate twice by 25 basis points (bp), thus bringing it down from 7.75 percent to 7.25 percent in annual terms. However, in September 2018, for the first time since December 2014, the CBR hiked its key policy rate by 25 bp to 7.5 percent and left it unchanged at the October monetary policy meeting (Figure 25). Among the main reasons behind this decision was growing inflationary risk due to the ruble depreciation prompted by elevated geopolitical tensions and turbulence in emerging markets. The Central Bank also took into consideration a planned increase in the VAT rate, which would result in inflation increase in the end 2018 -

2019. According to the Central Bank, the policy rate is close to neutral level in the short term, given increased country risk premium. In the medium to long term, the estimated neutral interest rate has shifted closer to its upper bound within the range of 6 to 7 percent.

To reduce volatility in the foreign exchange (FX) market and its influence on inflation, the CBR suspended FX interventions in the fiscal rule framework during the period of August 9th to 17th and August 23rd to the end of December 2018. The suspension of the CBR's FX purchases reduced ruble liquidity, contributing to the stabilization of financial markets. The CBR is going to compensate its suspended FX purchases in the market in the future when market fundamentals improve.

Figure 25: The CBR hiked its key policy rate by 25 bp in September (key policy rate, percent)



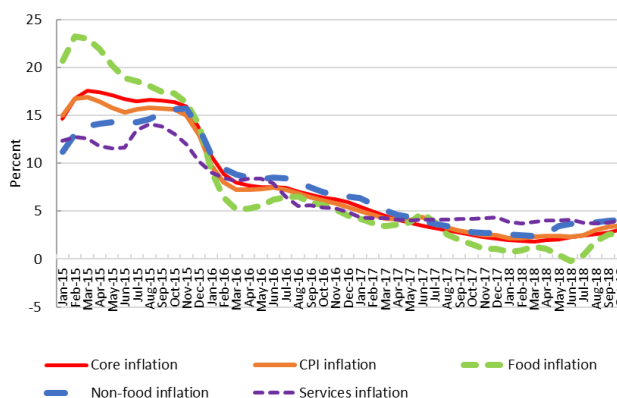
Source: CBR.

support programs. The policy maker's objective is to minimize both errors, and countries such as Azerbaijan, Poland, Turkey, and others have achieved a high targeting accuracy of 60-80 percent. See, for example: *The State of Social Safety Nets*, (2018), World Bank, Washington D.C., April 2018.

Consumer price inflation has been on the rise since July 2018, though it stayed below the CBR's target of 4 percent in annual terms (Figure 26). In October 2018, headline and core inflation increased to 3.5 and 3.1 percent respectively (year-on-year). Headline inflation in annual terms accelerated for all categories - food, non-food items, and services. Non-food inflation was the major contributor to the headline inflation, 1.5 percentage points (pp), while food inflation and inflation in services contributed by 1.0 pp (Figure 28). The increase in inflation since end-2017 has been mostly related to three factors. First, the low-base effect from last year's food price dynamics due to an exceptionally good harvest in 2017. The second factor was higher prices for oil, which affected gasoline prices and transportation costs for producers. The third was the ruble depreciation, which exerted upward pressure on inflation through higher prices of imported food and utilities.

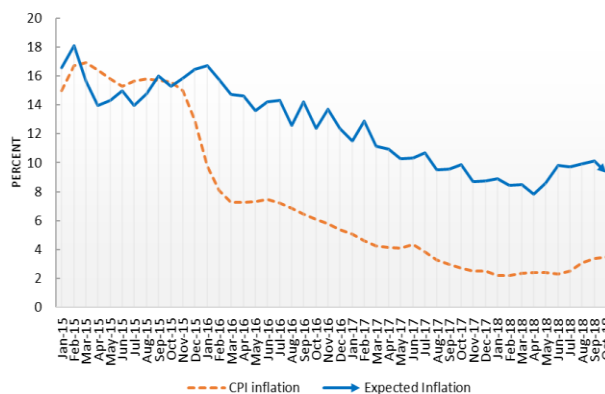
Household inflation expectations remain elevated, prompted by a gasoline prices hike (Figure 27). Although in October they dropped to 9.3 percent from 10.1 percent in September, likely due to the stabilization of the ruble exchange rate and gasoline prices, they still remain above the levels recorded in the year beginning. Moreover, it is likely that the October decrease in household's inflation expectations could be unsustainable, as they remain sensitive to ruble depreciation, geopolitical uncertainties, and to one-off factors, including price increases to individual products. Domestic inflationary risks stem mainly from VAT rate increase, the closing output gap in 2018, pass-through from the ruble depreciation, and elevated inflation expectations. Risks to inflation are therefore tilted to the upside.

Figure 26: Inflation rose but remained below the CBR's target (CPI index and its components, percent, y-o-y)



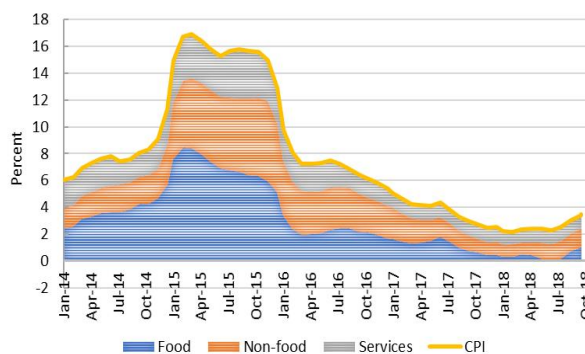
Source: CBR and Haver Analytics.

Figure 27: Inflation expectations are high (percent)



Source: CBR.

Figure 28: Non-food products influence the headline inflation (contribution to inflation by component, percent)



Source: CBR.

For the period of January-October 2018, the ruble depreciated 11.1 percent against the U.S. dollar, while oil prices (Brent) increased by 25.3 percent (Figure 29). In the first quarter of the year, the ruble had slightly strengthened on the back of higher oil prices, relatively favorable external conditions and the continued demand for Russian financial assets. Meanwhile, currency interventions conducted by the CBR on behalf of the Ministry of Finance exerted downward pressure on the ruble. Compared to previous years, the ruble's exchange rate correlation with oil prices weakened. Starting from the second quarter, elevated geopolitical tensions, tightening of monetary policy in the US and investor risk aversion to emerging markets (EM) resulted in the ruble's depreciation, even though the ruble performed better than many other EM currencies. The most significant depreciation happened in the period from August to mid-September. New sanctions, enacted under the Chemical and Biological Weapons Control and Warfare Elimination Act (CBW Act), and elevated geopolitical tensions, coupled with capital outflow from the emerging markets, led to a 5.1 percent ruble depreciation, m/m, with the ruble hitting a 2-year low. In an attempt to reduce volatility on the financial markets, the CBR raised the policy rate and suspended its daily purchases of foreign currency in the fiscal rule framework during the period August 9-17 and August 23 to the end of December 2018. The CBR's policy move provided the ruble with additional support from relatively high oil prices.

Figure 29: Ruble depreciation since the beginning of 2018 (change in oil prices and the nominal exchange rate, logarithmic scale)



Source: CBR.

1.6 The Banking Sector: largely stable despite remaining weaknesses and increasing concentration.

Despite recent bailouts and a continuing sector clean-up, Russia's banking sector remains relatively weak. However, the situation has stabilized, credit is expanding, albeit at a differential pace across various segments. The structure of the Russian banking system remains largely unchanged, with concentration and public dominance increasing even further due to the recent government bailouts of several private banks and further industry consolidation. External risks have increased due to financial turbulence in emerging markets and the possible expansion of sanctions.

Despite recent bailouts and a continuing sector clean-up, Russia's banking sector remains relatively weak, with less capital buffer (12.2 percent as of end-September) and higher NPL ratio (10.8 percent as of end-September) than other BRICS (15.6 percent and 4.4 percent, respectively) (Figure 30). However, the situation has stabilized, lending activity is recovering, and profitability is improving, though the sector remains weighed down by high provisioning charges. Lending growth continued in both the retail and corporate segments, though it was much weaker on the corporate side due to weak economic growth. Credit to the corporate sector grew by 9.7 percent, y/y, in the last ten months. During the same period, loans to households grew by 22.5 percent, y/y (Figure 31). The growth was predominantly driven by unsecured loans and mortgage loans, and household debt is at an all-time high (Box 4). To address the risks linked to accelerated consumer lending growth in 2018, the Central Bank of Russia (CBR) tightened risk-weighting requirements for unsecured consumer loans with an annual percentage rate (APR) in the range of 10-30 percent. The new requirements apply to consumer loans issued after September 1, 2018. The CBR also plans to further tighten risk-weighting requirements for mortgage loans with low down payments (in the range of 10 percent – 20 percent), due to come into effect on January 1, 2019. Approximately 44 percent of mortgage loans in 1H18 were issued with down payments of less than 20 percent, despite the initial increase in risk weights since the start of 2018. Strong demand for residential mortgages has been driven by declining interest rates and anticipated increases in real estate prices due to a change in a funding scheme for the construction companies.

Figure 30: Overall financial sector indicators remained broadly stable (Key credit and performance indicators, percent)

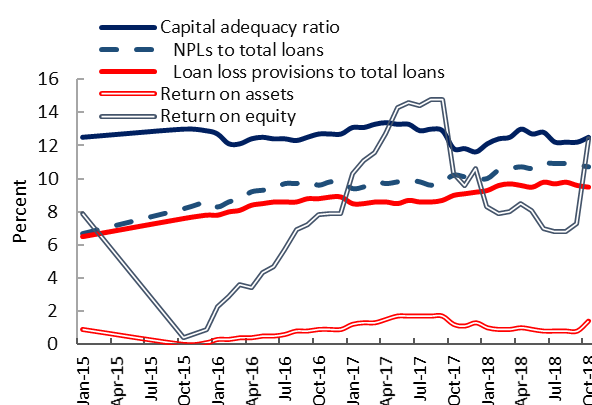
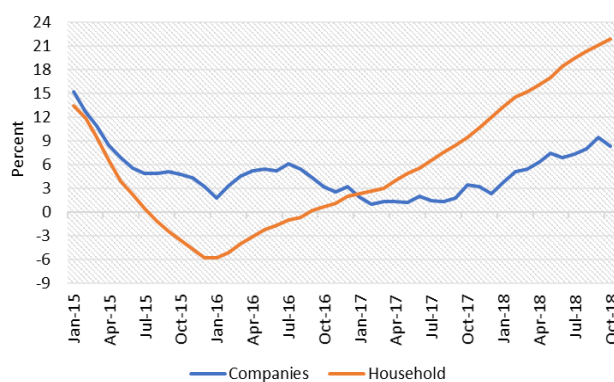


Figure 31: Credit growth is higher in the retail segment (y-o-y, percent)



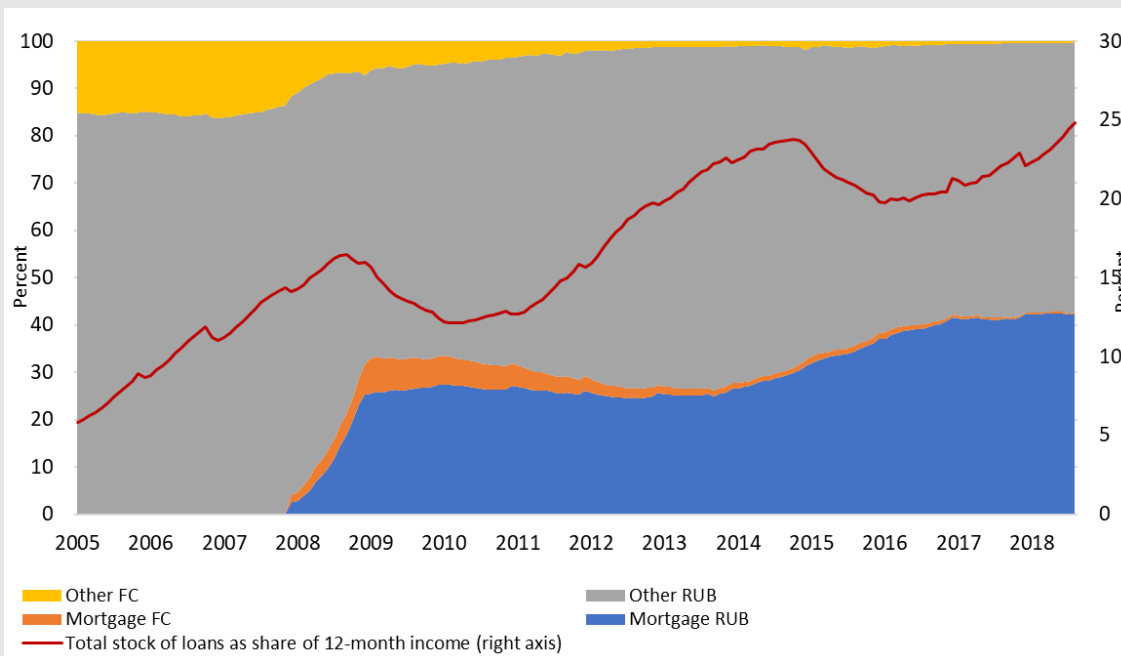
Source: CBR, World Bank staff calculations.

Box 4: Stock of household debt is at maximum levels

The total household stock of bank loans is currently at maximum levels. On September 1st, 2018 the total amount of accumulated household loans exceeded 14 trillion rubles. This is the highest amount registered in modern Russian history. If measured as share of 12-month household income, the total stock of debt reached 24.8 percent. This number exceeds the previous peak of late 2014 (Figure B4-1). The composition of household loans also changed over the last 10 years (Figure B4-1). Household debt denominated in foreign currency almost disappeared in Russia. The current share of loans denominated in rubles is 99.3 percent.

The share of mortgages rises. The share of ruble-denominated mortgage loans rapidly increased in Russia since 2008, then remained stable up to 2014. Moreover, the foreign currency-denominated mortgages in Russia decreased to marginal numbers over the that period. Starting in 2014, the share of mortgages started to increase again and is currently at 42.5 percent of total household indebtedness.

Figure B4- 1: Household debt stock is rising as share of disposable income (percent).



Source: CBR, Rosstat and World Bank staff estimates.

Note: data on mortgage loans are available from 2008 onwards. FC – foreign currency.

Since the beginning of 2018, lending to SMEs has revitalized, overperforming corporate loans. In the first 6 months of the year, loans to SMEs grew by 10.8 percent. This is largely due to massive state support measures undertaken in 2017-2018. Nevertheless, despite some emerging positive dynamics in SME lending, the overall volume of outstanding SME loans remains below the pre-crisis level. SME development is among the top national priorities outlined in the President's May Decree. The Russian government and the central bank developed additional measures to expand access to finance for SMEs to meet ambitious national growth targets (Box 5).

Russian banks remain largely funded by customer deposits. Retail deposits have been moderately decreasing since August 2018, by 0.6 percent, m/m, and 0.8 percent, m/m, in August and September, respectively. Banks began increasing their retail deposit rates in anticipation of, and following, a recent 25 bps increase in the CBR key policy rate. This may indicate the reversal of a prior trend of declining deposit rates, and a likelihood that banks' funding costs will increase through the remainder of 2018. In August-September, corporate deposits in rubles increased by 0.5 percent, m/m, and 1.6 percent, m/m, respectively. This could be due to a conversion of some USD-denominated deposits into rubles.

Concentration and public dominance in the banking sector increased even further. Five large banks control 60 percent of the system's assets⁹ – up from 52 percent at the end of 2013. Furthermore, state-owned entities account for nearly 70 percent of Russian bank assets. One reason for this increase was an establishment of a Banking Sector Consolidation Fund (BSCF) by CBR to resolve insolvent financial institutions. In 2017-2018, the BSCF took control of eight privately owned banks, including systemically important ones. CBR intends to privatize these banks once recapitalization procedures are complete and market conditions become more favorable. With increasing of public dominance in the financial sector (not only in banking, but also in insurance, financial infrastructure), private and smaller banks find it more and more difficult to compete, as public banks often enjoy preferential access to government programs, clients, cheaper funding and large distribution networks.

Increasing competition in the financial sector has become one of the priorities under the CBR financial sector development strategy 2018-2021¹⁰. In August 2018, the Russian government approved a three-year roadmap (2018-2020) for enhancing competition in various sectors of the Russian economy, including financial sector, which will be implemented jointly by the CBR, Financial Antimonopoly Service, Ministry of Finance and Ministry of Economic Development. Proposed measures include elimination of preferential access to various government programs (e.g. subsidized lending programs etc.), limiting the state in acquiring shares of financial institutions, development of financial technologies to lower competitive disadvantages for smaller players and other measures. Proportional regulation for banks introduced by CBR, which will fully come into effect in 2019, is aimed at decreasing regulatory compliance costs of the smaller financial institutions, thus removing some of their competitive disadvantages.

The banking system has sufficient liquid FX assets to repay its maturing external debt. The new bank resolution mechanism supports financial stability as it provides for the quick restoration of the solvency profiles of large and systemically important banks, though it can induce moral hazard in the long run due to limited bail-in. To reduce potential risks in the system, the CBR has taken measures to restrict growth in some of the riskier retail segments. To push the banks to further de-dollarize their loan portfolios, the CBR also tightened risk-weight requirements for FX-denominated loans. High international reserves (29.4 percent of GDP) and a flexible exchange-rate regime should keep serving as substantial buffers against external shocks.

⁹ Source: CBR. As of September 1, 2018

¹⁰ [https://www.cbr.ru/Content/Document/File/44185/onfr_2019-21\(project\).pdf](https://www.cbr.ru/Content/Document/File/44185/onfr_2019-21(project).pdf)

Box 5: Russian Government and Central Bank propose measures to expand access to finance for SMEs.

As of October 2018, there were 5.95 million SMEs in Russia employing 15.98 million people. 95 percent of the SMEs were micro enterprises, accounting for 47 percent of SME employment. SMEs account for 22 percent of Russia's GDP and 25 percent of total employment. Though their numbers were growing, they are still considerably lower than in other countries. In the OECD group, SMEs account for 50 to 60 percent of GDP, and 60 percent of total employment. The government of Russia has adopted a number of strategic documents aimed at SME development and growth. For example, the long-term SME Development Strategy through 2030 sets an ambitious target of nearly doubling the share of SMEs in Russia's GDP by 2030, to 40 percent. The mid-term National Project on SME and Individual Entrepreneurship Support (also known as the National SME Project) calls for increasing employment in SMEs by 1.5 times to 25 million people and raising their contribution to the GDP to 30 percent by 2024.

SMEs could become an even more important source of growth and jobs in Russia if their access to finance were improved. Access to finance is among the key business environment obstacles (following regulations and taxes, administrative burden, poorly educated workers and overall macroeconomic conditions) to SME growth, with an estimated financing gap of \$222 billion. According to the Russia Small Business Index (RSBI), as of the first quarter 2018, difficulties in obtaining loans were reported by 25 percent of surveyed SMEs. Micro enterprises experienced a higher rejection rate compared to small and medium companies. Credit to SMEs declined during the recent recession as more credit was directed to larger enterprises. This trend was reversed only recently, but SME lending volumes are still below the pre-crisis level, amounting to 11 percent of total credit and 12 percent of GDP.

More recently, the Russian government has signaled even stronger support for the SME sector, with emphasis on strengthening the legal and institutional frameworks and developing financial and non-financial support measures for SMEs. The National SME Project aims at substantially expanding SME access to finance by: (1) simplifying access to subsidized finance and increasing its volume; (2) facilitating access to capital markets for SMEs; (3) improving access to leasing instruments; (4) facilitating access to micro finance and crowdfunding. The Central Bank of Russia developed a corresponding roadmap to support the implementation of the above goals. The roadmap is aimed at leveling the playing field between SMEs and large corporates in their ability to access finance by lowering disincentives for banks and non-bank financial institutions to engage in SME financing as well as increasing financial literacy of SMEs.

The SME Development Strategy calls for improved access to finance for SMEs that would increase from 11 percent of total credit to 23 percent by 2030. A number of policy measures to support bank financing of SMEs have been introduced, including streamlining provisions of credit guarantees through a three-tiered national guaranty system, introducing a soft-loan program by the Central Bank of Russia (the so-called "6.5 program"), provisioning the interest rate subsidies from the budget to select banks that lend to SMEs, and developing legal and regulatory framework and operational standards for the securitization of SME loans, as well as non-financial support for SMEs.

While these measures, coupled with the economic recovery, have helped to reverse the declining trend in SME lending, SME access to finance still remains constrained by both demand and supply-side factors. On the demand side, SMEs are challenged by high collateral requirements by banks, difficulties in accessing government support programs, a limited number of suitable financial products for SMEs beyond traditional bank loans (e.g. leasing, crowdfunding, factoring), and weak financial knowledge and skills. On the supply side, SMEs are challenged by stringent regulatory requirements for banks to lend to SMEs, uneven access to government funding programs for banks, depriving smaller private banks of such access, and market distortions caused by the administration of the state support programs. Until recently, most government initiatives that were aimed at expanding SME access to finance were focused on supporting bank financing to them. The new policy measures include complementary policies to support access to a wider range of finance instruments, such as capital market financing, crowdfunding, leasing, securitization etc. This two-pronged approach, which seeks to complement policies to ease SMEs' access to credit with initiatives to support a more diversified financial offer for SMEs, is in line with the G20/OECD High-Level Principles on SME Financing. While many governments use subsidized loans to ease SME access to finance, this policy instrument should be used selectively to enable access for those SMEs who otherwise cannot get finance. Not all types of SMEs are equally sensitive to the cost of funding, especially when interest rates are at historically low levels. Subsidized finance programs should aim at bringing additionality by targeting SMEs unable to get loans on market terms.

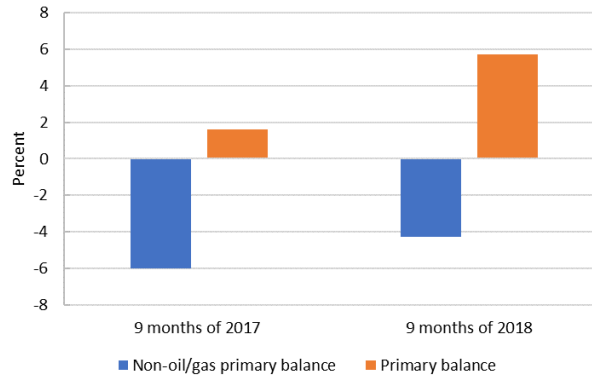
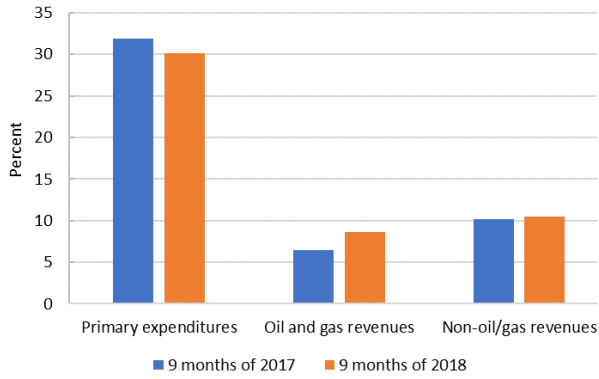
1.7 Fiscal policy: reforms are planned to support the ambitious goals set in the President's May Decree.

Higher oil prices, combined with a weaker ruble, a better tax administration, and a conservative fiscal policy further improved fiscal balances at all levels of the budget system. New development goals set by the President in the May Decree moved the government to increase spending on education, health, and infrastructure starting in 2019. This puts an emphasis on revenue mobilization through a VAT rate increase and tax maneuver in the oil sector. To fit in higher spending, the fiscal rule has been temporarily relaxed. These measures increase fiscal risks but are contained, given Russia's low public debt and manageable financing needs.

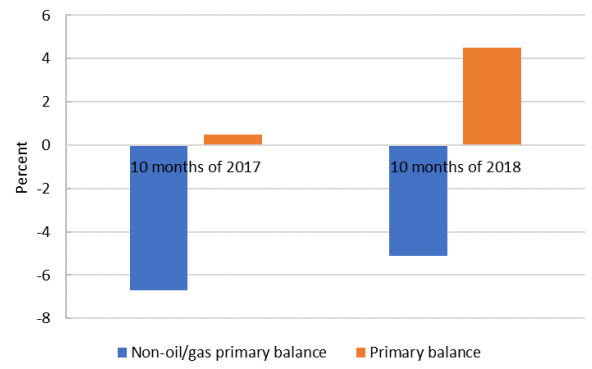
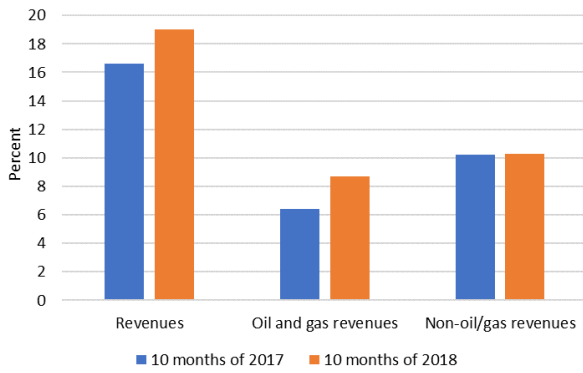
The fiscal balance improved at all levels of the budget system. The general government surplus widened in the first nine months of 2018 (to 4.7 percent of GDP compared to 0.6 percent in the same period last year); the federal budget deficit in 2017 (of 0.3 percent) turned into a surplus of 3.6 percent in the first ten months; and the consolidated regional budget surplus improved to 1.0 percent of GDP from 0.8 percent of GDP in the first nine months of 2018 (Figure 32 and Table 3). The across-the-board improvement in the fiscal stance was due to higher oil prices, combined with a weaker ruble, a better tax administration and a conservative fiscal policy. The non-oil/gas primary fiscal deficit improved to 4.3 percent of GDP in the first ten months of 2018, compared to 5.9 percent of GDP in the same period last year.

Figure 32: Budget balance improved at all levels of the budget system (Percent of GDP)

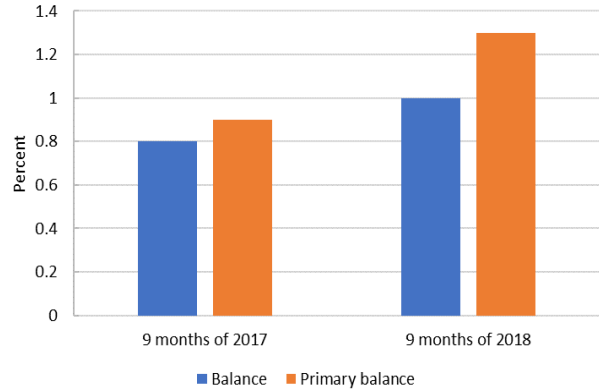
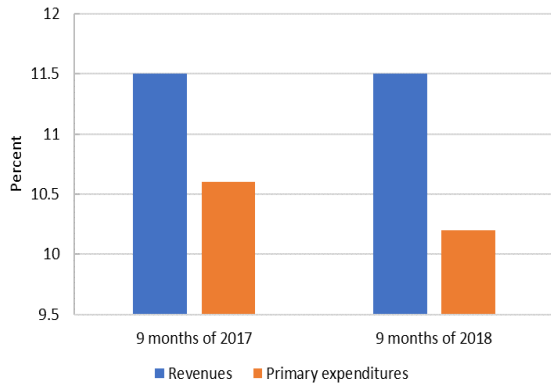
The General Budget



The Federal budget



The Regional budget



Source: Haver Analytics.

Table 3: Budget system balances

General government (% of GDP)		
	9 months of 2017	9 months of 2018
Revenues	33.5	35.8
Expenditures	32.9	31.1
Primary expenditures	31.9	30.1
Balance	0.6	4.7
Primary balance	1.6	5.7
Federal government* (% of GDP)		
	10 months of 2017	10 months of 2018
Revenues	16.6	19
<i>Oil and gas revenues</i>	6.4	8.7
<i>Non-oil/gas revenues</i>	10.2	10.3
Expenditures	16.9	15.4
Primary expenditures	16.1	14.6
Interest payments	0.8	0.8
Primary balance	0.5	4.5
Non-oil/gas primary balance	-6.7	-5.1
Balance	-0.3	3.6
Consolidated regional government (% of GDP)		
	9 months of 2017	9 months of 2018
Revenues	11.5	11.5
Expenditures	10.8	10.5
Primary expenditures	10.6	10.2
Balance	0.8	1.0
Primary balance	0.9	1.3
Extrabudgetary funds		
Revenues	13.4	12.5
Expenditures	13.3	12.5
Balance	0.2	0.1

Source: Economic Expert Group.

To boost growth, in May 2018, the President of Russia issued a “May Decree” which introduced a set of goals to be reached by 2024. Among others, they seek for Russia to become one of the five largest economies in the world (currently Russia is 6th in PPP terms); for the GDP growth rate to be on par with the world’s average; halving the poverty rate; fostering population growth; raising life expectancy to 78 years; and paving the way for the digital economy to reach 30 percent of GDP. These goals have already moved the government to increase spending on education, health, infrastructure, social policy, digital economy, support of SME and exports starting in 2019. Twelve national projects and the comprehensive plan for modernization and expansion of infrastructure are included in the federal budget for this purpose.

Additional budget spending in these areas is expected to be about 8 trillion rubles over six years (or about 1.1 percent of annual GDP, on average). As a result, overall federal budget spending is expected to total 17.0 percent of GDP in 2019, 17.2 percent of GDP in 2020, and 16.9 percent of GDP in 2021 (compared to previous plans of spending 15.9 percent of GDP in 2019, and 15.6 percent of GDP in 2020). The most important steps to mobilize revenues for the May Decree goals include:

- Increasing the VAT rate from 18 to 20 percent (would mobilize revenues worth 0.5 to 0.6 percent of GDP annually; also see Box 6 for distributional impact of VAT increase);
- Streamlining taxation of the oil sector by 2024 (would mobilize revenues worth 0.2 to 0.4 percent of GDP in 2020 and 2021); and
- Raising the retirement age (would mobilize revenues in the long-term; see Box 7)

The government also plans a temporary relaxation of the fiscal rule in 2019 – 2024. In this period, instead of targeting a zero federal budget primary deficit (at the benchmark oil price of USD 40 per barrel in 2017 prices), the fiscal rule would now target a deficit of 0.5 percent. This expenditure increase (of 0.5 percent of GDP) would be financed mainly via domestic debt issuance.

- At projected government oil prices of USD 63.4 per barrel, USD 59.7 per barrel, and USD 57.9 per barrel in 2019, 2020, and 2021 respectively, the federal budget is expected to register surpluses of 1.8 percent of GDP, 1.1 percent of GDP, and 0.8 percent of GDP. The general government budget is expected to register surpluses of about the same scale.
- The initiatives of the government on increasing spending on health, education, and infrastructure are all steps in the right direction, and, if resources are spent efficiently, should positively affect the labor force, productivity, and connectivity. (Please see Box 8, which covers problematic areas in the Russian education).
- Another option for the government to fit in higher spending is to increase tobacco taxation and cut tax expenditures (reconsider and reduce preferential tax rates), currently estimated at 2.8 percent of GDP¹¹.
- A temporary relaxation of the fiscal rule would increase the public debt. Public debt increase could potentially crowd out private debt, but this effect is difficult to assess at this point (especially in view of risk-averse behavior with regard to emerging markets). However, Russia's public debt is low (15.5 percent of GDP in 2017 compared to the OECD average of 73 percent), and the Russian domestic bond market (of about 19 trillion rubles) is sizable compared to the additional issuance (of about 1.5 trillion). Additional domestic debt issuance would also broaden the set of instruments for state banks with limited access to international financial markets.

Box 6: The proposed VAT rate increase would have a relatively neutral effect on the overall income distribution.

The value added tax (VAT) is due to increase Russia. Starting in January 2019, the standard VAT rate in Russia is due to increase from the current 18 percent to 20 percent. Some food products, children's supplies, books and other products are taxed at a reduced rate of 10 percent. The reduced rate will not

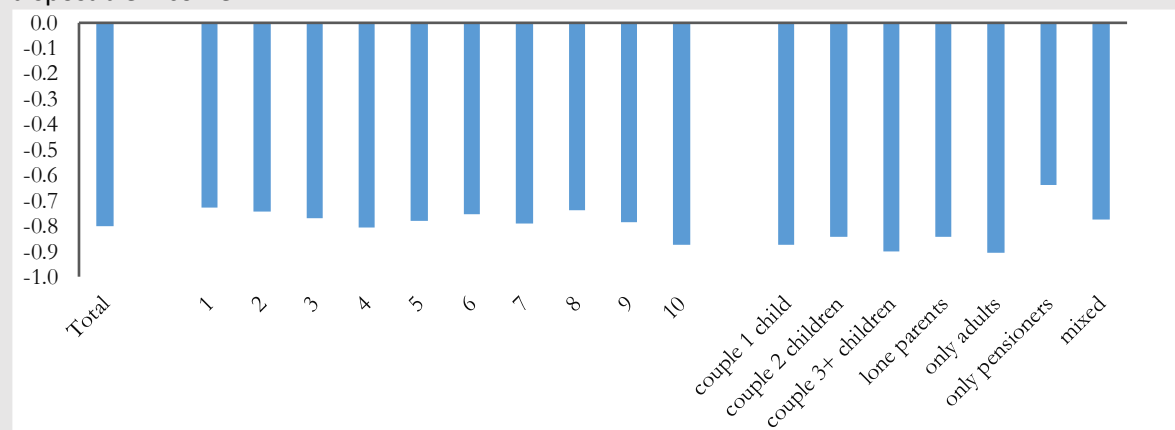
¹¹ Estimate of the Ministry of Finance.

change. The analysis below estimates the distributional effect of the VAT increase in Russia using the static microsimulation model RUSMOD.¹²

The VAT rate increase could lead to welfare losses of around 1 percent of disposable income. The model assumes that economic incidence of VAT fully falls on consumer. This corresponds to the assumption that the final consumers' price would increase to the same amount as the additional tax. Under this case the effect on welfare loss of VAT increase is estimated at the level of 0.8 percent of disposable income on average. According to the model, additional budget revenue collection of VAT could grow by 8.4 percent.

The proposed VAT increase would have relatively neutral effect on the distribution. According to simulations, the distributional effect of VAT increase in Russia would not be strongly progressive, nor regressive (Figure B6-1). Usually yet indirect taxes are regressive because households at the lower part of the distributions have fewer savings and spend a higher share of their income on current consumption. This is also the case in Russia. However, there is another effect – the effective rate of VAT is lower on foods and clothes. These two effects compensate each other and lead to a relatively neutral effect of VAT rate increase on the distribution in Russia.

Figure B6-1: Distributional effect of VAT increase in Russia by deciles and types of families, percent of disposable income



Source: World Bank staff estimates using RLMS-HSE-2016 data.

Note: Estimated using RUSMOD – a static microsimulation model, spin-off of EURMOD. The model does not take into account second-order and behavioral effects. It also assumes that economic incidence of VAT fully falls on consumers. Deciles are defined based on per capita disposable income.

¹² More details of the model can be found in Popova, D. (2013). Impact assessment of alternative reforms of Child Allowances using RUSMOD – the static tax-benefit microsimulation model for Russia. *International Journal of Microsimulation*, 6(1), 122-156.

Box 7: Russia's new Pension Law.

On October 3, 2018, the President of the Russian Federation signed Federal Law № 489161-7 *On Amendments to Several Legislative Acts of the Russian Federation on Pensions*. The cornerstone of the law is a gradual increase of the retirement age to 60 years for women and to 65 years for men. Starting from 2019, the retirement age would increase in six months increments in the first two years and then in 12 months increments for the rest of the transition period, ending in 2024. The new retirement age would result in longer service periods, later exits from the labor market, stronger pension contribution revenues and a lower deficit. In the long run, longer service periods imply higher pensions. Raising retirement age is undoubtedly the strongest pension system measure in the current package. In addition to the general retirement-age increase, the new law has also introduced other changes (Table B7-1).

Table B7-1: List of pension reform measures

Pension type/measure	Final version according to the new law
General retirement age	65/ 60 (6 months gradual increase during first two years of reform)
Social pensions eligibility age	70/ 65
Survivors (parents or spouse)	65/60
Survivors (grandparents)	65/60
Employees in the Far North regions	60/55
Mothers with three/four/five and more children	57/56/50
Early retirement based on length of service	42/37
Theatre employees	55-60 (condition for early retirement with 15 - 30 years' service)
Cosmonauts and their family members	65/60

Pensions in the Russian Federation consist of a fixed part (“basic pension”) set by the law and a variable part (“insurance component”), which reflects an individual’s length of service and paid contributions and is captured in the number of pension points that individual accumulates prior to official retirement. Starting from 2025, an individual must collect a minimum of 30 pension points and complete a minimum of 15 years of service to be eligible for an old-age pension. An individual can accumulate a maximum of 10 qualifying points per calendar year if they do not contribute to the funded pillar, or 6.25 pension points if they do contribute to the funded pillar.

The pension reform package has set both the fixed part of the pension and the point value for the 2019-2024 period (Table B7-1). Moreover, the fixed part indexation, which resumes from February 1, 2019, can be adjusted based on the previous year’s consumer price index (CPI) growth:

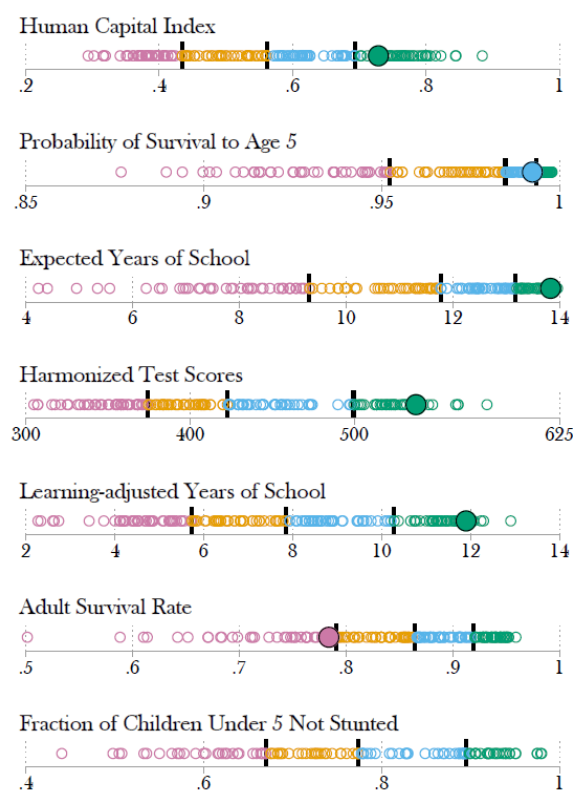
Table B7-1: Fixed part of pension and point value

in RUR	2019	2020	2021	2022	2023	2024	2025 - onwards
Value of one individual pension point	87.24	93.00	98.86	104.69	110.55	116.63	CPI+residual wage growth
Fixed part of pension benefit (basic pension)	5334.19	5686.25	6044.48	6401.10	6759.56	7131.34	TBC
Adjustment (indexation) of pensions in payment	CPI (linked to the pension point value) + residual point value growth						CPI+residual wage growth

During the period of 2019-2024 the pensions in payment (“indexation”) will be adjusted (“indexed”) in two rounds reflecting CPI and residual point value growth. From 2025 the adjustment of point value and pensions in payment would be identical. On February 1, pensions will be increased in accordance with the last year’s consumer price index (CPI) growth. On April 1, it can be increased for a second time with a difference between average wage growth and the CPI (residual wage growth) but only if that difference is positive and up to growth rate of the Pension Fund revenues per pensioner.

Box 8: Russia performs well and achieves a lot in terms of ensuring the equal access and quality of education for students, yet there are some problematic areas that need to be tackled.

Figure B8- 1: HCI and Components



An overall ranking of 34 out of 157 countries in the recently announced Human Capital Index puts Russia in a group of high performing countries (see Figure B8- 1¹³). Given the comparatively low share of human capital expenditures over the last several years, Russia has managed to do relatively well. In addition to sustaining gains in early childhood development, this is largely attributable to Russia's good performance in international assessments. Starting from 1995, Russia is the most consistent participant of PISA, PIRLS, TIMSS and other international studies¹⁴. The participation in international assessments enabled Russia to conduct rigorous research and find the weak points in education policy as well as address them timely. Recent World Bank analysis of education equity in Russia showed that the country performs well in terms of ensuring the equal access and quality of education for students¹⁵. Moreover, the sound progress of resilient schools in the same study shows the strong potential of the education system to serve as a social elevator and allow people to realize their potential in life¹⁶. The performance of Russian students aged 15 years in PISA 2015

reached the OECD average in mathematics and reading comprehension, while it is very close to the average in science. These cognitive domains are important, and in cognitive tests, the Russian students perform well starting from the end of primary schools. For instance, in PIRLS 2016 Russian students took the 1st place, and TIMSS 2015 Russian students reached the 7th place in mathematics and 4th place in science.

Yet, the area that needs more attention of the government is the socioemotional skills or skills of the 21st century (see Figure B8-2¹⁷). Recent PISA 2015 had a hardwired study of students' collaborative problem solving (CPS), that grasps the students' ability to build the shared understanding, solve problems, and organize teams. Russian students appeared to be below the OECD average. Moreover, the distance in scores between the main PISA test and CLPS appears to be the largest among all participating countries. That may mean that the current education gives students personal skills at the level of the OECD average. However, the socioemotional and life skills might be underrepresented in the curriculum and education practices.

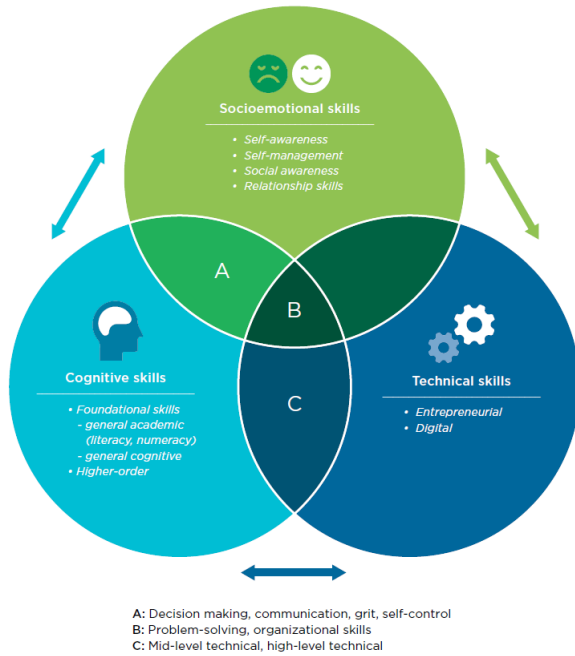
¹³ <http://www.worldbank.org/en/publication/human-capital>

¹⁴ Developing the enabling context for student assessment in Russia. Viktor Bolotov, Galina Kovaleva, Marina Pinskaya, Igor Valdman. The international Bank for Reconstruction and Development. The World Bank, 2013.

¹⁵ <http://documents.worldbank.org/curated/en/139291530189329351/pdf/P164840-Summary-Report.pdf>

¹⁶ The study defines as resilient the schools, operating in difficult social conditions that are able to achieve high educational results.

Figure B8- 2: Technical, socioemotional, and cognitive skills interact



With a goal to move the Russian education system into top 10 education systems globally, the Government is now working on the design and implementation of several projects. The large “National Project Education” would bring nine previously federal level projects under one umbrella. The topics of those nine projects include modern schools and learning environments, digital education, successful learners, modern parents, teacher of the future, young professionals, new opportunities for all, social responsibility of youth, and improving the competitiveness of higher education.

Another identified government goal is to bring Russia to the top 5 countries with the leading research and development systems in the several priority areas of the technological development. To support this goal, the large “National Project Science” will bring together three federal level projects. These will include: development of cooperation between research and industry, development of the research

infrastructure, development of research capacity.

The government is currently working on the metrics and results indicators. Some challenges on this front include measuring the impact of the proposed federal projects, providing for improvement of socioemotional skills development and orienting the national educational system towards the benefits of 21st-century learning, improving the efficiency of the overall program and its components.

¹⁷ World Bank World Development Report 2018.

PART 2. Growth continues, but risks are elevated

External economic conditions are expected to weigh on growth. External financing conditions for EMDEs are also expected to tighten further in coming years, resulting in higher borrowing costs and a moderation of capital flows. Growth in major trading partners is expected to slow. Russia's growth prospects for 2018 - 2020 remain modest, with growth forecasted to be between 1.5 and 1.8 percent in the 2018 - 2020 period subject to mostly unfavorable risks.

External economic conditions are expected to weigh on growth. External financing conditions for EMDEs are expected to tighten further in coming years, resulting in higher borrowing costs and a moderation of capital flows. Growth in major trading partners is expected to slow. Euro Area growth is projected to decelerate toward potential, from 2.1 percent in 2018 to 1.5 percent in 2020. Growth in China is expected to slow from 6.5 percent in 2018 to 6.2 percent in 2020 (Table 4).

Oil prices are expected to average \$71/bbl over the next three years, although there is considerable uncertainty to the forecast. Demand is expected to remain robust, with the International Energy Agency forecasting an increase of 1.4 mb/d, although their forecast has been revised down relative to earlier estimates as a result of weaker global growth and higher prices. Non-OPEC oil production is expected to increase 2.0 mb/d in 2019, with much of the additional supply coming from the United States despite significant bottlenecks such as a lack of pipeline capacity and labor shortages.

As non-OPEC oil supply growth is expected to be greater than that of global demand, the outlook for oil prices depends heavily on supply from OPEC members. Saudi Arabia has raised the possibility of new production cuts by OPEC and non-OPEC members, of around 1 mb/d, in response to the recent weakness in oil prices, although it would have to convince other countries, notably Russia, to also participate. Production is expected to continue to decline in Venezuela and will likely fall in Iran when the waivers expire in 2019, although there is uncertainty about the speed and size of these developments. In addition, geopolitical risks remain elevated in other key oil producers, such as Libya. The level of spare capacity among OPEC members is estimated to be low at present, suggesting there are limited buffers in the event of a sudden shortfall in supply of oil, raising the likelihood of oil price spikes in 2019.

Metals prices are forecast to gain 5 percent in 2018 and stabilize in 2019. The key downside risk is a worsening of trade tensions between the United States and China, as well as weaker global growth. Upside risks include stronger demand from China due to policy stimulus, and policy actions that limit production, such as environmentally-driven cuts, notably in China. Agricultural prices are projected to gain nearly 2 percent in 2019 as input costs rise, including energy and fertilizers. Downside risks to the price forecast emanate from escalating trade tensions. On the upside, persistently high energy prices could raise fuel costs and fertilizer prices.

Table 4: Global Growth is Broadly Stable (GDP Growth Projections, percent)

	2016	2017	2018f	2019f	2020f
World	2.4	3.1	3.1	3.0	2.9
Advanced economies	1.7	2.3	2.2	2.0	1.7
<i>United States</i>	1.5	2.3	2.7	2.5	2.00
<i>Euro Area</i>	1.8	2.4	2.1	1.7	1.5
Emerging and developing economies	3.7	4.3	4.5	4.7	4.7
<i>China</i>	6.7	6.9	6.5	6.2	6.2
<i>Russia</i>	-0.2	1.5	1.6	1.5	1.8

Source: WDI, World Bank staff projections.

In the absence of a sharp escalation of geopolitical tensions, we expect Russian economy to continue modest growth supported by relatively high oil prices.

Russia’s growth prospects for 2018-2020 remain modest, forecasted at 1.5 to 1.8 percent (Figure 33 and Table 5). This suggests that growth rates in Russia will stay below the EMDE average (4.6 percent) and exceed the AE average (1.7 percent) only in 2020. In 2018, we expect growth in the fourth quarter to accelerate slightly q/q, compared to the previous period. Consumption would support growth driven by higher demand for durable goods ahead of VAT rate increase. Overall growth for 2018 is expected a notch above 2017, at 1.6 percent.

Figure 33: The growth forecast for Russia suggests benign growth (real GDP growth, percent)



Source: Rosstat, World Bank.

The fiscal rule suggests reduced sensitivity of Russia’s GDP growth to oil price volatility. A simulated decrease of 10 percent in oil prices would reduce growth in Russia to 1.4 percent in 2019 and 1.7 percent in 2020. A simulated rise of 10 percent in oil prices would increase growth to 1.6 percent for 2019 and 1.9 percent in 2020.

In 2019, we expect growth to slow down slightly to 1.5 percent. Fixed capital investment growth will accelerate, supported by public spending on infrastructure projects and the slightly positive contribution from restocking (compared to destocking in 2018). Yet, household consumer demand is expected to slow down on the back of lower real wages growth. Public sector wages growth will slow down from a high base of 2018. Higher inflation would weigh on real wage growth in the private sector. Meanwhile, credit growth will continue supporting consumer demand. Export growth will decelerate slightly as growth in Russia’s major partners is expected to slow.

In 2020, we expect GDP growth in Russia to accelerate to 1.8 percent. Household consumption growth will somewhat restore after its 2019 deceleration. If the Fund for Development establishes itself as an efficient government tool, fixed capital investment growth would also slightly rise.

Table 5: Projected growth rates are modest (Major macroeconomic Indicators)

	2017	2018	2019	2020
GDP growth, percent	1.5	1.6	1.5	1.8
Consumption growth, percent	2.5	2.0	0.9	1.5
Gross fixed capital formation growth, percent	4.3	2.2	2.0	2.5
General government balance, percent of GDP	-1.5	2.0	2.0	1.5
Current account (US\$ billions)	33.3	97.6	100.5	89.0
Current account, percent of GDP	2.1	6.0	5.9	5.0
Exports (GNFS), bln USD	411.3	497.1	524.4	539.7
Imports (GNFS), bln USD	326.9	349.5	372.6	397.8
Trade balance (GNFS), bln USD	84.3	147.6	151.8	142.0
Trade balance (GNFS), percent of GDP	5.3	9.1	8.9	8.0
Capital and financial account (US\$ billions)	-19.6	-65.6	-36.1	-30.5
Capital and financial account, percent of GDP	-1.2	-4.0	-2.1	-1.7
CPI inflation (average)	3.7	2.9	5.1	4.2

Source: WB staff calculations

Supported by relatively high oil prices, the general government budget is expected to stay in surplus in 2018 – 2020. A temporary relaxation of the fiscal rule would increase the public debt level, although to a still modest level of about 18 percent of GDP by 2020. The current account will stay in surplus but decrease slightly as import demand grows. International reserves will increase due to currency purchases in the fiscal rule framework.

The moderate poverty rate is expected to continue to decline in 2018 and throughout 2020 (Table 6). A rebound in the economy, wage growth in the private sector, and the indexation of pensions to inflation will support disposable incomes and contribute to a gradual decline in the poverty rate. However, many individuals lack formal employment and many households remain close to the poverty line, suggesting a level of social vulnerability that will continue to require close monitoring.

Table 6: The moderate poverty rate is expected to continue to decline in 2018 and throughout 2020

	2010	2011	2012	2013	2014	2015	2016	2017	2018 f	2019 f	2020 f
Poverty rate, percent	12.5	12.7	10.7	10.8	11.2	13.3	13.3	13.2	12.4	12.0	11.6

Source: Rosstat, WB staff calculations.

Risks to the outlook are mostly unfavorable. Higher-than-expected oil prices could favorably affect the growth forecast. Unfavorable factors stem from the potential expansion of sanctions and continued elevated geopolitical tensions, which translate into high uncertainty that dampens domestic demand. A marked escalation of trade tensions among major economies could negatively affect growth in Russia and globally. A potential sudden tightening of global financial conditions could negatively affect growth in

Russia by pressuring the financial account and exchange rate, translating into higher inflation and lower domestic demand. Inflationary risks stem from the VAT rate increase, pass through from the ruble depreciation, a higher-than-expected rise in gasoline prices, a closing of the output gap, elevated inflation expectations and heightened external volatility. And with a large state footprint, the risk of contingent liabilities (in the banking sector, for instance) are elevated. On balance, thus, unfavorable factors outweigh favorable ones, keeping the emphasis on maintaining stability.

As discussed in Section 1.2 on growth, REER depreciation is not enough for economic diversification, which would make the country more resilient to external shocks. The government is undertaking important measures which could raise human capital potential (national projects targeted at human capital) and improve connectivity (infrastructure investment). Substantial progress has been achieved in enhancing regulatory environment. Another key dimension is providing for level playing field (**Error! Reference source not found.**) and reducing the state footprint.

Box 9: Competition conditions in Russia have not improved as rapidly as broader investment climate conditions.

Product market regulations remain the most restrictive in the OECD (OECD Product Market Regulations Index) and Russia ranks 95th of 137 countries on the Global Competitiveness Index's competition perceptions indicator. The continuing presence of high price-cost margins, lower than average market entry rates, and lower levels of private investment in innovation all point to limited levels of competition.

Competition policy has become an increasing priority for the government and in December 2017, Presidential Executive Order No. 618 was adopted on State Competition Policy Guidelines. The guidelines *are in line with good global practices* and outline policy objectives and expected outcomes and include a National Competition Development Plan for the 2018 – 2020 period. The Government of the Russian Federation coordinates the implementation of the guidelines among stakeholders including the Federal Antimonopoly Service (FAS), ten federal ministries, executive authorities of the regions of the Russian Federation, and local self-government bodies. Numerous reforms have been introduced to federal laws and by laws under the guidelines, with a focus on an initial set of 13 sectors.

At the regional level, a 'Competition Standard' was put in place in 2015 to establish a common approach to promoting competition. The standard sets a number of measures grouped in seven requirements to be implemented by each region ranging from the development of roadmaps to promote local competition to awareness raising with market participants. Regions are measured annually on progress against the competition standard and the standard itself is currently being amended to incorporate feedback from the regions.

While considerable progress has been achieved in establishing a functioning legal and institutional competition framework, several challenges need to be addressed to make this framework more effective in enhancing competition:

- *reverse a trend towards cartelization of the economy, especially, in public procurement (Source: Federal Antimonopoly Service).*
 - *promote competitive neutrality principles among SOE and private sector actors;*
 - *ensure the transparency of state support and privileges to minimize competition distortions.*
-

Box 10: Russia continued its efforts to enhance the regulatory environment for small and medium enterprises carrying out four reforms in the past year.

The reforms aimed to improve the business climate for domestic small and medium enterprises as applied to both Moscow and St. Petersburg, the two Russian cities benchmarked by the Doing Business report. As a result of the latest reforms, Russia advanced to 31st place in the global ease of doing business ranking (Table B10-1), representing an improvement from the 35th place last year and 40th place two years ago. Russia was ranked 120th seven years ago.

Table B10-1: Top 5 economies in Doing Business 2019 ranking

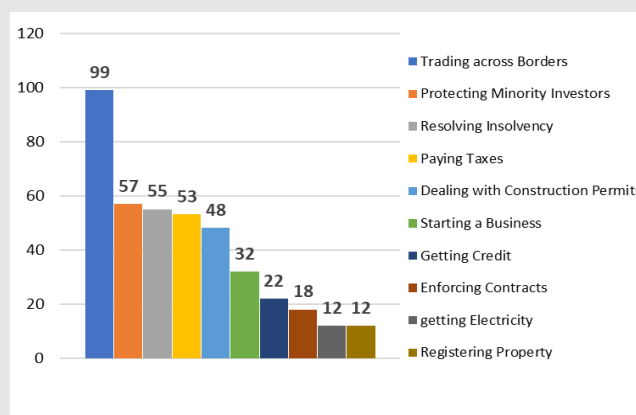
Economy	Global Rank
New Zealand	1
Singapore	2
Denmark	3
Hong Kong SAR, China	4
Korea, Rep.	5

Source: Doing Business 2019.

Highlights of the past year’s reforms are:

- Dealing with Construction Permits was made faster by reducing the time needed to obtain construction and occupancy permits. Quality control measures during construction were also enhanced by introducing risk-based inspections.
- Getting Electricity was made faster by imposing new deadlines for connection procedures and by upgrading the utility’s “one-stop shop” as well as its internal processes. Getting Electricity was also made cheaper by reducing the cost to obtain a connection to the electric grid.
- Paying Taxes became less costly by allowing a higher tax depreciation rate for fixed assets.
- Trading Across Borders was made easier by prioritizing online customs clearance and introducing shortened time limits for its automated completion.
- Russia excels in the area of Getting Electricity, with a global rank of 12. With the latest reform, it now takes only 2 procedures and costs 5.7 percent of income per capita to get connected to the electrical grid, compared to the average of 5 procedures and 325 percent of income per capita in the Europe and Central Asia region. The number of days needed to obtain an electricity connection
- also has been reduced to 73 days from 83 earlier. Here again, Russia performs significantly better than

Figure B10- 1: Ranking in five areas exceeds Russia’s average score substantially



Source: Doing Business 2019.

the regional average, which is 110 days.

- Registering Property and Enforcing Contracts are also areas of strength for Russia. Registering Property has been a focus of reforms in recent years, which have helped place Russia in 12th place globally. In the area of Enforcing Contracts, it takes only 337 days for a business in Russia to resolve a commercial dispute through a local first-instance court, compared to 496 days in the region.

However, there is room for further improvement in several areas, in which ranking exceeds Russia's average score (Figure B10- 1), including Trade Across Borders, Resolving Insolvency and Protecting Minority Investors. Russia scores only 2 out of 10 in the extent of director liability index, which means that in case of misuse of corporate assets, directors would be held liable in very few situations.

PART 3. Potential growth: Outlook and options for Russia*

Russia's potential growth peaked before the 2008 global financial crisis and continued to decline up to 2017. The estimated potential growth rate was 3.8 percent in 2000-09 and 1.7 percent in 2010-17, a 2.1 percentage point decline. The most recent deceleration was due to a slowdown of productivity growth and a shrinking potential labor force – rather than a shortfall in capital accumulation. Regarding its future trajectory, under the baseline scenario, Russia's potential growth is expected to continue its gradual downward trend from 1.5 percent in 2017 to bottoming out at 1.3 percent in 2022. But it recovers gradually thereafter, primarily driven by a stabilization of the labor force. The simulations of proposed reform measures being currently considered by policymakers, which include a combination of pension reform, more inward migration, higher investment, and gradual acceleration of Total Factor Productivity (TFP) growth can double Russia's potential growth rate to 3.0 percent by 2028.

I. Evolution and drivers of potential growth: productivity, capital, and labor

After demonstrating remarkable resilience in the early 2000s, Russia's potential growth — the rate at which the economy can grow when labor and capital are fully employed - slowed in the late 2000s and continued to weaken. The recent potential growth slowdown is a global phenomenon. However, in Russia the slowdown of potential growth was more serious than the rest of the world, reflecting weaker productivity growth and worse demographic outcomes. This analysis showed that the average potential growth rate was 3.8 percent in 2000-09 and 1.7 percent in 2010-17, a 2.1 percentage point decline. On the other hand, the potential growth rate for advanced economies declined by 0.7 percentage point in the same period. The recent deceleration was due to a slowdown of productivity growth and a shrinking potential labor force rather than a shortfall in capital accumulation.

A. Productivity

Russian productivity growth outpaced the advanced economy (AE) average and global average during the previous decade. On average, TFP growth was 2.9 percent in Russia compared to 0.7 percent in AEs in 2000-2009. This high TFP growth reflects a one-off transition process characterized by the reallocation of excess capacity to more productive sectors of the economy (World Bank 2014).

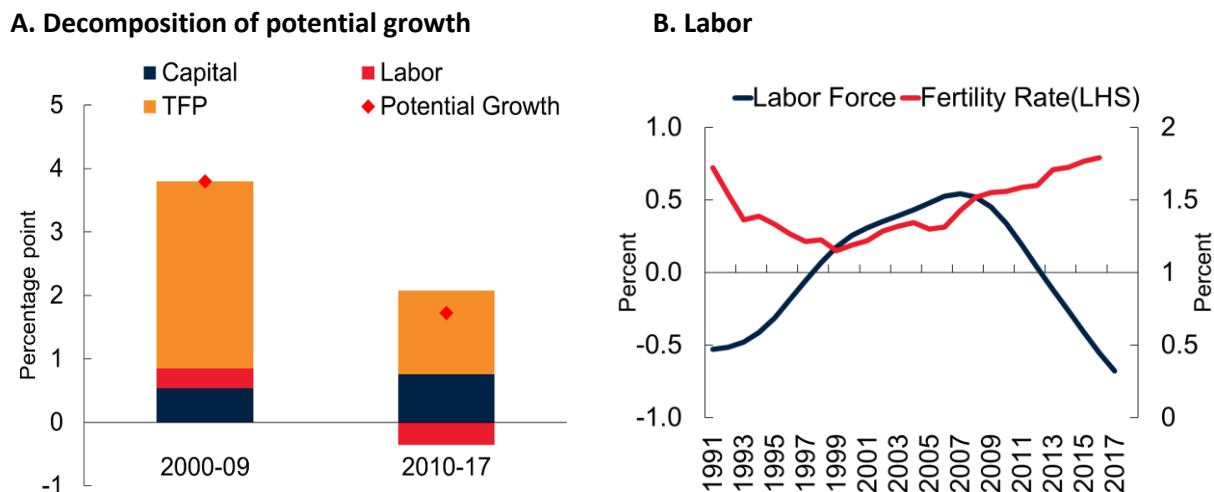
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*This part of the report is based on a World Bank Policy Research Working Paper “*Potential growth: Outlook and options for Russia*” by Yoki Okawa and Apurva Sanghi (forthcoming, December 2018) and with valuable contributions from Sinem Kilic Celik and Y. Modeste Some. The paper has benefited from comments and suggestions by Zoran Anusic, Olga Emelyanova, Evsey Gurchich, Andras Horvai, Sandeep Mahajan, Alexander Morozov, Franziska Ohnsorge, Irina Rostovtseva, Marc Stocker, Maria Ustinova.

Figure 34: Slower potential growth was driven by TFP growth slowdown and decline in labor force

shows, Russian TFP growth began to slow down during the global financial crisis period in 2008-09, and ultimately declined to 1.3 percent in 2017. The declining trend in TFP is a global phenomenon. Weaker productivity growth has been attributed to slower investment growth, partly because of deleveraging pressures and other crisis legacies, combined with population aging and maturing global value chains (World Bank 2018). In Russia, TFP growth slowed as productivity gains from first generation reforms wore off (World Bank 2014). The changing composition of investment from machinery to construction could have also contributed to lower TFP growth (Voskoboynikov 2017).

Figure 34: Slower potential growth was driven by TFP growth slowdown and decline in labor force



Source: International Labor Organization(ILO), World Bank.

Notes:

A. Average contribution to the potential growth for capital, labor, and total factor productivity (TFP) for Russia. The diamonds show average potential growth.

B. Labor force is the estimated annual potential labor force growth. Fertility rate is ILO model estimate of total fertility rate.

B. Capital

Globally, investment growth halved between 2010 and 2016, with the weakness shifting from advanced economies to EMDEs over this period. In Russia, although investment growth slowed from an average growth of 10.4 percent during the previous decade to 2.8 percent in 2010 – 2017, the investment as a share of GDP increased. This helped to accelerate capital growth over the period 2010-17¹⁸ (

¹⁸ While investment growth and capital accumulation are closely related, they sometimes do not move together. When the *level* of investment is high relative to GDP or capital, the capital *growth rate* is high.

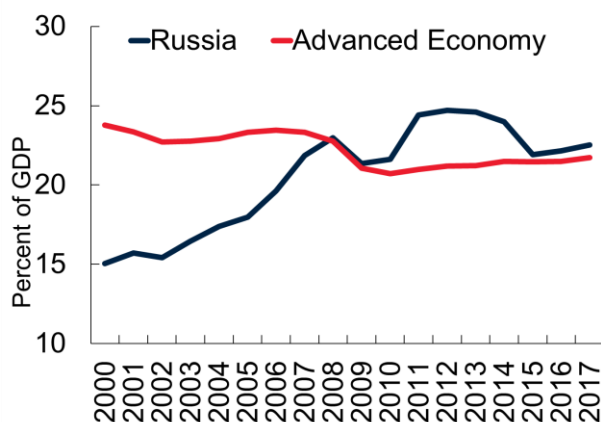
Figure 35: Russia's Investment-to-GDP ratio stopped increasing; capital-to-GDP ratio remains low

) (Voskoboynikov 2017).

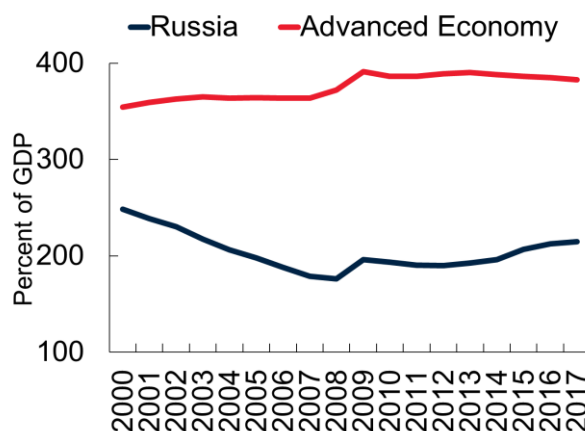
While investment weakness in advanced economies mainly reflects sluggish demand and output growth, in EMDEs, a broader range of factors has been at play. In commodity importers, slowing FDI inflows and spillovers from soft activity in major advanced economies accounted for much of the slowdown in investment growth after 2011. In commodity exporters, including Russia, a sharp deterioration in terms of trade (particularly for energy exporters), slowing growth in China, and mounting private debt burdens accounted for much of the slowdown in investment growth.

Figure 35: Russia’s Investment-to-GDP ratio stopped increasing; capital-to-GDP ratio remains low

A. Investment



B. Capital



Source: Haver Analytics, Penn World Table, World Bank.

Notes:

- A. B. Red line indicates GDP weighted average of 32 advanced economies.
- A. Gross fixed capital formation as a percent of GDP for Russia
- B. Capital as a percent of GDP for Russia.

C. Labor

Growing working-age populations can lift potential growth through both direct and indirect channels. Directly, increasing the working-age population lifts the potential labor force and has been associated with “demographic dividends” to output growth. Indirectly, a higher share of the working-age population has been accompanied by higher capital accumulation and employment (Bloom and Canning 2004; IMF 2004).

Russian demographic trends are worse than those found in other EMDEs as the country’s low total fertility rate in the early 1990’s accelerated population aging. Russia’s total fertility rate remained low until the mid-2000s. The decline in the total fertility rate began to take a toll on the working-age population after 15 years, with potential labor force growth peaking in 2007 at 0.7 percent before declining to -0.7 percent in 2017.

II. Russia’s potential growth: outlook

Factors weighing on potential growth for Russia are likely to persist over the next decade. Demographic trends are expected to become less favorable. This will weigh on potential growth even if trend improvements in human capital and labor force participation continue. Short of unexpected surges in productivity growth, these trends imply an outlook of mediocre potential growth.

The forward-looking scenario (“baseline scenario”) presented below applies the production function approach to assumed paths for capital, population statistics, and education and health outcomes:

- Investment to potential GDP ratio is assumed to stay at the 2010-2017 average level (of 23 percent). This means investment growth is roughly in line with the potential growth.

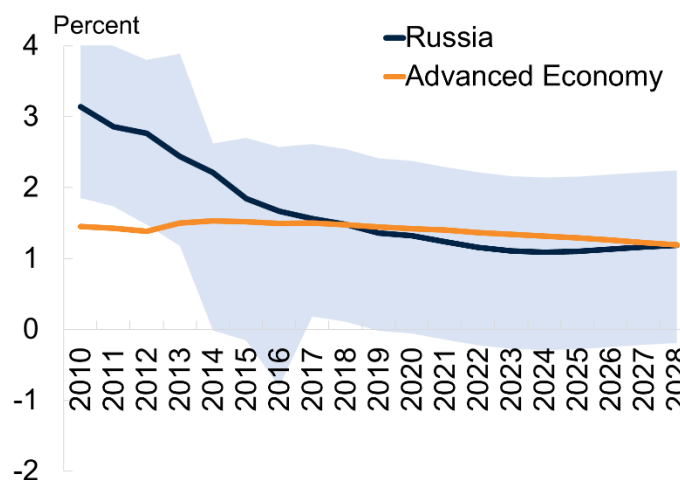
- The size of the Russian population and its composition are assumed to grow in line with a median fertility scenario (as in the UN Population Projections).
- Labor market participation rates are taken from International Labour Organization (ILO) forecasts.

The baseline scenario focuses on long-term factors, i.e, the supply side of the economy. While demand side factors such as oil price fluctuations can have large, short-term impact on growth through changes in demand, they have a limited impact on long-term growth.¹⁹

Under the baseline scenario, Russia’s potential growth is expected to continue a gradual downward trend from 1.5 percent in 2017 to 1.3 percent in 2023 (Figure 36). It is expected to bottom out in 2023 and to recover gradually thereafter. This recovery is primarily driven by labor inputs. According to the UN’s forecasts, the rate of contraction in the working-age population is expected to bottom out in 2022 (0.9 percent decline) but subsequently bounce back. While our forecasts contain significant variations, the upper bound of forecasts without reforms is expected to remain below 2.5 percent in our forecasting horizon.

In 2019, Russian potential growth is expected to be below the advanced economy average for the first time in 20 years, reflecting a faster contraction of the potential labor force. The difference is at most 0.2 percentage point and well within the confidence interval. While expected demographic improvements will raise the Russian potential growth above the advanced economy average again in 2026, a minor difference in potential growth suggests that Russia’s catching-up to the advanced economy average is expected to stall for the next decade.

Figure 36: Russia’s potential growth is expected to decline slowly due to declining productivity growth



Source: World Bank.

Notes: Blue line indicates potential growth estimates and forecasts for Russia using a production function approach. Orange line indicates GDP weighted average of potential growth estimates and forecasts for 23 advanced economies. The shaded area is maximum and minimum of 10 potential growth estimates for Russia (Production function approach, multivariate filter, Hodrick-Prescott filter, Baxter and King filter, Christiano and Fitzgerald filter, Butterworth filter, 5 years ahead forecasts from IMF World Economic Outlook and Consensus Economics, potential growth estimates from OECD Economic Outlook and OECD Long-Term Baseline Projections). It is assumed that confidence interval remains constant for the year 2018 and after.

III. Boosting potential growth: role of pensions, migration, investment and productivity

A. Pensions

In 2018, the Russian government proposed a gradual increase in the retirement age—by five years to 65 for men to 60 for women—starting in 2019 and ending in 2028.²⁰ We simulated the impact of this reform

¹⁹ Higher oil prices could affect the long-term potential growth through higher investment. However, we found that the empirical relationship between oil prices and investment is not robust in Russia.

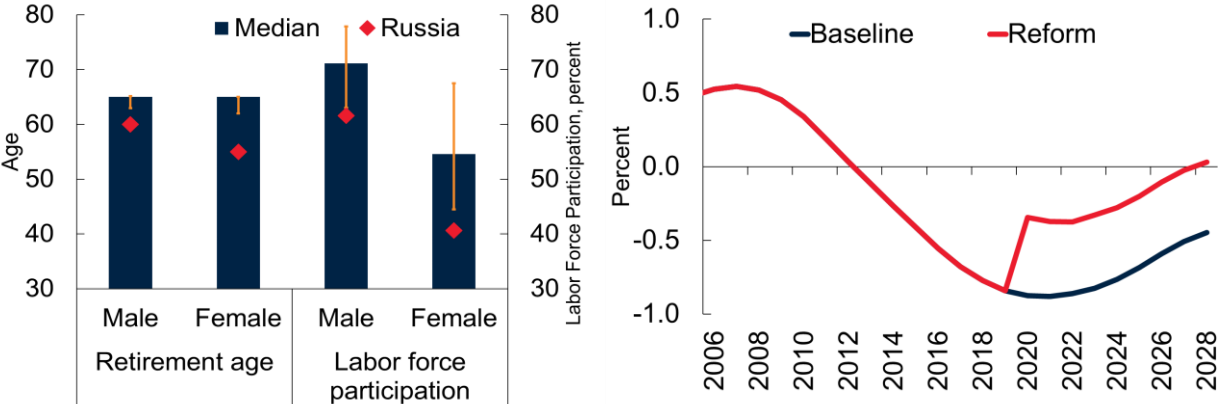
²⁰ The proposed pension reforms go beyond retirement age reform. For purposes of this paper, we consider the effect of only the increase in retirement age.

on potential growth. In line with the other countries, we assume that this reform will increase the average retirement age by half as much as the increase in the mandatory retirement age.²¹ As a result, pension reform is expected to raise the potential growth throughout the enacted time period (Figure 37). During 2020-2028, with a rise in the retirement age for both men and women, potential labor force growth is expected to increase by about 0.9 percentage point per year compared to the baseline scenario. The potential growth rate is expected to increase by 0.3-0.4 percentage point over 2020-2028. The cumulative impact of pension reform is around 3-4 percent of potential output during 2020-2028 (after which additional increases will be negligible). We emphasize that the realized impact of the reform could be smaller than this number. Data limitations forced an emphasis on evidence from advanced economies to estimate the impact of retirement age reform. Also, reforms could be potentially backtracked during the implementation period.

Figure 37: The simulated effects of pension reform in Russia

A. Labor market for aged workers

B. Potential employment growth under pension reform scenario



Source: International Labour Organization (ILO), Organization for Economic Cooperation and Development (OECD), World Bank.

Notes:

- A. Blue bar indicates median of OECD countries. Yellow lines indicate first and third quantile. Retirement age means mandatory retirement age. Labor force participation rates are for ages 55-64.
- B. Potential employment growth under pension reform scenario discussed in this section. Baseline scenario refers to the assumptions mentioned in the outlook section.

B. Migration

Traditionally, linguistic, family, cultural, and economic ties between Russia and neighboring countries created strong migration flows to Russia, especially from Central Asia (World Bank 2017). An increase in migration flows will partially offset the adverse demographic implications on potential growth.

²¹ In the United States, the mean retirement age of the affected cohorts has increased by about half as much as the increase in the normal retirement age (Giovanni Mastrobuoni 2009). Similar evidence was found in Germany (Börsch-Supan et al. 2008; Fehr et al 2012) and Switzerland (Lalive and Staubli 2014).

The model simulated the impact of increased migration on potential growth²². In this scenario, the number of net migrants per year increases to 289,000 until 2028 (while the United Nations forecast is 100,000 in the same year). This results in a 0.2 percentage points higher potential growth. The effects are expected to continue after 2028. The cumulative impact of increased migration is around 2 percent of potential output during 2018-2028.

C. Investment

Russian investment needs are vast and estimated at 75 percent of its 2015 GDP (World Bank 2016). By mobilizing private capital through public-private partnerships (PPPs) and opening up infrastructure subsectors to direct private investment, infrastructure can be expanded without creating excessive pressure to the fiscal deficit.

The investment growth path is taken from the Ministry of Economy and Development's projections up to year 2025 and extrapolated afterwards. These forecasts imply that the ratio of investment to potential GDP is expected to increase from 23 percent²³ in 2017 to 34 percent by 2028. Since 1990, more than 70 countries have experienced such an increase. Other than the well-known example of China, other relevant examples include Indonesia, India, the Republic of Korea, Saudi Arabia and Turkey. All these countries experienced over a 11 percentage points increase in their investment rates in 11 years.

The increase in the investment/GDP ratio raises potential growth by 0.2 percentage point in 2020 and 0.6 percentage point in 2028. The cumulative impact of the higher investment rate is around 4 percent of potential output during 2018-2028.

D. Productivity

Russian TFP growth began slowing down around the global financial crisis period in 2008-09, and ultimately declined to 1.3 percent in 2017. The decline of TFP growth in Russia is supported by firm-level data (World Bank 2016), Firm-level TFP has been declining since 2007 in all sectors. At the same time, productivity dispersion, especially in the service sector, has risen since 2005, which may imply increasing economic distortions. These economic distortions ultimately create an uneven playing field, limiting the entry and expansion of more efficient firms and the exit of less efficient ones.

Assuming a gradual acceleration of TFP growth of an increase by 0.1 percentage point in 2028 from its 2017 level (instead of 0.2 percentage points decline expected in the baseline scenario), this increase would push potential growth up by 0.3 percentage points. The cumulative impact of increasing the TFP growth rate is around 2 percent of potential output. Unlike for capital and labor, a one percentage point increase of TFP growth would increase potential growth by the same one percentage point.

²² Even though the government projects higher net migration, it is worth noting that recently, Russia saw less, not more net in-migration due to a weaker exchange rate and mediocre income growth, which has made Russia less attractive for migrants. Also, due to data limitations, we do not consider the quality of migrant labor. As of now, most migrant labor into Russia is cheap, unqualified labor, in low-productivity sectors of economy.

²³ 23 percent refers to the investment to GDP ratio using 2010 PPP numbers. Russia's nominal investment to GDP ratio was 21.6 percent in 2017.

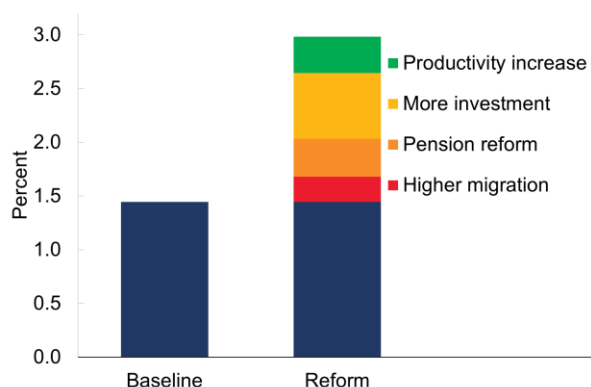
IV. Can Russian potential growth match global growth?

Global growth is expected to remain around 3 percent. As we have seen, in the baseline case, Russian potential growth is expected to remain around 1.3 to 1.5 percent for the same period. This suggests a relative decline of Russian economy for the coming decade.

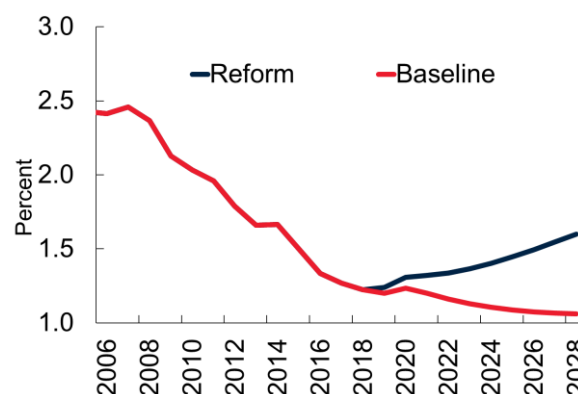
However, simulations of specific reform measures currently being considered by the government such as pension reform, more inward migration, higher investment, and gradual acceleration of TFP growth *can* increase Russia’s potential growth rate to 3 percent in 2028 (Figure 38). Pension reform, and increases in inward migration, investment, and productivity contribute 0.4 percentage points, 0.2 percentage points, 0.6 percentage points, and 0.3 percentage points, respectively, to the increase in the potential growth rate. Improvement in the demographic conditions by 2028 contributes to the potential growth rate as well. Even without reforms, the potential employment growth rate in 2028 is 0.2 percentage points higher than that in 2023.

Figure 38: Comprehensive reforms can raise potential growth to the global growth

A. Impact of reforms



B. Total Factor Productivity



Source: World Bank.

Notes:

A. B. Baseline scenario refers to the assumptions mentioned in the previous section. Reform refers to the assumptions outlined in section V.

A. Potential growth rate estimate in 2028.

B. Annual growth rate of total factor productivity. Baseline scenario refers to the assumptions mentioned in the outlook section.

There are several additional considerations for the implementation of the reform package in Russia:

- *Synergies*. Implementing multiple reforms simultaneously rather than piecemeal can generate mutually-reinforcing synergies.
- *Timing*. Reform payoffs may take more time to materialize than in the stylized scenarios discussed here.
- *Political economy*. It is important to emphasize that any structural reform creates winners and losers. Moreover, minority vested interests may upend reforms that benefit the public at large.

The current cyclical upswing is an auspicious time for Russia to implement reforms that may yield long-term gains. Mitigating pressures from short-term risks and long-term headwinds requires the adoption of

appropriate policies over time. A package that delivers substantial material benefits at an early date thus stands more chance of success in the long run.