



WORLD BANK GROUP

RUSSIA'S RECOVERY: HOW STRONG ARE ITS SHOOTS?

38 RUSSIA ECONOMIC REPORT
NOVEMBER 2017





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This report is produced twice a year by World Bank economists in the Macroeconomics and Fiscal Management Global Practice. The team that prepared this edition was led by Apurva Sanghi (Lead Economist for the Russian Federation, asanghi@worldbank.org) and consisted of Olga Emelyanova (Research Analyst), Mikhail Matytsin (Research Analyst), Irina Rostovtseva (Research Analyst), Katerina Levitanskaya (Senior Financial Sector Specialist), Christopher Miller (Program Leader, ECCRU), Yoki Okawa (Economist), John Baffes (Senior Economist), Naoko Kojo (Senior Economist, GMF11), Eva Gutierrez (Lead Financial Sector Specialist, GFM09) and Oleg Petrov (Senior Program Officer, GTI09). Artavazd Hakobyan (Senior Agriculture Economist, GFA03) authored the focus note on Russia's agriculture sector based on a World Bank paper titled Russia: Policies for Agri-Food Sector Competitiveness and Investment. Peer reviewers included Kamer Karakurum Ozdemir (Senior Economist, GMF05), Yaroslav Lissovlik (Chief Economist, Eurasian Development Bank), Yaroslav Baklzhanskiy (Advisor, Macroeconomic Policy Department, Eurasian Economic Commission) and Kateryna Schroeder (Agriculture Economist, GFA03). The report was edited by Christopher Pala (Consultant). The team would like to thank Hans Timmer (Chief Economist of the Europe and Central Asia Region), Andras Horvai (Country Director for Russia), Maria De los Angeles Cuqui Gonzalez Miranda (Practice Manager, Macroeconomics and Fiscal Management Global Practice), 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 and Department for the budget policy and strategic planning of the Ministry of Finance for the collaboration. This report went to press on November 29, 2017.

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ABBREVIATIONS AND ACRONYMS

AE	Advanced Economies
ASEAN-5	Indonesia, Malaysia, the Philippines, Singapore, and Thailand
B2B	Business-To-Business
B2C	Business-To-Consumer
BRICS	Brazil, Russia, India, China, and South Africa (emerging economies)
BRRD	Bank Recovery and Resolution Directive
BSCF	Banking Sector Consolidation Fund
CBR	The Central Bank of the Russian Federation
CDS	Credit Default Swap
CIT	Corporate Income Tax
CPI	Consumer Price Index
DIA	Deposit Insurance Agency
EAEU	Eurasian Economic Union
ECB	European Central Bank
ECM	Energy Corrected Milk
EMDEs	Emerging Markets and Developing Economies
EU	European Union
FAOSTAT	Food and Agriculture Organization Corporate Statistical Database
FDI	Foreign Direct Investment
FDIA	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
GDP	Gross Domestic Product
GVA	Gross Value Added
HSE- RLMS	Higher School of Economics - The Russia Longitudinal Monitoring Survey
ICT	Information and Communication Technology
IEA	International Energy Agency
IFCN	International Farm Comparison Network
MA	Monthly Average
NPL	Nonperforming Loan
NWF	National Welfare Fund
OECD	The Organization for Economic Co-operation and Development
OFZ	Federal Loan Bonds
OLA	Orderly Liquidation Authority
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers' Index
REER	Real Effective Exchange Rate
Rosstat	Russian Federal State Statistics Service
SRF	Single Resolution Fund
TFP	Total Factor Productivity
WTO	World Trade Organization

EXECUTIVE SUMMARY

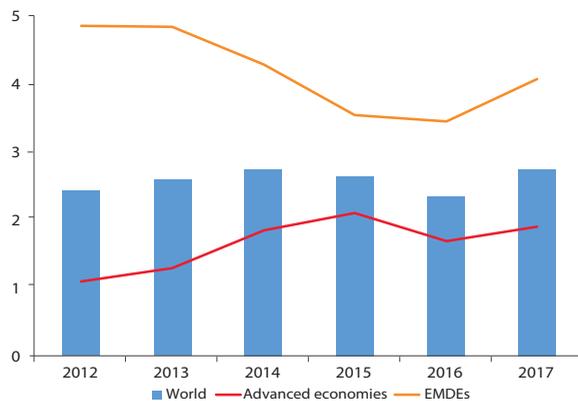
Global growth gained momentum in 2017. After slowing to 2.4 percent in 2016 as investment and trade weakened, global growth accelerated to a projected 2.7 percent for 2017 (Figure 1a). Moreover, the recovery has been broad-based. The economies of the United States and Japan strengthened, while growth in the Euro Area economies accelerated to 2.5 percent in Q1-Q3, well above its estimated potential growth of around 1 percent¹. China—an important trading partner for Russia—is expected to sustain growth at 6.7 percent points for the year, amid strong trade and supportive fiscal and financial policies.

Global trade also continued to strengthen and external financing conditions remain benign. Trade began to recover in mid-2016 and continued in 2017, supported by strong demand, especially in the manufacturing sector (Figure 2a). In the financial markets, monetary policy remained on a tightening trend. The U.S. Federal Reserve hiked its policy rate in March and June 2017 and began reducing its balance sheet. The ECB signaled a further reduction in its asset-purchase program in 2018. However, bond yields in the U.S. and the Euro Zone remained at historical lows,

reflecting subdued inflation trends. Capital flows to Emerging Markets and Developing Economies (EMDEs) remained resilient in 2017, reflecting the continued search of yield through cross-border bank lending and bond issuance. The increase in capital inflows was particularly notable in China and India.

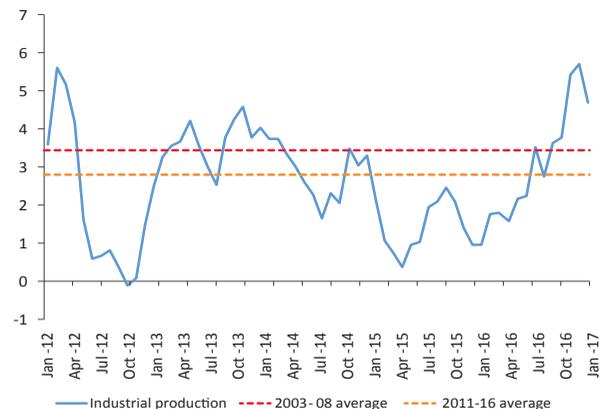
Amid these positive tailwinds, along with firming oil prices and growing macro-stability, the Russian economy returned to modest growth in 2017. The growth momentum of the second half of 2016 spilled over to 2017 and was especially strong in the second quarter (Figure 3a); this was supported by a rebound in domestic demand in the first half of 2017—which also contributed to a growth slowdown starting in the third quarter. On the production side, mineral resource extraction, transportation, and state management and provisioning for national security drove growth in the first quarter of 2017. Growth in non-tradables was the key contributor to GDP growth in the second quarter of 2017. Manufacturing production expanded too, but at a modest pace. Non-public services, in particular ICT, grew robustly (Box 1 in the main

Figure 1a: Global growth gained momentum
(Percent)



Source: World Bank.

Figure 2a: Global industrial production picked up
(Percent, 3m-o-3m saar)



Source: World Bank.

¹ Source: Autumn 2017 Economic Forecast, European Commission.

report discusses Russia's foray into exploring the new digital frontier). Helped by a bumper harvest, agricultural growth was notable (Part 3 analyzes the long-term performance of the sector). Unemployment declined slightly in the first half of 2017, while low inflation and a recovering economy allowed real wages to increase (Figure 5a). And the poverty rate (under its national definition), also decreased marginally in the first half of 2017.

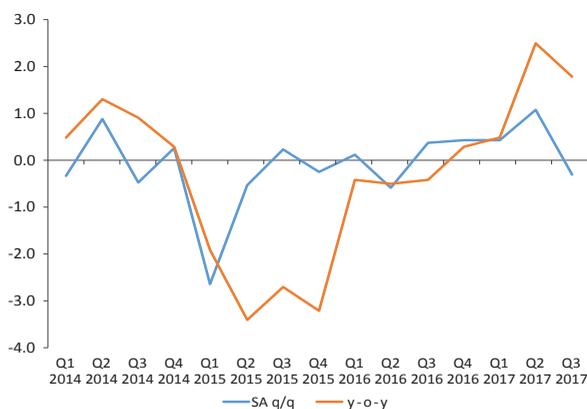
Monetary policy remained prudent and consistent with the inflation-targeting framework. A combination of relatively tight monetary policy and tight fiscal policy, together with some one-off factors, led the Central Bank to undershoot the CPI inflation end-year target as early as July 2017 (Figure 4a). Annual consumer inflation had reached 3.9 percent y/y in July, and stayed below the end-year target in July-October.

However, improvement in headline indicators masks underlying disparities and remaining vulnerabilities. Although real wages grew, real disposable-income growth remained negative, driven, in part, by contractions in other income sources. Box 2 in the main report discusses the apparent discrepancy between wage growth and income growth. Inflation expectations, even

though trending downward, remained elevated. Despite the marginal decline in the poverty rate in the first half of 2017, vulnerability is still on the rise: the share of the economically secure population (with consumption above 10 US\$/day in 2005 PPP) decreased from 48.2 percent in 2015 to 46.3 percent in 2016. Even with historically low unemployment rates due to low labor mobility, unemployment by regions remains unequal. The lowest level of unemployment was registered in Moscow (1.3 percent in the third quarter of 2017) and Saint-Petersburg (1.7 percent), while the highest was in the Tuva Republic (18.7 percent) and Ingushetia (27 percent). Finally, though the banking sector's fundamentals have improved since the crisis years, pockets of weakness remain. The bail-out of two large private banks (the second- and fifth-largest private banks, jointly accounting for 5.2 percent of the banking sector assets) in August-September 2017 points to a continued fragility in the Russian banking system. How the new banking resolution mechanism is implemented will be key to preserving stability and preventing moral hazard (Box 3 in the main report analyzes the resolution mechanism). While these recent failures of large private banks have not caused noticeable stress across the broader banking sector, their long-term effect—absent full divestment—will likely increase public

Figure 3a: Growth momentum of the second half of 2016 spilled to 2017

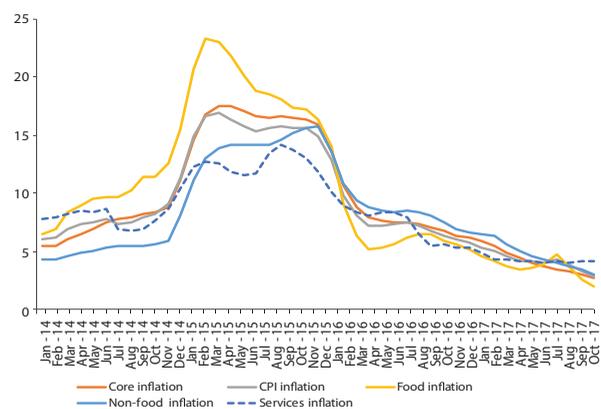
(GDP growth, percent, y/y and q/q, sa)



Source: Rosstat, Haver Analytics.

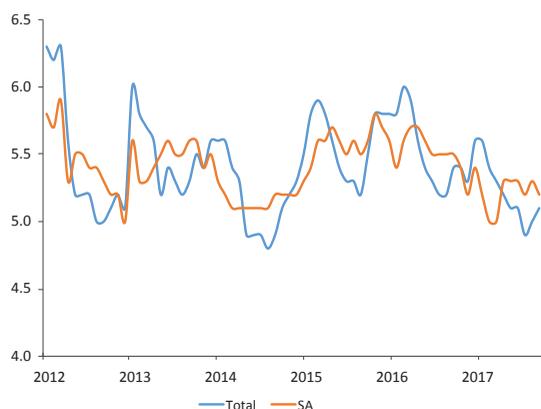
Figure 4a: Inflation was below the end-year target

(CPI index and its components, percent, y-o-y)



Source: Rosstat, Haver Analytics.

Figure 5a: Unemployment rate remains low (Percent)



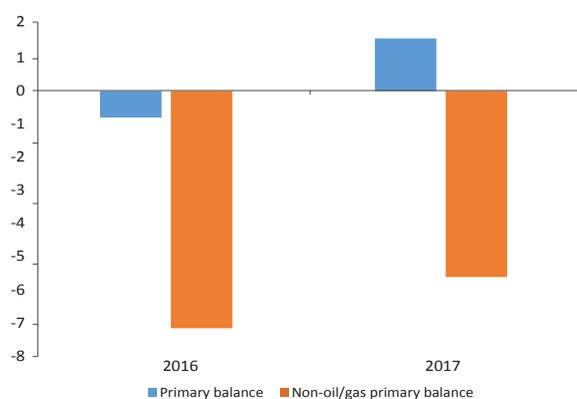
Source: Rosstat and Haver Analytics.

ownership of the banking sector, which raises concerns about competition and innovation in the financial system in the medium to long term.

Moreover, Russia's growth momentum seems to have decelerated in the third quarter. Sluggish investment demand appears to be the key factor behind the slowdown. The growth composition of 2017 also remains broadly similar to that observed in the pre-crisis period, driven mostly by mineral-resource extraction and non-tradable sectors.

In the first nine months of 2017, the general government fiscal stance improved, mostly helped by higher revenues (Figure 6a). The overall general government deficit of 1.8 percent of GDP changed to a surplus of 0.6 percent of GDP in the first nine months of 2017. The consolidated regional budget registered a primary surplus of 0.9 percent of GDP, compared to 0.8 percent in the same period last year. However, there remain substantial variations in debt levels among regions. As of October 1, 2017, there were eight regions (out of 80+ regions) with a share of debt exceeding the region's own revenues. Extra-budgetary funds registered a marginal surplus of 0.1 percent of GDP, compared to 0.1 percent of GDP deficit in the same period last year.

Figure 6a: The general government budget primary balance improved in the nine months of 2017 (% of GDP, January to September)

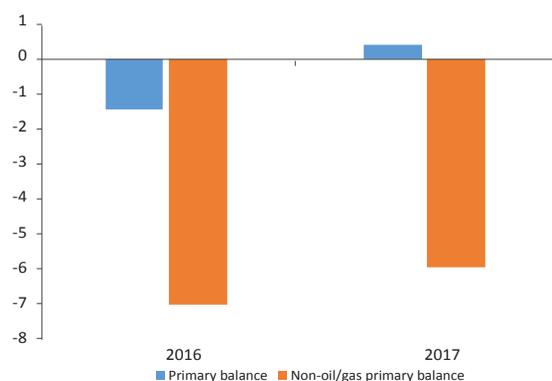


Source: Haver Analytics.

The federal government has adhered to its fiscal consolidation path, adjusting the budget system to fit into the new fiscal rule by 2019 through expenditure cuts, improved tax administration, and some revenue mobilization effort. In the January-October 2017 period, buoyed mainly by higher revenues (both non-oil/gas and oil/gas revenues grew in January-October 2017 by 0.8 and 0.5 percent of GDP respectively), the federal budget registered a primary surplus of 0.4 percent of GDP, compared to a deficit of 1.4 percent of GDP in the same period last year (Figure 7a). Russia's new fiscal rule, expected to reduce the influence of external volatility on the budget and the real exchange rate, comes into effect in 2019 and will require fiscal consolidation in 2018-2020. Box 4 in the main report discusses the rule. Operationally simple and based on a fixed benchmark price, Russia's new fiscal rule is a major structural reform. And combined with the move towards inflation-targeting, it underscores the Russian authorities' commitment to enhance macro-stability.

Regarding expenditure cuts, care should be taken to preserve growth-enhancing investments, especially in health and education. As Box 5 in the main report discusses, at around 3.4 percent of GDP in 2015 and 3.6 percent of GDP in 2016, public spending on health is well below the EU

Figure 7a: The federal budget registered a primary surplus in the first ten months of 2017
(% of GDP, January to October)

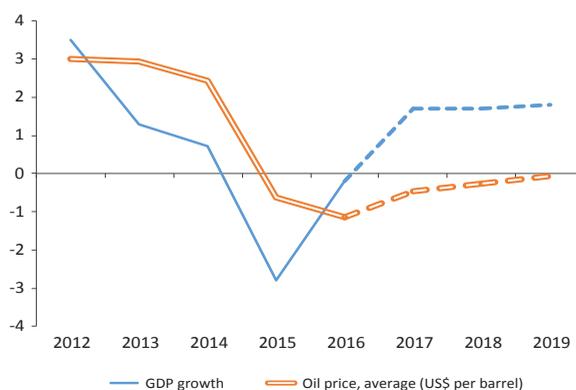


Source: Haver Analytics.

average of 7.2 percent of GDP and 6.5 percent for OECD countries. For education, Russia allocates only 3.6 percent of GDP compared to the OECD average of 5.3 percent of GDP and 4.9 percent for EU countries. Further cuts in health and education may jeopardize both economic growth and the well-being of the population, especially given Russia's desire to be a leader in the digital economy, which requires investments in education and skills. Additional resources are needed to improve health outcomes, although these resources must be accompanied by reforms to increase the value for money spent.

Uneven growth dynamics notwithstanding, positive tailwinds, firming oil prices and growing macro-stability have allowed consumer demand and consumption to rise as the business environment improved. These green shoots underpin projections that Russia's economy will grow 1.7% both in 2017 and 2018, and then 1.8% in 2019. Compared to the forecast from spring 2017, in which growth estimates of 1.3 percent, 1.4 percent, and 1.4 percent were predicted for 2017, 2018, and 2019, the new estimates have been upgraded to 1.7 percent, 1.7 percent and 1.8 percent for the same years (Figure 8a). Consumer demand is expected to be the main engine of GDP growth. In 2018, consumption is likely to benefit further from the soccer World

Figure 8a: In the firming global environment, Russia's economy is expected to grow at a modest pace
(Real GDP growth, percent)



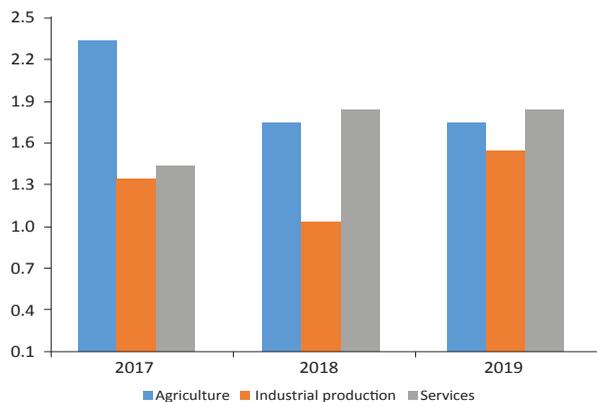
Source: Rosstat, World Bank staff calculations.

Cup hosted by 11 Russian cities. Growth in gross fixed capital formation, however, is expected to slow down after strong growth in the second quarter of 2017.

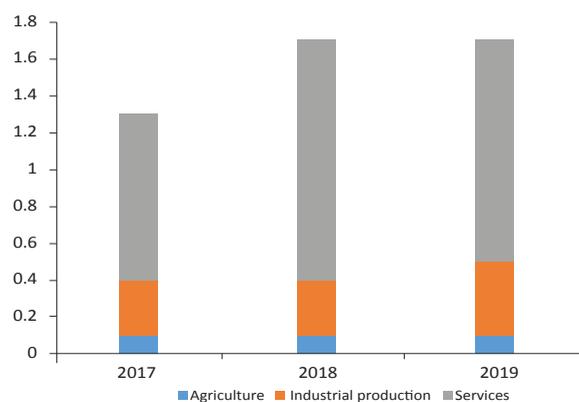
Non-tradable sectors are expected to drive growth in the medium term. Supported by transportation, construction, real estate, wholesale trade and the financial sector, services are set to resume growing in 2017 (Figure 9a). With the banking sector's performance gradually stabilizing, its near-term outlook is also improving. However, reviving credit growth, especially in the corporate and SME segment, will remain a key challenge. Growth in the retail segment is expected to be largely driven by mortgages, given a strong demand coupled with declining mortgage interest rates. Due to an anticipated flat oil production in 2018, industrial production growth is expected to slow down in 2018 and bounce back in 2019 as oil production increases.

The fiscal rule and the lead-up to it suggests there will be less sensitivity of GDP growth to oil price volatility in the future. A simulated decrease of 15 percent in oil prices would reduce growth to 1.4 percent in 2018 and 1.5 percent in 2019. A simulated rise of 15 percent in oil prices would increase growth to 2.0 percent for 2018 and 2.1

Figure 9a: The recovery is expected to be broad-based
(Projected growth by sector, percent)



(Contribution to GDP growth, pp)



Source: World Bank staff calculations.

percent in 2019 (Figure 10a). These estimates suggest reduced sensitivity of GDP growth to oil price volatility than in the past.

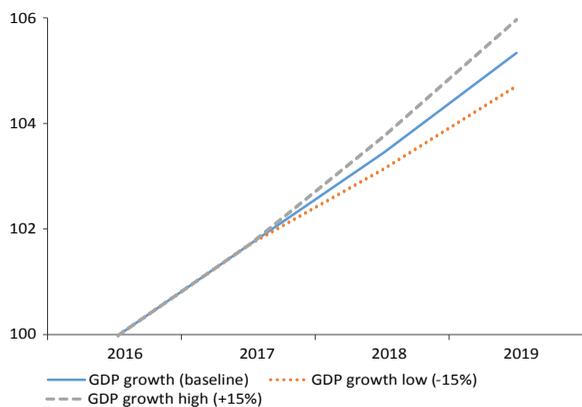
The poverty rate is expected to decrease slightly on the back of decelerated inflation and recoveries in private income and consumption.

Driven by a rebound in disposable income and consumption, the poverty headcount is projected to decline in 2017 to 12.9 percent in the baseline scenario after reaching 13.5 percent in 2016 (Figure 11a). The poverty rate should continue declining in the baseline scenario in 2018 and 2019 to 12.6 and 12.2 percent, respectively, as income and consumption grow further.

The outlook is subject to both upside and downside risks, and structural issues remain.

The upside risk comes from possible stronger-than-expected growth in large, advanced economies and hence higher Russian exports other than crude oil, which is limited by the OPEC+ agreement on production cuts. External downside risks stem from a significant drop in oil prices, a sudden tightening of global financial conditions and possible additional negative impacts from the expansion of sanctions. Domestic downside risks stem from vulnerabilities in the banking sector and a remaining gap between real wages and real disposable incomes. While the authorities have undertaken various legal and regulatory

Figure 10a: Government policy is making the GDP growth rate less sensitive to oil price volatility
(GDP Growth, percent)



Source: World Bank staff calculations.

Figure 11a: The poverty headcount is likely to decline in 2017 and beyond
(Percent)



Source: Rosstat, World Bank staff calculations.

measures to increase the resilience of the banking system, preserving its stability and maintaining public confidence in it will be a key challenge, given the recent failures of some large banks. In the medium to long term, as was noted in Russian Economic Report #37 “From Recession to Recovery,” productivity growth in Russia has been declining over time. Addressing this constraint will require deeper and speedier structural reforms.

While Russia continues its progress in improving its regulatory environment (Box 6 summarizes Russia’s latest Doing Business performance), priority policy objectives should include limiting the role of the state in the economy, improving institutional and regulatory frameworks, and promoting fair competition. To ensure that the shoots of recovery grow and strengthen, easing Russia’s productivity constraint remains central.

PART I

RECENT ECONOMIC DEVELOPMENTS



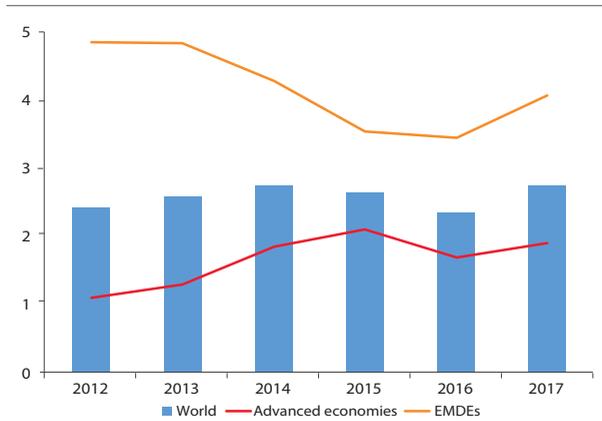
1.1 Growth

Global growth is on the uptick amidst strengthening global demand and firming oil prices. Global trade is strengthening as a result, with a noticeable increase in capital inflows to emerging economies, notably China and India. These external developments provide positive tailwinds for Russia's economy.

Global economic trends

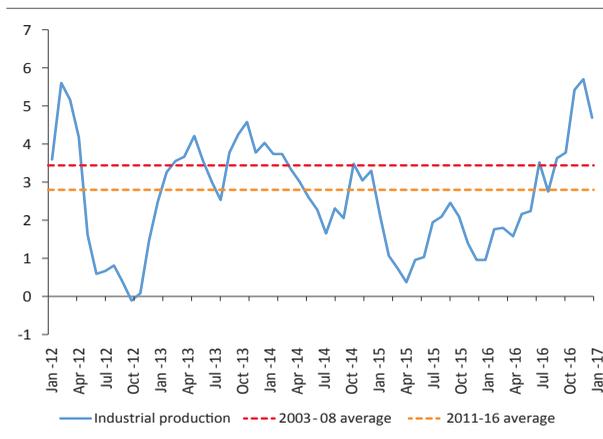
Global growth gained momentum in 2017. After slowing to 2.4 percent in 2016 as investment and trade weakened, it has accelerated to a projected 2.7 percent for 2017 (Figure 1). The recovery has been broad-based. The economies of the United States and Japan strengthened, while growth in the Euro Area economies accelerated to 2.5 percent in

Figure 1: Global growth gained momentum
(GDP growth, percent, y/y)



Source: World Bank.

Figure 2: Global industrial production picked up
(Percent, 3m-o-3m saar)



Source: World Bank.

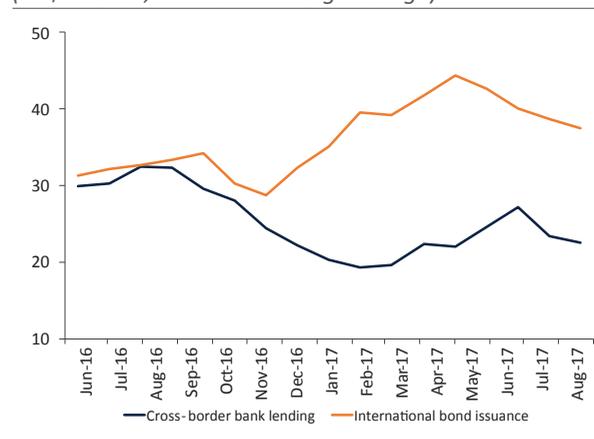
Q1-Q3, well above its estimated potential growth of around 1 percent². It was supported by the European Central Bank's (ECB) stimulative stance and by a strengthening global demand. The Chinese economy is expected to sustain growth of 6.7 percentage points for the year, amid strong trade and supportive fiscal and financial policies.

Global trade has continued to strengthen and external financing conditions remain benign.

The recovery of trade started in mid-2016 and has continued in 2017, supported by strong demand, especially in the manufacturing sector (Figure 2). In the financial markets, monetary policy has remained on a tightening trend. The U.S. Federal Reserve hiked its policy rate in March and June 2017 and began reducing its balance sheet. The ECB signaled a further reduction in its asset-purchase program in 2018. However, bond yields in the U.S. and the Euro Zone remained at historical lows, reflecting subdued inflation trends (Figure 3). Capital flows to Emerging Markets and Developing Economies (EMDEs) remained resilient in 2017, reflecting the continued search of yield through cross-border bank lending and bond issuance.

Figure 3: Cross-border bank lending and bond issuance to EMDE

(US\$ billions, 6-month moving average)



Source: World Bank.

² Source: Autumn 2017 Economic Forecast, European Commission.

Crude oil prices rose marginally, by 1.6 percent in the third quarter (q/q) to \$50.20 per barrel³ on average (Figure 4). Despite improved compliance by 22 OPEC (Organization of the Petroleum Exporting Countries) and non-OPEC oil producers to their production cut agreements, oil prices trended lower during the first half of the year, primarily due to the presence of large inventories (Figure 5), recovery in U.S. shale oil production, and expanding output from OPEC members Libya and Nigeria, which were exempted from the accord. In the third quarter, prices recovered moderately on declining inventories due to the strong global demand, improved compliance among OPEC and non-OPEC producers with the agreement, and stabilizing U.S. shale oil production.

Russia: Growth dynamics are positive but uneven

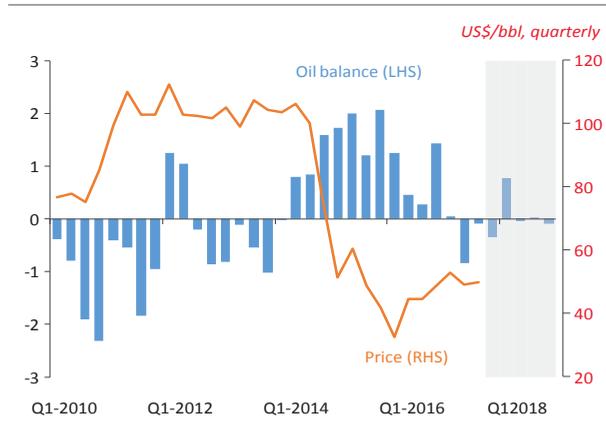
Supported by higher oil prices and macro stabilization, the Russian economy returned to modest growth in 2017. Yet, growth dynamics were uneven. The growth momentum was especially strong in the second quarter, but it slowed down in the third quarter of 2017. Sluggish investment demand appears to be the key factor behind the slowdown. Moreover, the growth composition of 2017 remains broadly similar to the pre-crisis one, driven mostly by mineral resource extraction and non-tradable sectors.

Powered by higher oil prices and macro stabilization, which improved business and consumer confidence, the Russian economy returned to growth in 2017. GDP expanded by 1.6 percent in January-September 2017 (0.5 percent y/y, 2.5 percent y/y, and 1.8 percent y/y in the first, second, and third quarter of 2017 respectively (Figure 6). Growth momentum was especially strong in the second quarter, when growth reached 1.2 percent, q/q sa. However, after a high base in the second quarter and sluggish investment, the growth momentum decelerated in the third quarter (Figure 7).

Domestic demand rebounded in the first half of 2017 after a significant contraction in previous years (Figure 8).

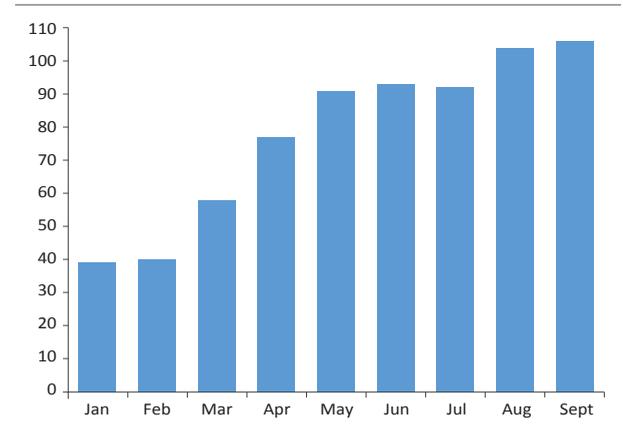
- In the first quarter of 2017, after a contraction of 12.2 percent in 2014-2016 driven by the drastic terms-of-trade shock and by economic sanctions, domestic demand rebounded and expanded by 1.5 percent in the first quarter of 2017. Supported by growth in real wages, the ruble’s appreciation and increased consumers’ confidence, consumer demand was the main driver of domestic demand’s growth in the first quarter. Fixed capital investment also expanded as macro stabilization and a stronger ruble increased business confidence and helped some

Figure 4: World oil balance and oil price (mb/d, quarterly)



Source: International Energy Agency, World Bank.
Notes: Shaded area (2017Q3-2017Q4) represents IEA projections. Balance is defined as the difference between world oil demand and supply.

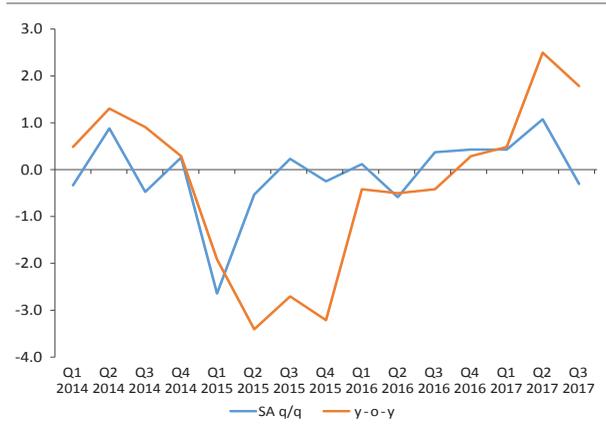
Figure 5: Russian compliance to agreed cuts is increasing (Percent)



Source: International Energy Agency.

³ The World Bank oil price, which is an average of three prices (Brent, WTI and Dubai oil prices).

Figure 6: The positive growth momentum of the second half of 2016 spilled to 2017
(GDP growth, percent, y/y and q/q, sa)



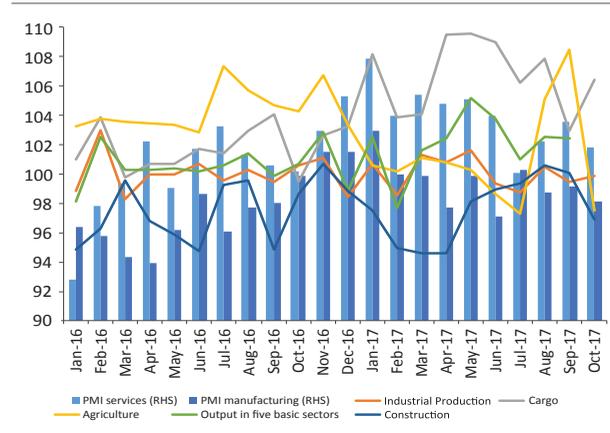
Source: Rosstat, Haver Analytics.

firms catch up with their deferred demand on durable and investment goods, especially imported ones (imports rose by 16.5 percent).

- In the second quarter of 2017, investment demand became the main factor driving GDP growth. Fixed capital investment increased by 6.3 percent y/y, supported by public investment—both direct and by large state energy and transportation companies. According to high-frequency statistics, mineral resource extraction (namely mining support service activities) contributed the most to the fixed capital investment increase in the second quarter of 2017. In addition, the fixed capital investment of small enterprises made a significant contribution to investment growth in the first and second quarters of 2017. Improved business sentiment fueled an increase in inventories stock, which contributed approximately 2 percentage points (pp) to GDP growth in the second quarter of 2017. Consumer demand continued expanding. A domestic demand growth of 6 percent drove a hefty increase in imports (20.7 percent, y/y), with import of machines, equipment and transport vehicles increasing by 32 percent in real terms in the second quarter of 2017, y/y.

A stronger momentum in global demand supported exports, but prominent increases in imports made the contribution of net exports to GDP growth

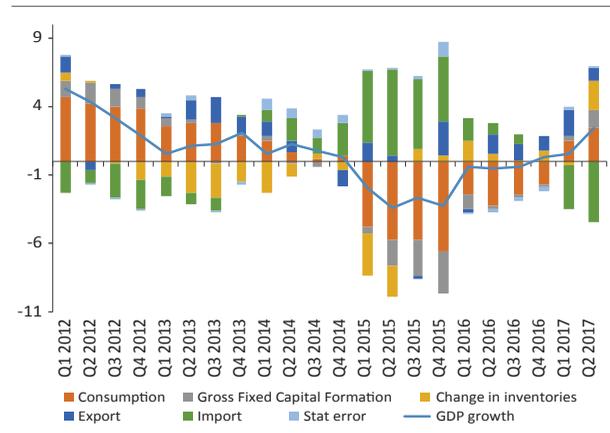
Figure 7: Growth remained positive, but slowed down in the third quarter
(Output in five basic sectors, IP, agriculture and cargo turnover growth, percent, y/y)



Source: Rosstat.

negative in the first two quarters. Exports of goods and services grew by 5.1 percent y/y in real terms in the first half of 2017. The export of goods was mainly supported by non-energy items: agricultural and food (wheat, fish, vegetable oil), metals and metal goods, wood and pulp. Despite strong natural gas export growth⁴, the export of energy goods increased only slightly in real terms, with declines in volumes of export of crude oil, oil-products, and electricity. According to Balance of Payments data, export of services grew robustly, driven by transport, construction, travel and ICT services. Over the last five years, ICT exports have doubled

Figure 8: Domestic demand rebounded in the first half of 2017
(Contribution to GDP growth by components, pp. GDP growth – percent, y/y)



Source: Rosstat.

³ The World Bank oil price, which is an average of three prices (Brent, WTI and Dubai oil prices).

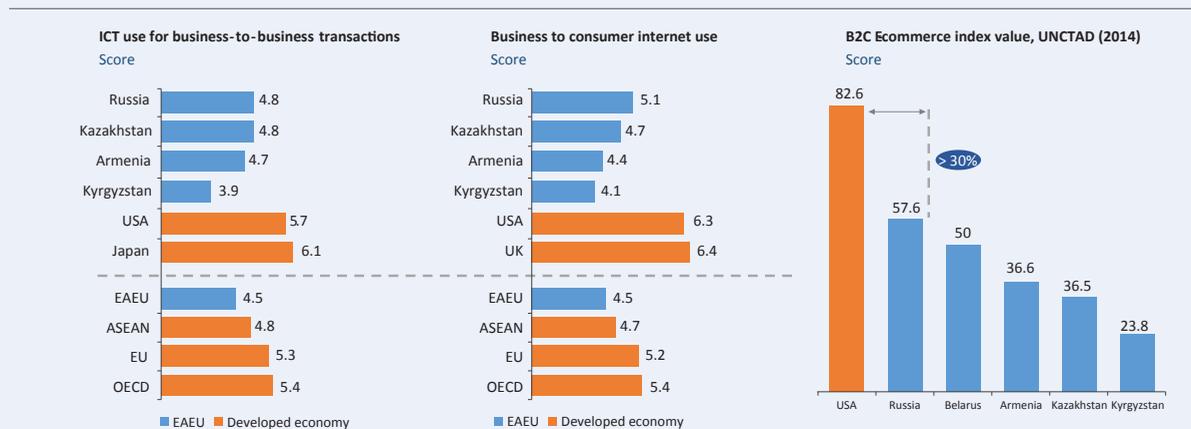
(Box 1 discusses Russia’s foray into the new digital frontier). Meanwhile, the net export contribution to GDP growth was negative, especially in the second quarter of 2017, as import increases fueled by growing domestic demand offset the growth

of exports. However, using a different time frame, import volumes in 2017H1 were still 18.4 percent below their level three years before, while the exports levels had increased 7.7 percent over that 3-year period.

Box 1 Russia explores the new digital frontier

Digitization now affects all aspects of development as the digital revolution spans the entire globe, with half of the world’s population connected to the Internet. Russia has made significant strides in its own digital transformation process. Fixed-broadband penetration has reached 56.5%, while mobile penetration is at 81.6%. Internet access is affordable and fast. Russia has the highest number of fiber connections in Europe. A high 60% of the population now owns smartphones, while the number of users of online government and municipal services has doubled in just one year to reach 40 million. A network of over 2,600 E-government service centers has been set up and a new national education platform has been established to deliver open online courses. In B2B transactions, Russia is on par with the ASEAN region. E-commerce is also growing, as Russia comes close to the EU average and pulls ahead of Korea, Brazil, Mexico, South Africa, the ASEAN region and its Eurasian Economic Union neighbors in B2C sales (Figure B1-1). Financial inclusion in Russia is also advanced at 67.4% of residents having accounts in formal financial institutions, compared to other countries in Europe and Central Asia at 51.4%.

Figure B1-1: ICT Use is growing in Russia



Source: World Bank research based on UNCTAD E-commerce Index Value 2017 and WEF Networked Readiness Index 2016.

Over the last 5 years, ICT exports have doubled, reaching over US\$7 billion in 2016, while several Russian ICT companies have emerged as global players. These include well-established firms like Yandex and Kaspersky labs as well as relative newcomers in ICT services, business-process automation and security. The use of emerging technologies such as data analytics, cloud computing, the internet of things, 3D printing, blockchain, etc. are also quickly gaining ground.

Despite these strides, however, today Russia is not among the global leaders of Digital Transformation. The World Bank divided countries into three groups, depending on their level of development of digital technologies: emerging, transitioning, and transforming (Figure B1-2). Russia today is in the “transitioning” group of countries.

There are several factors at play here. Despite the solid technical education foundation remaining from Soviet times, broad, high-level ICT skills are still lacking and the alignment between the educational system and industry's requirements needs to be improved. Business usage of ICT tools by Russian companies still lags that of global leaders like Singapore, Finland, Denmark and the US. This in turn negatively affects the innovation and entrepreneurial environment.

Realizing the urgency of speeding up the digital transformation process, the Russian government launched several key initiatives in 2017. In July 2017, Russia adopted a new Digital Economy program with an expected annual budget of US\$1.8 billion until 2025 to address the current weaknesses that

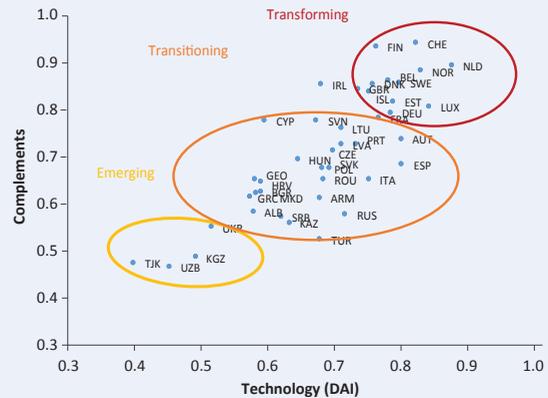
are preventing Russia from joining global leaders in the digital economy. The program is quite comprehensive, focusing on both analogue and digital foundations of Digital Transformation and addressing the legal, technical, organizational and financial aspects of this process. Drawing on international best practices, the program prioritizes changes in the legal and regulatory framework, addresses key aspects of building digital skills, education and R&D, proposes investments in digital infrastructure and cybersecurity, emphasizes strict program management requirements and suggests specific initiatives in E-government, Smart Cities and E-health. Given the priority assigned to this program at the highest levels of government as well as funding allocated in the federal budget, there is reason to believe that if properly implemented, this program will allow Russia to make significant progress in its Digital Transformation process.

The program also provides for Russia's participation in the Digital Agenda of the Eurasian Economic Union, another key digital transformation initiative announced in 2017. The agenda is aimed at the creation of a single digital space across Eurasia. It focuses on the use of digital technologies to eliminate obstacles to economic cooperation across Eurasia. According to a joint study by the Eurasian Economic Commission and the World Bank, this digital integration agenda could, if properly implemented, yield economic benefits such as GDP growth, job creation and services transformation to all EAEU members, with Russia as the Union's largest economy standing to gain significant competitive advantages.

By 2025, the World Bank estimates that the digital transformation of Russia could create between 7 and 13 million new digital-economy jobs in the country, and lead to productivity gains of over US\$38 billion.

These forecasts imply not only the digitization of existing business processes, but also the adoption of new business models, platforms and ecosystems, as well as the use of emerging technologies, such as industry 4.0, robotics, blockchain and the Internet of things. The government has also recently passed a decision to complete cryptocurrencies regulation legislation by July 2018, to consider the launch of a national cryptocurrency and to pilot the establishment of the first crypto-advisory and crypto-detective agencies in the city of Vladivostok. The potential digital dividends for Russia are considerable. Given the recent government focus on digital transformation as a national priority, the country is well-positioned to make the leap from the group of transitioning countries to that of transforming ones and join the world's digital economy leaders, while reaping all the economic and social benefits this implies.

Figure B1-2: Russia is not yet at the digital frontier



Source: World Bank's report "Reaping Digital Dividends: Leveraging the Internet for Development in Europe and Central Asia," March 2017.

Mineral resource extraction, transportation, state management and provisioning for national security drove growth in the first quarter of 2017.

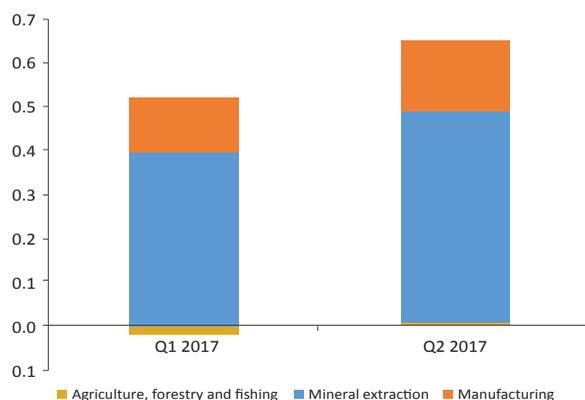
Mineral resource extraction, mainly natural gas, was the top contributor to growth (Figure 9). According to high-frequency statistics, in the first quarter of 2017, gas production expanded by 8.2 percent y/y, which reflected higher external and domestic demand, as well as more space available in the underground storage from the cold winter of 2016-2017. Growth in crude oil production was limited as Russia joined the agreement among OPEC and non-OPEC countries to cut production.

Growth in non-tradables was the key contributor to GDP growth in the second quarter of 2017.

In the second quarter of 2017, the tradable sectors'

Figure 9: Mineral resource extraction drove growth in tradables

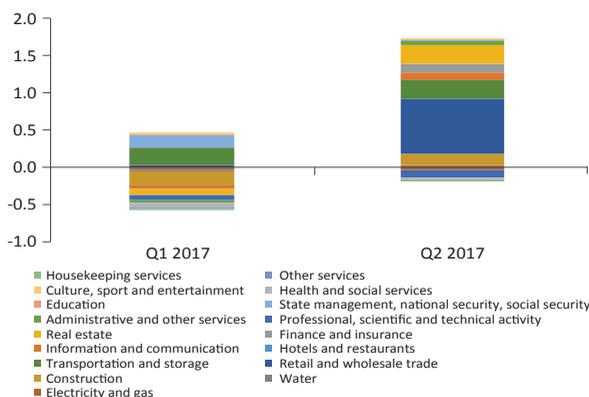
(Contribution of tradable sectors to GDP growth, pp)



Source: Rosstat.

Figure 10: The contribution of non-tradable sectors to GDP turned positive and was the key factor of GDP growth in the second quarter of 2017

(Contribution of non-tradable sectors to GDP growth, pp)



Source: Rosstat.

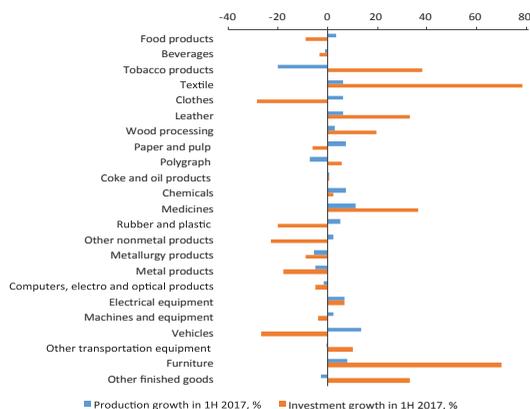
contribution to GDP growth increased, compared to the previous quarter, as agriculture resumed growing and natural gas production sped up. Yet, GDP growth was underpinned by recovery in non-tradables: retail and wholesale trade, real estate, and construction. Retail trade high-frequency statistics points to increasing growth momentum, but showed it was still quite limited in the second quarter of 2017. It was mainly wholesale trade that drove the growth of non-tradables on the back of inventory restocking. In addition, strong gas production also contributed to wholesale trade growth. Lower interest rates for mortgages buoyed real estate growth, while recovery in construction was partly related to the large state infrastructure projects, both public and conducted by state companies. In the second quarter of 2017, all non-tradable sectors recorded growth except for scientific research and public services, which were restrained by tight budgetary spending (Figure 10).

Manufacturing production expanded, yet at a modest pace.

Despite the ruble appreciation in the first three quarters of 2017, the REER index was below the level of December 2013, still providing a competitive advantage to manufacturing. Manufacturing increased by 1 percent y/y in the first three quarters of 2017. Growth within manufacturing was uneven (Figure 11). However, fixed capital investment in manufacturing (large and medium-sized enterprises) continued a contraction that began in 2014. While a lot of manufacturing industries demonstrated fixed

Figure 11: Growth in manufacturing was uneven

(Growth in manufacturing by sector, percent; fixed capital investment growth in manufacturing by sector [large and medium enterprises], percent)



Source: Rosstat.

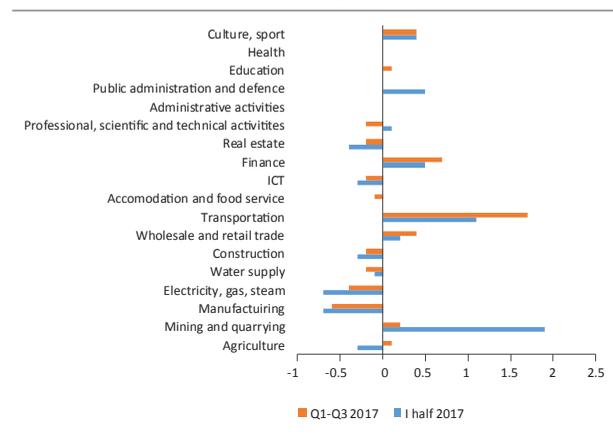
capital investment growth in the first three quarters of 2017, investment in some industries with high shares in manufacturing decreased (metallurgy, metal goods, vehicles).

Growth momentum decelerated in the third quarter of 2017 after the high base of the second quarter—likely caused by a slowdown in gross capital formation. In the third quarter of 2017, quarterly GDP growth fell close to zero levels, while annual GDP growth slowed down to 1.8 percent, y/y. National accounts data for GDP composition by type of economic activity are not available yet. High-frequency statistics show that output in five basic sectors⁵ increased by 2 percent y/y, compared to 3.8 percent in the second quarter (Figure 7). Slowdown of growth was registered in mineral resource extraction. Growth in crude oil production slowed down and turned negative in September, largely due to a high base of oil production in the end of 2016. The growth of gas production also decelerated, partly because of warmer weather conditions. In September, Rosstat revised its high-frequency series on construction. As a result, the increased growth momentum noted previously turned to a rather flat performance. Output growth was at 0 percent in the third quarter, y/y, as opposed to about 7 percent y/y growth in July and August recorded previously. Agriculture was the only basic sector in which the growth rate increased notably, helped by a bumper harvest (Part 3 discusses developments in the agricultural sector in more detail).

Demand-side high-frequency statistics suggest continued growth momentum in retail trade, thus pointing to continued momentum in growth of consumption. Meanwhile, fixed capital investment

annual growth decelerated in the third quarter of 2017, compared to the previous quarter. According to available high frequency statistics, the slowdown of fixed capital investment in the third quarter comes largely from large and medium enterprises investment in mineral resource extraction (mining support service activities) (Figure 12). Meanwhile, transportation, financial services, retail and wholesale trade, culture and sport (most likely related to the soccer World Cup) continued supporting fixed capital investment in the third quarter of 2017. Thus, high fixed capital investment growth in the second quarter was mainly due to temporary factors, with third quarter fixed capital investment growth more in line with trend. A slowdown in investment demand (both from fixed capital investment and from inventory restocking, which contributed 2 pp to GDP growth in the second quarter of 2017) is likely to have led to decelerating growth momentum in the third quarter.

Figure 12: Slowdown of investment to mineral resource extraction was the key factor behind fixed capital investment slowdown in the third quarter (Contribution to fixed capital investment [large and medium enterprises], by sector, pp, percent)



Source: Rosstat.

⁶ Output in five basic sectors is an aggregate indicator, which includes agriculture, industrial production, construction, transport, retail and wholesale trade.

1.2 Balance of Payments: A favorable External Environment (Recovering External Demand and improved Terms of Trade) Supported the Balance of Payments

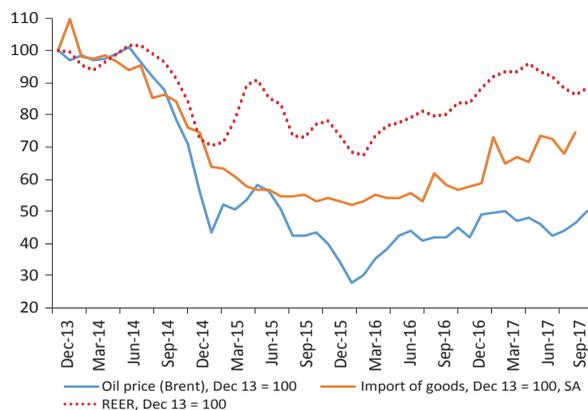
Higher oil prices supported the current account through energy exports. Energy export revenues more than compensated for the significant growth in imports that accompanied a stronger ruble and a recovering domestic demand. Non-oil exports and exports of services also expanded in the first half of 2017, supported by a recovering external demand and higher prices for other commodities. While short-term capital flew into the government sector on the back of continued interest in the financial assets of emerging and developing economies (EMDEs), net capital outflows from the non-government sector increased.

Improved terms of trade for Russia, together with the continued accommodative monetary policies of advanced economies, stimulated investors' interest in EMDE assets, resulting in some REER appreciation. Despite the Ministry of Finance's purchases of currency, which sterilized part of oil and gas export revenues, the REER appreciated by 19.6 percent y/y in the first three quarters of 2017. In January-September 2017, the current account surplus increased to US\$26.6 billion from US\$15.3 billion last year, as the improvement in the trade balance more than compensated for the deterioration in the balance of services and factor income accounts:

- **The trade balance improved (Table 1).** Higher oil prices, especially in the first quarter of 2017 (Figure 13), boosted exports in oil (negative volume growth, but positive price effect) and gas (growth in volume, positive price effect), which increased by 29 percent in the first

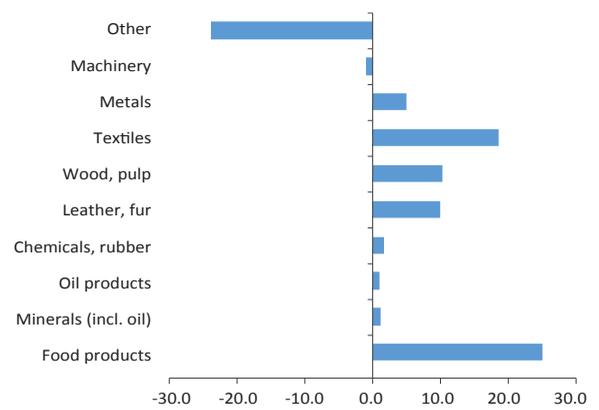
three quarters of 2017, compared with the same period last year. Favorable price trends for metals and chemicals and the growth of exports volumes for certain categories (Figure 14) supported non-oil/gas exports, compared to 2016. On the back of adverse terms-of-trade shock and restrictions on food imports from Western countries, imports sharply contracted in the second half of 2014 and in 2015 before rebounding in the second half of 2016. The trend rolled over to 2017 as domestic demand hardened and the ruble strengthened. The nominal value of imported goods increased by 25 percent in January-September 2017, y/y. Yet an increase in the nominal value of exports more than compensated for an increase in the nominal value of imports and the trade balance strengthened to US\$80.3 billion from US\$63 billion in the same period last year.

Figure 13: The nominal value of imported goods increased by 25 percent in January-September 2017, y/y (Contribution of tradable sectors to GDP growth, pp)



Source: CBR, Haver Analytics.

Figure 14: In the first half of 2017, all export categories, except for machinery and other exports, demonstrated growth in real terms (Percent)



Source: Russian Customs statistics.

Table 1: Balance of payments, 2014–2017
(US\$ billions)

	2013	2014	2015	2016	Q1 2017	Q2 2017	Q3 2017e	9m 2017e
Current account balance	33.4	57.5	68.8	25.5	22.6	2.8	1.2	26.6
Trade balance	122.3	133.7	111.5	66.4	34.5	25.1	20.7	80.3
Non-oil current account balance	-315.6	-266.9	-134.5	-128.5	-27.2	-43.5	-43.9	-114.4
Capital and financial account	-46.6	-89.0	-69.4	-11.1	-11.0	2.5	9.4	0.8
Errors and omissions	-8.9	8.0	2.9	-4.6	-0.4	2.7	-4.2	-1.9
Change in reserves (- = increase)	22.1	107.5	-1.7	8.2	-11.3	-7.5	-6.5	-25.4
Memo: average oil price (Brent, US\$/barrel)	108.4	97.5	54.4	45.9	54.7	49.9	54.2	52.9

Source: CBR.

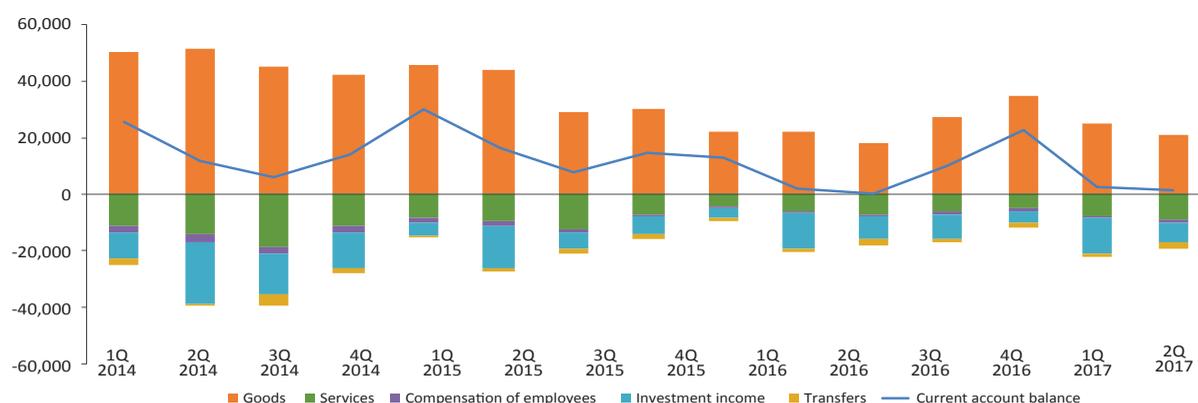
• **The balance of services and factor income accounts deteriorated (Figure 15).** Exports of services, driven by transport, construction, ICT and travel services, registered substantial growth of 15 percent in nominal value. The companies providing these services were helped by the sharp ruble depreciation of 2014. In 2017, the REER was still about 10 percent lower than its level in December 2013. Improved external demand also helped. Meanwhile, a substantial increase in foreign travel caused by growing real wages and a stronger ruble in the first nine months of 2017 worsened the overall deficit of the services account to US\$21.8 billion from US\$17.8 billion in the same period last year.

The non-oil/gas current account deficit increased, underlining the challenges in diversifying the

economy. The non-oil/gas current account worsened to negative USD114.4 billion from negative US\$94.2 billion. The share of oil and gas exports remained high (above 50 percent of exported goods) and the increase in exports of non-oil/gas goods and services was not sufficient to compensate for the growing imports. The improvement in the overall current account was driven primarily by external factors, such as hydrocarbon prices.

Short-term capital flew into the government sector, driven by a resilient risk appetite for EMDE financial assets and supported by the still-accommodative monetary policy in advanced economies. Net capital outflows⁶ from the non-government sector increased. In January–September 2017, the government sector registered net capital inflows that were mainly due to OFZ (federal loan bonds)

Figure 15: The balance of services and factor income accounts deteriorated
(US\$ billion)



Source: CBR.

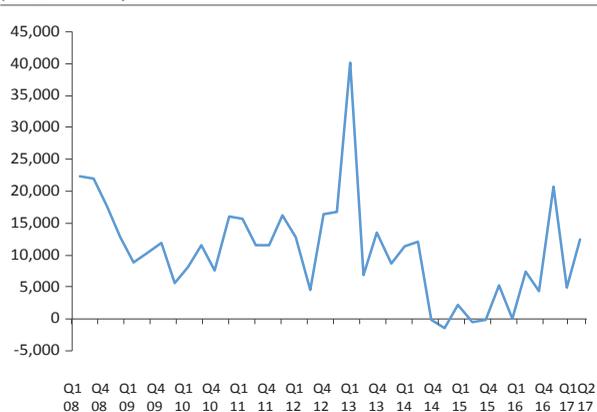
⁶ Adjusted for currency swaps and correspondent accounts of resident banks in the central bank, and repayments of foreign-currency loans by large banks to the central bank.

purchases by non-residents. The overall nominal value of OFZ held by non-residents increased to US\$34.7 billion as of September 1, 2017, compared to US\$25 billion as of January 1, 2017.

In January-September 2017, an increase in net capital outflows came from the banking sector. Banks continued deleveraging, but their net foreign assets decreased less strongly than they did last year, which could be largely associated with the Rosneft privatization deal closing. Meanwhile in the non-banking sector, the acquisition of net foreign assets stayed at the same level as last year and net foreign liabilities rose by US\$18.2 billion. This increase was mainly due to a boost in FDI, especially in the second and third quarters of 2017. FDI data for the first two quarters suggest that the hike happened both on the back of investment in capital (including reinvestment of profit) and investment in debt instruments. In the first quarter of 2017, it largely came from offshore zones usually associated with capital flight (Figure 16). Overall, net capital outflow in the non-banking sector decreased to US\$1.6 billion from US\$13.5 billion last year.

The international reserves of the Central Bank increased by US\$14.2 billion⁷ in the first three quarters of 2017, compared to a marginal decrease of US\$1.1 billion in the same period last year. The increase was mostly due to currency purchases

Figure 16: Incoming FDI increased in the second quarter of 2017
(US\$ billion)



Source: CBR.

conducted by the Central Bank on behalf of the Ministry of Finance from February 2017. The Central Bank refrained from intervening on its own, in line with its flexible exchange-rate regime. As of September 1, 2017, international reserves reached US\$424.8 billion up from US\$377.7 billion in the end of 2016. The import cover stays at a comfortable level, although slightly lower, compared to end 2016 (16.3 months of goods and services in the end of September 2017, compared to 17 months of goods and services in the end of 2016). High levels of international reserves and the flexible exchange-rate regime continue to help the economy navigate external shocks.

1.3 Labor Market and Poverty Trends: Unemployment is Stable, Wages are Recovering, but a High Share of the Population Remains Vulnerable

Unemployment declined slightly in the first half of 2017, while low inflation and a recovering economy allowed real wages to increase. However, real disposable income growth remained negative, driven by contractions in other income sources. The poverty rate in Russia, under its national definition, decreased marginally in the first half of 2017, while the share of the vulnerable population continued to grow.

The employment and labor force participation rates both decreased slightly in the first half of 2017, while unemployment was close to a minimum. The absolute numbers of economically active people decreased by 800,000 to 76 million and those of employed people fell by 600,000 people to 73 million in September 2017. This led to a marginal decline of the seasonally adjusted

labor force participation and employment rates by about 0.5 percentage points. These rates are still above 69 and 65 percent, respectively (Figure 17). However, because of the continued decline in the working-age population (over 2016, the working-age population decreased by almost a million from 84.2 to 83.2 million people), the decrease in the employment rate did not translate into an increase

⁷ Not accounting for the price effects.

in the unemployment rate. The latter even dropped to 5.1 percent in the first ten months of 2017, compared to 5.4 percent a year ago (Figure 18). Due to low labor mobility, unemployment by regions remained unequal. The lowest unemployment was registered in Moscow (1.3 percent in the third quarter of 2017) and St. Petersburg (1.7 percent), while the highest was in the Tuva Republic (18.7 percent) and Ingushetia (27 percent).

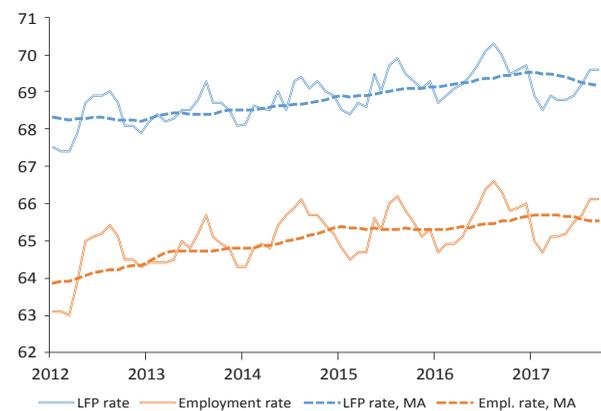
Other labor-market indicators have not been overly affected. The job vacancy rate⁸ increased slightly to 2.7 percent in second quarter of 2017, compared to 2.5 percent a year ago, reflecting a gradual recovery in the real sector. The number of part-time employees decreased in the first half of 2017 and remained far below the levels of the 2009 crisis period. The average number of hours worked remains stable.

With inflation low, wages continued to grow in real terms. Real wages started growing in August 2016 (Figure 19). In the first nine months of 2017, their average growth was 3.1 percent compared to the same period of 2016. Pensions were indexed at close to the current inflation rate and stayed broadly constant in real terms. Other components of household incomes, including incomes from business activity and the informal sector, continued to decline. This led to a stagnation in

disposable income (Figure 20) and to a widening of the gap between disposable income and real wages (See Box 2).

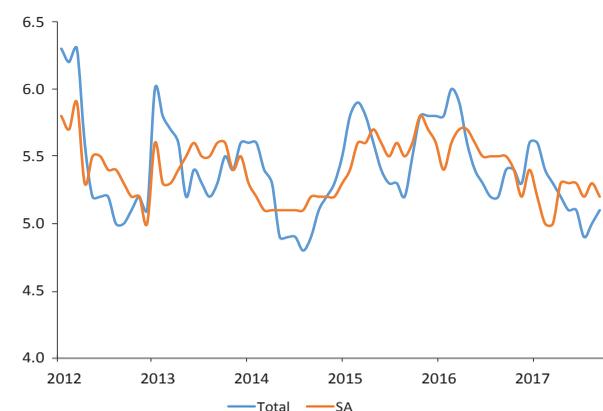
The economically secure share of the population declined further in 2016. The threshold of 10 US\$ a day or more in 2005 PPP, which corresponds to almost 11,000 Russian rubles per person per month in 2016 prices, is commonly used to define the economically secure population, while the population below is considered vulnerable. Half of this threshold (5 US\$/day or less in 2005 PPP or 5,500 rubles per person per month in 2016 prices in Russia) is the limit for the international moderate-poverty rate. Using these criteria, the population in Russia became much more vulnerable in 2015 and situation worsened further in 2016. The share of the population under 5 US\$/day increased from 10 percent in 2014 to 13.2 percent in 2015 and 13.8 percent in 2016⁹. And the share of the vulnerable population, spending between 5 and 10 US\$/day in 2005 PPP, increased from 33.5 percent in 2014 to almost 40 percent in 2016. At the same time, the economically secure population (with consumption above 10 US\$/day in 2005 PPP) decreased by 10 percentage points from 56.5 percent in 2014 to 48.2 percent in 2015 and further to 46.3 percent in 2016. This contraction was driven by a massive decline in disposable incomes and wages in 2015, and a continued fall in incomes in 2016.

Figure 17: LFP and employment rates declined (Percent)



Source: Rosstat and World Bank staff estimates.
Note: MA – 12 month moving average.

Figure 18: ... while unemployment rate remains low (Percent)

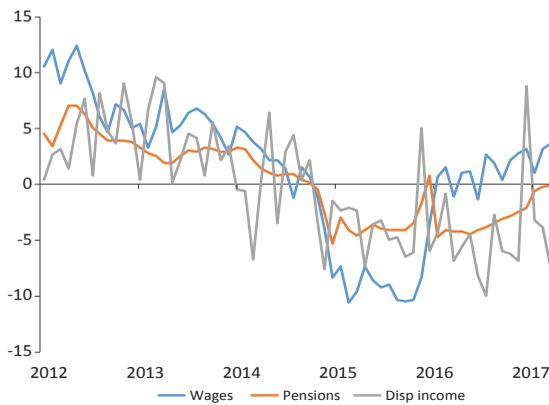


Source: Rosstat and Haver Analytics.

⁸ Ratio of vacancies to the total numbers of jobs.

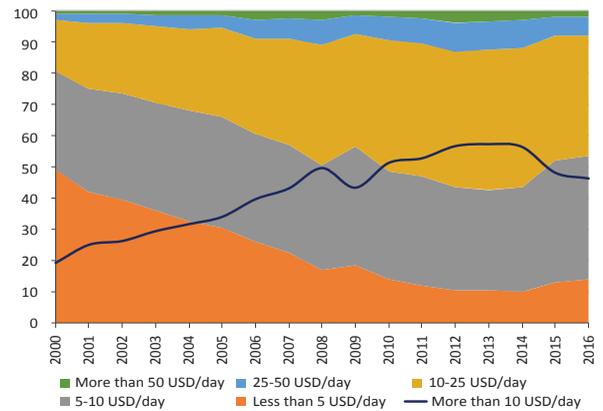
⁹ Note that this numbers should not be compared to the official poverty rate reported by Rosstat. Although the thresholds for poverty are lower in this case, the welfare aggregate that is used (consumption expenditures instead of incomes) is also different. These calculations are also based on another source of data (HSE-RLMS) that provides similar trends in time, but the levels might be different.

Figure 19: Wages and pensions grow, but the overall disposable income stagnates
(Percent to previous year)



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

Figure 20: Share of population with consumption per capita over 10 USD/day in 2005 PPP declined further
(Percent)



Note: Consumption is defined as consumer expenditures on food, non-food and services and excludes taxes, savings and other payments in various forms as well as non-consumption expenditures.
Source: World Bank staff estimates using HSE-RLMS data.

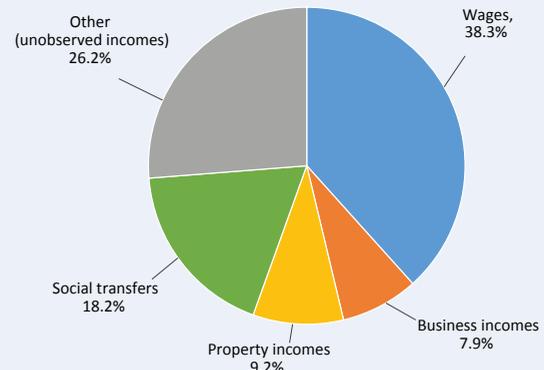
Box 2 Is there a wage-income paradox?

Prima facie, there is a growing discrepancy between growing wages and contracting incomes in Russia. Wages have grown faster in boom periods and contracted more in recessions than disposable incomes in Russia. Cumulative wage growth was higher than that of disposable income in the past 15 years. Wages increased more than disposable incomes during periods of economic expansion. During economic contractions—in 2009 and from 2015—, wages fell more than disposable incomes. The situation is the opposite in most of OECD countries, including resource-rich Australia, Canada and Norway, where disposable income has grown faster than real wages in recent decades.

In the first half of 2016, real wages in Russia stopped contracting and flattened, while real disposable income declined at the same rate as in 2015 (Figure 18). The difference between the two indicators is driven by the non-wage component of disposable income. Wages are responsible for a relatively small share of disposable income, because regular wage statistics cover only large- and medium-sized enterprises and there is a big informal labor market for which wages are not well captured by official statistics.

Formal wages account for less than half of total household income.¹⁰ Only 38.3 percent of household incomes comes from wages that are officially reported. Public transfers (mainly pensions and social assistance) make up almost a fifth of household income, and property income (dividends and interest rates, renting out or selling real estates, selling currency, etc.) and income from entrepreneurial activity also contribute (Figure B2-1). The rest, nearly a quarter of all income, is not recorded by statistical methods. Instead, it is estimated in order to make

Figure B2-1. Formal wages account for 38 percent of total household income
(Structure of Total Household Income in 2015, percent)



Source: Rosstat and World Bank staff calculations.

¹⁰ The real disposable-income indicator is used to analyze trends over time, while total income is used to analyze structure by sources. This is done to be consistent with commonly used definitions and does not affect conclusions. The difference is that disposable income does not include taxes and other mandatory payments.

reported incomes consistent with the total amount of consumer expenditures, which are better captured by statistics than incomes. Unreported incomes mainly come from self-employment or employment in the informal sector. Informal-sector activity is not covered by macroeconomic statistics and for detailed analyses, micro-survey information is used, but is released with a lag of one to several years.

A large share of unreported incomes is due to the informal sector of the labor market. The total amount of jobs in the formal sector (all types of legal entities: registered business, public and non-commercial organizations) is 45 million, while according to the Labor Force Survey, there are 73 million employed people. The others are employed in the non-corporate sector¹¹ and partly in the informal sector, including in self-employment, working as individuals or without official contracts. Wage statistics are based on information collected from enterprises, not from employees. This means that for those who are not employed in organizations—almost one third of all employees—there is almost no systematically collected wage data.

Real wage-growth numbers are based only on statistics covering wages in large and medium enterprises, which is why they contribute even less to real disposable income dynamics than total wages. Monthly and quarterly wage-growth statistics are related not to those employed in all organizations, but only to those who are working in large and medium enterprises,¹² which covers 35 million people, or less than half of the total employed population. This accounts for 70 percent of all observed wages or 28 percent of total household incomes. The number of people employed in large and medium enterprises declined, but their wages grew faster than the rest of incomes, so their share remained relatively stable in time.

While not fully conclusive, it therefore seems that the wage-income paradox is a combination of two things: (i) contraction in non-wage incomes and (ii) reporting, data and statistics issues.

The official poverty rate decreased slightly in the first half of 2017. Despite the continued contraction of real disposable income, the official poverty rate, measured as the share of the population with incomes below the subsistence minimum, as reported by Rosstat, decreased in the first half of 2017 compared to the same period a year ago (Table 2). The contraction of poverty was especially strong in the first quarter of 2017, when it dropped by 1 percentage point to 15 percent, compared to the first quarter of 2016. This was mainly explained

by a slow nominal growth of the subsistence minimum that increased in the first quarter by only 1.4 percent, which is far below the inflation rate. This means that some households whose real incomes declined might have escaped from official poverty only because the poverty line decreased more in real terms. However, in the second quarter, the growth of the subsistence minimum was closer to inflation, explaining why the poverty rate returned almost to the levels of the previous year (14.4 percent in 2017).

Table 2: The poverty rate decreased slightly

	2010	2011	2012	2013	2014	2015	2016				2017	
							Jan-Mar	Jan-Jun	Jan-Sept	Jan-Dec	Jan-Mar	Jan-Jun
Poverty rate, percent, average for the period	12.5	12.7	10.7	10.8	11.2	13.3	16.0	14.6	13.9	13.5	15.0	14.4
Number of poor, million people	17.7	17.9	15.4	15.5	16.1	19.5	23.4	21.4	20.3	19.8	22.0	21.1

Source: Rosstat.

¹¹ Non-corporate sector employment is the difference between total employment and employment in legal entities (large, medium and small enterprises).

¹² With the number of employed above 100 people or annual revenue more than 400 million rubles.

1.4 Monetary Policy: The Central Bank Continued a Gradual approach to Monetary Easing Aimed at Anchoring Inflation Expectations

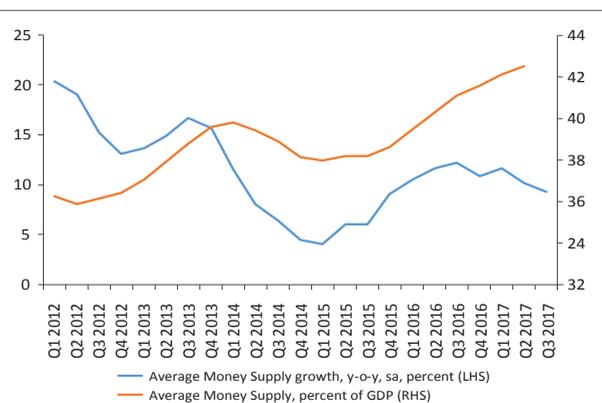
Monetary policy remained prudent and consistent with the inflation-targeting framework. A combination of relatively tight monetary policy and tight fiscal policy, together with some one-off factors, led the Central Bank to undershoot the CPI inflation end-year target as early as July 2017.

The Central Bank continued its gradual approach to monetary easing in 2017. The Central Bank reduced the key rate by 175 bp in January–November 2017 from 10 to 8.25 percent in annual terms (Figure 21). Meanwhile, annual consumer inflation had almost reached its end-year target by April 2017. It undershot the end-year target in July, reaching 3.9 percent y/y. Annual consumer inflation stayed below the end-year target in July–October. Core inflation decreased from 6 percent y/y in December 2016, to 2.5 percent y/y in October 2017, reflecting subsiding inflation pressures. Meanwhile, inflation expectations trended downward during the year, but remained elevated (Figure 22). To anchor inflation expectations and make them sustainable and consistent, the Central Bank continued with its gradual approach to monetary easing. In the October statement, the Central Bank confirmed that its transition from moderately tight to neutral monetary policy will be gradual, but acknowledged possible key rate cuts during the upcoming meetings.

Despite the resumption of a gradual monetary easing, monetary conditions remain relatively

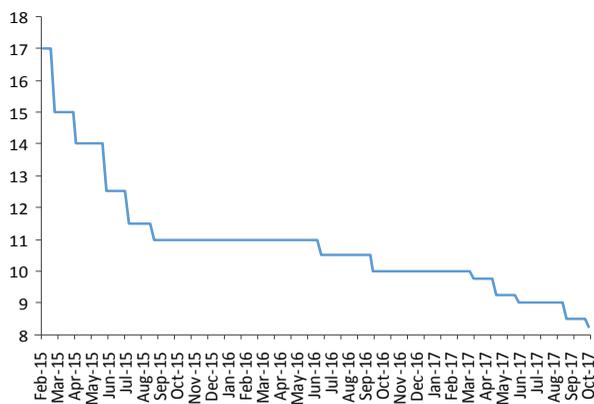
tight. The monetization of the economy increased with the ratio of M2 to GDP, rising from 41.5 percent at the end of 2016 to 42.5 percent at the end of the second quarter of 2017 (Figure 23). The observed moderate relaxation in monetary stance led to a reduction in money market rates from 10.5 percent y/y at the end of 2016 to 8.1 percent y/y in early November 2017. However, real interest rates are sufficiently positive, keeping monetary conditions relatively tight.

Figure 23: The monetization of the economy increased



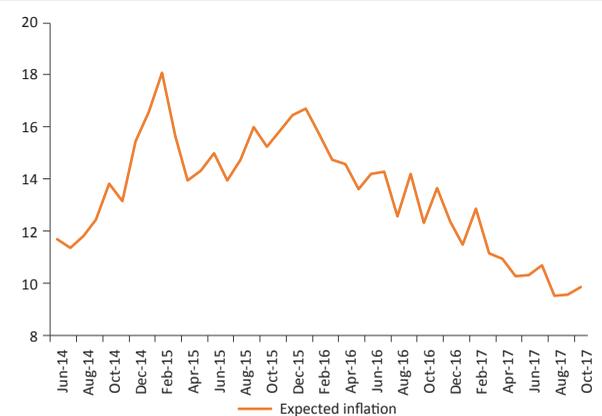
Source: CBR and World Bank staff calculations.

Figure 21: The Central Bank cut the key rate by 175 Basis Points in January–November 2017



Source: CBR.

Figure 22: Inflation expectations trended downward during the year, but remained elevated (Median expected inflation, percent, y/y)

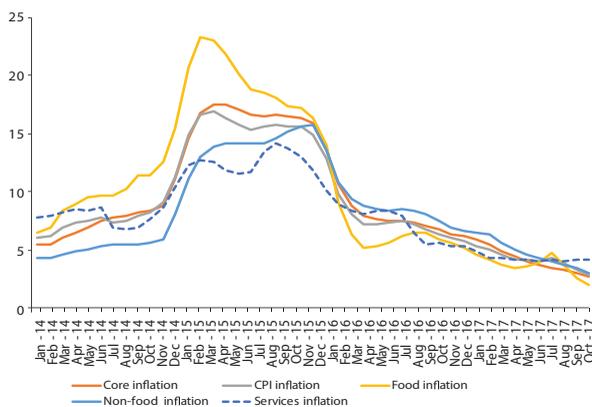


Source: CBR.

Moderately tight monetary policy combined with tight fiscal policy helped by some one-off factors eased inflation pressures, letting consumer inflation reach the end-year target by July. In January–October 2017, annual average consumer inflation decelerated to 3.9 percent compared to 7.4 percent in the same period of 2016. The inflation slowdown was largely due to the deceleration of non-food inflation from 8.6 percent y/y in January–October 2016 to 4.3 percent in the same period this year (Figure 24). Inflationary pressures subsided, especially in the third quarter of 2017, partly supported by the stronger ruble and a good harvest.

In January–October 2017, the improved terms of trade and the continued interest of investors in the EMDE markets supported the ruble, while

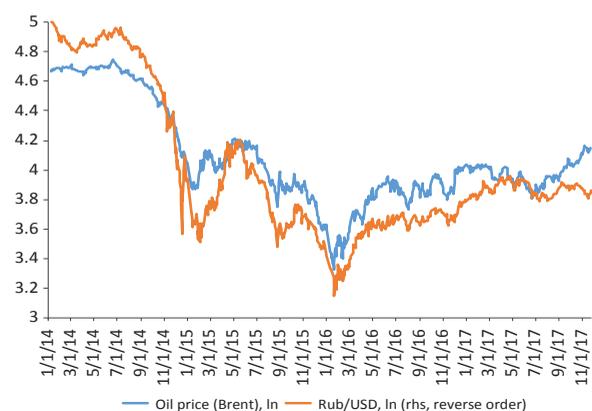
Figure 24: Inflation is below the end-year target
(CPI index and its components, percent, y-o-y)



Source: CBR and Haver Analytics.

geo-political tensions exercised some downward pressure (Figure 25). While oil prices trended slightly lower in the first half of 2017, the ruble exchange rate against the US dollar appreciated slightly, helped by continued demand for ruble-denominated financial assets, which offered attractive returns in view of soft monetary conditions in major developed countries. This demand was supported by a perception of decreased risk of these assets, as Russia's CDS spreads continued declining. Yet, with rising geo-political tensions in June and the expansion of sanctions against Russia in July, the ruble depreciated. It bounced back with the moderate recovery of oil prices in July–October. Despite oil prices trending upwards in November, the ruble depreciated. Such dynamics was broadly in line with other EMDE currencies and reflects temporary decrease of investors' interest in EMDEs

Figure 25: The oil price remained an important factor of the Ruble exchange rate dynamics
(Changes in oil prices and the nominal exchange rate, logarithmic scale)



Source: CBR and World Bank staff calculations.

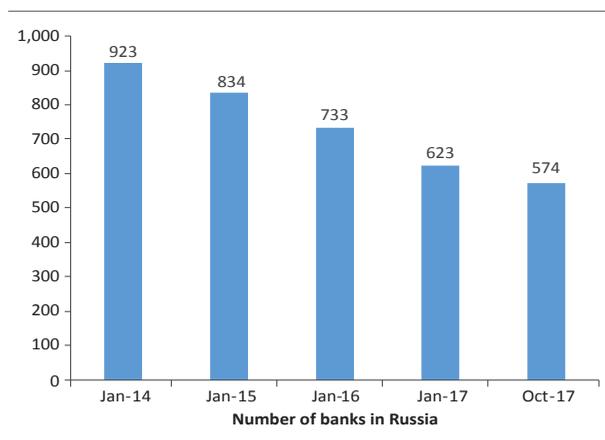
1.5 The Financial Sector: The Banking Sector's Fundamentals Improved with the Economic Recovery, but some Pockets of Vulnerability Remained

The Russian Central Bank bail-out of two large private banks (the second- and fifth-largest private banks, jointly equal to 5.2 percent of the banking sector assets) in August–September 2017 pointed to a continued fragility in the Russian banking system. Concerns over asset quality due to rapid credit growth and connected lending weakened their liquidity positions. The banks, bailed out under a newly established resolution framework, received liquidity support from a new emergency liquidity window with expanded eligible collateral. They also will be given capital injections from the Banking Sector Consolidation Fund (BSCF). Full details of the bailout are yet to be revealed, including the extent to which shareholders will have to contribute to the rescue of their banks. How the mechanism is implemented will be key to preserving stability and preventing moral hazard. While these recent failures of the large private banks have not caused noticeable stress across the broader banking sector, their long-term effect—absent full divestment—will likely be increased public ownership of the banking sector, which raises concerns about competition and innovation in the financial system in the medium- to long-term.

The 2014-2016 economic recession amplified vulnerabilities that had been accumulating over time in the banking system. The ongoing sector consolidation and continuing bank failures point to the underlying problems that need to be addressed to ensure stable and sustainable growth in the future. While the Central Bank's recent bail-out of two large private banks, Otkritie and B&N Bank, helped avoid noticeable stress across the broader banking sector, the scale and magnitude of the interventions point to the remaining vulnerability in the Russian banking system.

Since the CBR stepped up its efforts to clean up the banking system in 2014, the number of banks in Russia fell by over a third (Figure 26). Flawed business models, over-aggressive growth, high exposure to related-party lending and misrepresentation of asset quality were the most common problems that led to the bank failures. As the pace of the banking sector consolidation has been increasing over time, the size and systemic importance of the banks that required intervention has also increased. Several banks among the top fifty by assets have recently lost their licenses or undergone a resolution. In 2017, five of the largest fifty banks were closed (Yugra, Tatfondbank) or resolved via creditors bail-in (Peresvet) or with the use of public funds (Otkritie, B&N Bank).

Figure 26: The number of banks has fallen by over a third between 2013 and 2017



Source: CBR.

In 2017, the Russian authorities strengthened the bank resolution framework to allow for a faster resolution of problem banks. In July, the CBR established the Banking Sector Consolidation Fund (BSCF). This new resolution tool allows the CBR to provide direct capital injections to banks instead of using long-term soft loans from the Deposit Insurance Agency (See Box 3). In addition, the CBR introduced a new emergency liquidity facility with an expanded eligible collateral to support banks in case of stress. The new resolution mechanism was implemented for the first time during the bailout of Otkritie and B&N Bank. The CBR (via BSCF) has become a major shareholder in each of the banks and has appointed temporary administrations consisting of both CBR and BSCF staff to run these banks. There was no credit moratorium¹³ or bail-in¹⁴ of unsecured senior creditors, but subordinated instruments will be written off as well as bank liabilities due to shareholders and top managers. Full details of the bailouts are yet to be revealed, including the extent of resources to be injected in the banks. According to the CBR's preliminary estimates, the amount required to restore their capital to regulatory levels could be in a range of RUB 800-820 billion (approx. US\$13.9-14.3 billion).

Despite the failure of some large private banks in 2017, the overall performance of the banking sector has been stable. The banking sector's fundamentals have improved through August 2017, following the rest of the economy. Throughout the year, the key risk and performance indicators remained largely unchanged and credit growth picked up moderately. The aggregate capital adequacy ratio remained stable throughout the year at around 13 percent, against a regulatory minimum of 8 percent, due to modest lending growth and profitable bank performance earlier in the year.

¹³ According to the Russian bankruptcy law, a moratorium on satisfaction of creditors' claims could be imposed by the temporary administration. It extends to monetary obligations and mandatory payments of the entity under the resolution.

¹⁴ Bail-in is a statutory power to restructure the liabilities of a distressed financial institution by converting into equity and/or writing down unsecured debt.

Box 3 Russia moves towards a new bank resolution regime

“Resolution” is the restructuring of a bank by a resolution authority designed to ensure the continuity of its critical functions, the preservation of financial stability and the restoration of the viability of all or part of that institution, while the remaining parts are put into normal insolvency proceedings. In normal insolvency procedures, the primary objective is to maximize the value of assets of the failed firm in the interest of creditors. However, these may take many years, especially for complex institutions undermining confidence in the sector. In contrast, the primary objective of a bank resolution is to preserve financial stability. Effective resolution should also discourage banks from undertaking excessive risks (moral hazard) by ensuring that shareholders and creditors, as opposed to taxpayers, bear the losses in the value of the bank’s investments.

Recent financial crises have exposed shortcomings in bank resolution regimes around the world and prompted a revision of resolution frameworks to adhere to best practices. At the Cannes Summit in November 2011, the G20 endorsed the Financial Stability Board core recommendations for effective resolution (“Key Attributes of Effective Resolution Regimes for Financial Institutions”) that jurisdictions should implement to achieve the G20 commitments. Effective resolution tools include the power to sell the bank or merge it with another bank, to set up a temporary bridge bank to operate critical functions, to separate good assets from bad ones and to convert to shares or write down the debt of failing banks (bail-in).

In May 2017, the Russian authorities introduced a law amending the bank resolution framework.¹⁵ While the Deposit Insurance Agency (DIA) retains its ability to take part in rehabilitation of banks, the new mechanism allows the Central Bank of Russia (CBR) to take part in the rehabilitation of banks through the Banking Sector Consolidation Fund (BSCF). BSCF is set up as an asset management company with the authorized share capital of RUB 1.5 billion (approx. US\$26m), which is fully owned, financed and managed by the CBR.¹⁶ The amounts of the CBR’s further contributions to BSCF are to be authorized by the CBR’s Board of Directors. BSCF does not carry an explicit arrangement for federal government funding and its size would be determined on a case-by-case basis.

The new mechanism allows the CBR to provide an equity capital injection, but only after writing down shareholders’ equity and writing off subordinated debt. Some elements of the bail-in are contemplated for individuals who are managers or/and exercise control over the bank—obligations of a bank under BSCF resolution towards those individuals have to be terminated. BSCF can also provide loans (including subordinated loans), place deposits, issue bank guarantees, acquire assets of problem banks and rights to claims to them. It is assumed that the CBR will sell the acquired shares of the banks in an open auction after the rehabilitation process is complete.

There are no strictly defined eligibility criteria for the banks to receive BSCF support, and the scheme can be used to bail out non-systemic banks, if there is a major threat to financial stability. After the assessment of the problem bank is performed, CBR’s Committee on Banking Supervision proposes a way forward and then CBR’s Board of Directors approves the plan of financial rehabilitation of the bank, either under BSCF or DIA.

In contrast to the Russian framework, EU and US regulations either severely limit or outright forbid the possibility of injecting capital to support failing banks (bail-out). The European Bank Recovery and Resolution Directive (BRRD) of May 2014 only allows that in exceptional circumstances, and only where it is critical to financial stability. Public funds can be used to bear bank losses (up to 5% of bank liabilities) only when shareholders and creditors have borne sufficient losses (i.e. 8% of the liabilities of the bank under resolution) through write-downs or conversions. In most cases, public funds will be limited to providing loans to a bridge institution, purchasing specific assets of an institution under resolution, guaranteeing certain assets or liabilities of the institution under resolution, compensating shareholders or creditors who incurred greater losses than under normal insolvency proceedings. The application of the resolution tools goes hand in hand with the recovery and reorganization measures that are reflected in the Business Reorganization Plan that aims at restoring the bank’s long-term viability.

¹⁵ Federal Law No. 84-FZ from May 1, 2017.

¹⁶ Limited liability company «Fund of Banking Sector Consolidation Asset Management Company», «FBSC AMC» Ltd.

For banks that are solvent and not failing or likely to fail, the BRRD contains the possibility of precautionary recapitalization.

State aid in this context can only be granted to prepare for the possible capital needs of a bank that would materialize if economic conditions were to worsen. It does not trigger resolution of the bank. The main conditions for such injection are (i) the European Central Bank (ECB) needs to declare that the bank is solvent; (ii) the State support shall not be used to offset losses that the institution has incurred or is likely to incur in the future, (iii) the State support is temporary (i.e. the State should be able to recover the aid in the short- to medium-term), and (iv) the State support has received final approval under EU State aid rules, which involve burden-sharing measures (shareholders and subordinated debt holders contribute), a credible and effective restructuring plan to ensure the bank is viable and distortions of competition are limited through proportionate remedies.

In the case of the USA, the Dodd-Frank Act creates an orderly liquidation authority (OLA) that allows the Treasury Secretary to close, and the Federal Deposit Insurance Corporation (FDIC) to unwind, failing bank holding companies or other financial companies that at the time of resolution are deemed as systemically important by the Treasury Secretary.

The FDIC can use resolution procedures it deems appropriate, including selling of its assets, merging it with another company, purchasing and assuming transactions or creating a bridge financial company. This process is known as a closed bank bail-in, in which all creditors are “bailed-in” by having their claims impaired in proportion to the bank’s losses and the creditors’ seniority under the statutory claims hierarchy. Insured depositors are protected under FDIA, but uninsured depositors may suffer losses. Shareholders and unsecured creditors bear losses, and management is removed.

The new resolution frameworks in both Europe and the US aim to limit the costs to taxpayers by ensuring that resolution costs are born by the entities, its shareholders and creditors and through resolution funds financed by the industry.

The Single Resolution Fund (SRF) is funded with contributions from credit institutions and certain investment firms in the 19 participating States in the Banking Union. The SRF will be gradually built up during the first eight years (2016-2023) and shall reach the target level of at least 1% of the amount of insured deposits of all credit institutions within the Banking Union. Country members have committed to provide contingency funding to the SRF in case accumulated resources are insufficient under a harmonized Loan Facility Agreement. In the US, funds spent in the liquidation must be recovered from the assets of the company. If not, other systemically important financial companies will be charged the cost of the liquidation through assessments. The FDIC can issue debt to bridge funding for resolution costs.

The new Russian resolution framework presents important advantages over the previous mechanism by promptly restoring the solvency of the institution to support financial sector stability.

Before this new mechanism was put in place, to facilitate the operation of undercapitalized banks, a long-term (10-15 years) soft loan was extended by the DIA, while the CBR granted regulatory forbearance during the recovery period. However, BSCF support has only limited bail-in requirements (e.g. senior creditors are not subject to bail in) and the fact that resolution funds are provided by the CBR, as opposed to being funded by/recouped from the industry, may induce moral hazard. If approved, authorities’ ongoing efforts to pass legislation that would force bank owners to surrender assets in exchange for bailouts of their banks would help mitigate moral hazard and reduce resolution costs. Furthermore, BSCF funding through CBR currency issuance, if large enough, may result in monetization of resolution costs given CBR’s profitability (albeit its capitalization level mitigates this concern). Usage of budget rather than CBR funding could address this issue.

However, loss of capital and recognition of negative financial results of banks under resolution weakened the overall sector performance in September (Figure 27). The failure of some of the largest private banks negatively affected Russia’s aggregate banking sector profits, which declined for the first time since the beginning of 2017. The total net profit of the Russian banking sector from 1Q-

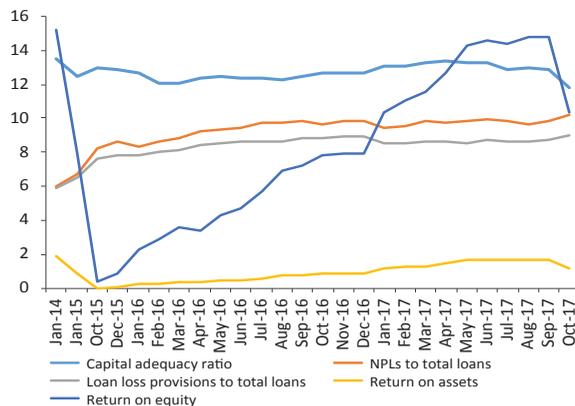
3Q17 declined to RUB 675 billion (US\$11.7 billion) from RUB 997 billion (US\$17.3 billion) seen from January to August. This drop observed in banking profits was attributed to the one-off recognition of negative financial results caused by additional provisioning for non-performing loans of banks under the BSCF resolution.

Non-performing loans fluctuated at around 10 percent, which is high by historical levels (pre-crisis NPLs stood around 6% in January 2014), but they remain adequately provisioned. In comparison, the other BRICs and large emerging markets such as Turkey and Mexico have on average NPLs around 4 percent.

Lending growth was uneven as demand recovered faster in the retail sector than in the corporate

Figure 27: Overall sector performance weakened slightly

(Key credit and performance indicators, percent)



Source: CBR.

sector and SMEs (Figure 28). Corporate lending experienced modest, single-digit growth, while retail lending in rubles grew 10.7% in the first ten months of 2017. The strongest growth was observed in the mortgage segment (25 percent in the first nine months of 2017 compared to the same period last year), supported by a large unmet demand for housing and more favorable conditions brought by declining interest rates, which are at their historical minimum.

Figure 28: Credit growth in rubles picked up moderately

(y-o-y, percent)



Source: CBR.

1.6 Government Budget: The Government Followed the Path of Fiscal Consolidation

In the first nine months of 2017, the general government fiscal stance improved, mainly helped by higher revenues. The Russian Government adhered to a path of fiscal consolidation and introduced a new fiscal rule that is expected to smoothen the influence of external volatility on the budget and the real exchange rate. The rule comes into effect in 2019 and will require fiscal consolidation in 2018-2020.

In the January-October 2017 period, buoyed largely by higher revenues, the federal budget registered a primary surplus of 0.4 percent of GDP¹⁷ compared to a deficit of 1.4 percent of GDP in the same period last year (Figure 29). In January-October 2017, the federal budget revenue totaled 16.5 percent of GDP, an increase of 1.2 percent of GDP compared to the same period last year, with oil revenues higher by 0.8 percent of GDP (Table 3). Despite the appreciating ruble, oil and gas revenues grew, mostly due to increases in energy prices. Non-

oil/gas revenues increased by 0.5 percent of GDP, compared to the same period last year, largely due to improved tax administration and higher CIT¹⁸, excise, and VAT receipts from a recovering domestic demand. Compared to the same period last year, primary expenditures decreased by 0.6 percent of GDP but slightly increased in real terms. In 2017, pensions were indexed at the inflation level, but civil servant salaries and the savings pillar of the pension system were frozen, as in 2015-2016 (2014-2016 for the savings pillar). In the first ten months

¹⁷ On a cash basis.

¹⁸ An increase in CIT receipts comes largely from a higher share of CIT channeled to the federal budget, compared to 2016: out of 20 pp tax rate, 3 pp belongs to the federal level, compared to 2 pp last year. Meanwhile, in the first nine months of 2017, general government budget receipts from CIT demonstrated substantial growth of 16.2 percent, y/y.

Table 3: Federal budget revenue increased by 1.2 percent of GDP in 2017
(Main indicators, January-October, percent of GDP)

	2016	2017
Revenue	15.3	16.5
<i>Oil revenues</i>	5.6	6.4
<i>Non-oil revenue</i>	9.7	10.1
Expenditure	17.5	16.9
Balance	-2.2	-0.4
Primary expenditure	16.7	16.1
Interest	0.8	0.8
Primary balance	-1.4	0.4
Non-oil primary balance	-7.1	-6

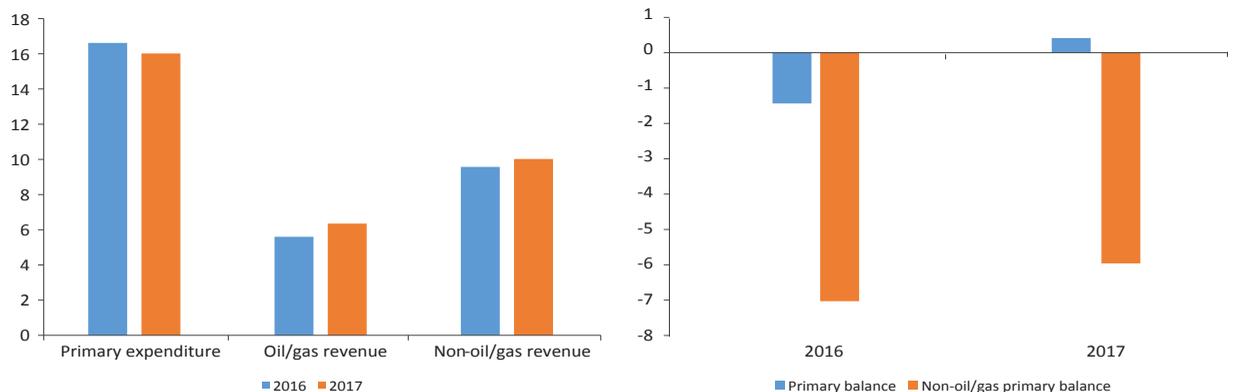
Source: Haver analytics.

of 2017, federal budget spending decreased largely due to lower spending on defense (-0.5 percent of GDP), security (-0.2 percent of GDP), and health (-0.2 percent of GDP). In this period, the non-oil primary deficit narrowed by 1.1 percent of GDP. Overall, the federal budget deficit narrowed to 0.4 percent of GDP from 2.2 percent of GDP last year. As of November 1, 2017, federal debt stock in domestic currency increased to about 9.7 percent of GDP from 9.3 percent of GDP in the end of 2016, as the federal budget deficit was mainly financed from the ruble debt issuance and the government has not started using the Reserve Fund. By the end of 2017, the federal government debt (in domestic and foreign currency) is expected to reach 13.6 percent of GDP, compared to 12.9 percent in the end of 2016.

In preparation for the introduction of the new fiscal rule, the government created a system of currency interventions in the domestic market in February 2017. Foreign currency is purchased when the price of oil exceeds US\$40/bbl and is sold if the opposite happens. The amount of currency purchased is defined by additional oil and gas fiscal revenues received by the federal budget compared to the baseline scenario, as stipulated in the federal budget for 2017. By November 22nd, 2017, the government had purchased US\$9.7 billion via these interventions, and planned to transfer about US\$12 billion to the National Welfare Fund in the beginning of 2018.

- **The general government's¹⁹ fiscal stance also improved (Figure 30).** In the first nine months of 2017, the general government registered a primary surplus of 1.6 percent of GDP, compared to a deficit of 0.8 percent in the same period last year. The consolidated regional budget registered a primary surplus of 0.9 percent of GDP in 2017, compared to 0.8 percent of GDP in the same period last year (Figure 31). Higher revenues helped reduce the regional debt stock by 7.7 percent in nominal terms, compared to the beginning of the year. The Ministry of Finance continued to ease the regional debt burden, increasing budgetary loans with lower interest rates to regions. The stock of commercial credit decreased by about 20 percent in nominal terms and the share of budgetary loans increased to 48 percent from 42 percent by the end of 2016.

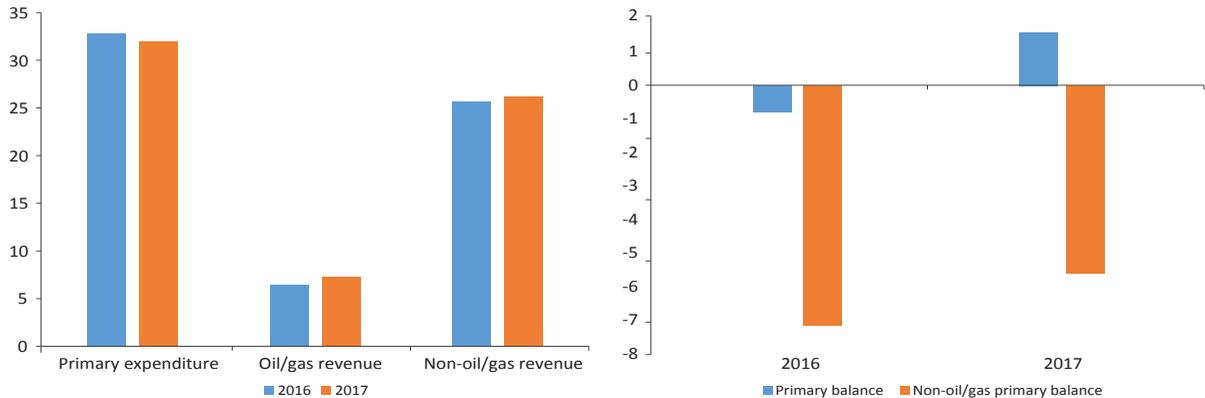
Figure 29: The federal budget registered a primary surplus in the first ten months of 2017
(% of GDP, January to October)



Source: Haver Analytics.

¹⁹ The general government budget includes the federal budget, the subnational budgets and extra-budgetary funds, i.e. pension, mandatory medical insurance and social security funds.

Figure 30: The GG budget non-oil/gas primary balance improved in the first nine months of 2017
(% of GDP, January to September)



Source: Haver Analytics.

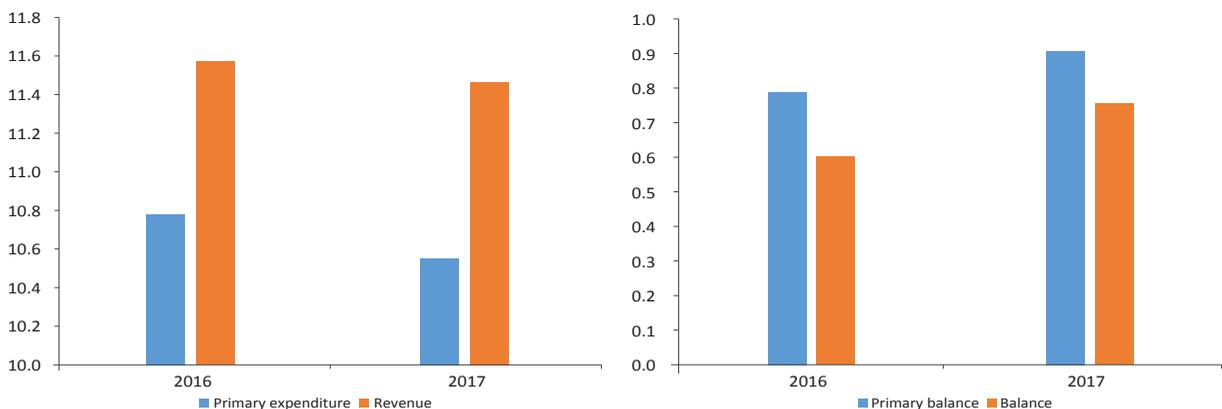
Yet the aggregate debt dynamics concealed substantial variations in debt levels among regions. As of October 1, 2017, there were eight regions, out of more than 80, with a share of debt exceeding the region's own revenues (the same number as at the end of 2016).

- **Extra-budgetary funds registered a marginal surplus of 0.1 percent of GDP, compared to a deficit of 0.1 percent of GDP in the same period last year.** Federal transfers to the Pension Fund, covering pension fund financing gap, reached about 28 percent of the pension fund revenues.

The overall general government deficit of 1.8 percent of GDP changed to a surplus of 0.6 percent of GDP in the first nine months of 2017.

The federal government has adhered to its fiscal consolidation path, adjusting the budget system to fit in the new fiscal rule (see Box 4) by 2019 through expenditure cuts, improved tax administration and some revenue mobilization effort. The draft federal law on the federal budget for 2018-2020 was approved by the State Duma in the third reading. The draft law is based on GDP growth forecasts of 2.1 percent, 2.2 percent, and 2.3 percent in 2018, 2019, and 2020, respectively, and conservative oil prices projections of US\$43.8/bbl, US\$41.6/bbl, and US\$42.4/bbl for the respective years (Table 4). Federal budget revenues are projected to fall from 16 percent of GDP in 2017 to 14.8 percent of GDP in 2020, mainly on the back of lower oil and gas

Figure 31: The regional budget primary balance improved in the first nine months of 2017
(% of GDP, January to September)



Source: Haver Analytics.

revenues due to lower prices, a decreasing share of the oil sector in the economy and a lower effective tax rate with the increased depletion of stocks. Non-oil/gas revenues are projected to increase from 9.7 percent of GDP in 2017 to 10 percent, 10 percent and 9.8 percent in 2018, 2019, 2020 respectively. The increase is projected to come from a growing tax base, continued efforts on improving tax

administration and revenue mobilization, including by channeling 50 percent of state companies' profits to the budget via dividend²⁰. The draft law was developed in accordance with the new fiscal rule provisions. In 2018, transitional provisions are to be applied: primary expenditures are expected to be larger by 1 percent of GDP than the ones stipulated by the fiscal rule.

Box 4 New fiscal rule—Third Time's the Charm?

In 2019, the government will adopt a new fiscal arrangement to manage its oil/gas revenue more effectively. Starting in 2019, a portion of the oil/gas revenue the federal government can spend in a given year will be determined by a fixed oil price benchmark (US\$40 per barrel in 2017 prices), unlike the previous two rules based on historical oil prices. If actual oil prices exceed the benchmark price, the difference will be saved in the National Welfare Fund (NWF), which will be merged with the Reserve Fund in February 2018. If actual prices are below the benchmark price, the government can supplement the oil/gas revenue shortfall by withdrawing an equal amount from the NWF. The new rule is therefore symmetrical. The fiscal rule limits the budgetary use of the NWF, only to smooth out the volatility of oil/gas revenue. In the event the balance of the NWF falls short of 5 percent of GDP, withdrawals from the NWF in the following year will be limited to one percent of GDP.

In principle, full implementation of the new fiscal rule should help moderate fiscal cyclicity by de-linking federal expenditure from commodity-price volatility and protect the NWF by restricting the use of oil/gas windfalls. The transition from a short, backward-looking formula to a fixed-price one will provide greater predictability of medium-term expenditure paths at a conservative oil price. The new rule is simple to carry out, monitor, and communicate to the public—important operational considerations for their effective implementation and greater accountability.

Russia's new fiscal rule—a major structural reform—is a solid step in the right direction, with the following considerations:

- **First, by focusing exclusively on oil price volatility and federal expenditure, Russia's new rule does not directly address business cycles in the non-oil/non-gas sector.** A major and temporary output expansion in the non-oil/non-gas sector could translate into an increase in federal spending, potentially creating overheating pressures. Similarly, large-scale off-budget expenditure could give rise to fiscal cyclicity, as the fiscal rule applies only to federal outlays. Effective monetary and exchange-rate policies can dampen pressures arising from such cyclicity, but with a limit.
- **Second is the aspect related to escape clauses, meant to accommodate rare and exceptional circumstances such as wars or calamities.** A well-defined escape clause is increasingly being recognized as an integral part of modern fiscal rules. By allowing it to deviate from the rule temporarily, an escape clause can prevent the government from violating or exiting the fiscal rule. Repeated reinstatement or revisions can hence be avoided by an effective escape clause. Over the past decade, many of the fiscal rules without an escape clause were either abandoned (Chad, Ecuador, Papua New Guinea), or modified in an ad hoc manner (Kazakhstan, Oman, Trinidad and Tobago), to counter exceptionally large shocks, such as the global financial crisis. Against this backdrop, formal escape clause provisions are becoming increasingly common in newly introduced fiscal rules (Brazil, Germany, Slovakia, Switzerland). Even though Russia has separate budgetary provisions for Force Majeure events such as wars or catastrophic disasters, codifying such circumstances, and allowing for other events beyond war and disasters (such as global financial crises) in an explicit escape clause, would be closer to current practice.

¹⁹ The general government budget includes the federal budget, the subnational budgets and extra-budgetary funds, i.e. pension, mandatory medical insurance and social security funds.

- **Third, in the long run, Russia could consider introducing an additional provision in the rule to accumulate more fiscal savings in the NWF.** With a relatively long oil/gas reserve horizon and low public-debt levels, the most important policy consideration for Russia at present is to shield the economy from short-term oil-price volatility. However, considering the aging population and an eventual depletion of oil and gas, it may be desirable to build more assets in the NWF for the increased future cost of aging while keeping fiscal sustainability in check.
- **Finally, while Russia’s new rule targets a zero primary fiscal deficit at the benchmark price, it does not constrain federal government borrowing.** Unlike deficits resulting from lower-than-benchmark actual oil prices, fiscal deficits created by other factors—for example, due to overly optimistic projection of non-oil/gas revenue or volume of oil/gas production as well as large swings in the exchange rate—will need to be closed by borrowing, or through a discretionary expenditure adjustment over the 3-year budget cycle. Different countries have experimented with different approaches. Chile’s structural balance rule, for example, addresses both cyclicity and sustainability concerns, by setting annual expenditure appropriations based on structural revenue, calibrated by using potential GDP and longer-term copper prices. To reduce political economy considerations, an independent panel of experts sets key parameters for the fiscal rule. Norway’s fiscal rule limits the non-oil structural deficit to the long-term return on the Government Pension Fund assets. However, the implementation of structural balance rules is generally disappointing, due to technical and institutional constraints. As an alternative, some commodity exporters combine an expenditure rule with a debt, (nominal) balance, or revenue rule, and supplement them with effective monetary and exchange-rate policies.

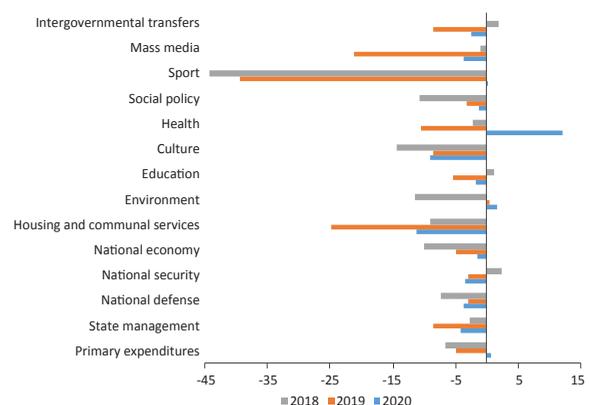
There is, of course, no one-size-fits-all fiscal rule that can address all policy concerns. Ultimately, successful implementation of any fiscal rule depends on political commitment. Operationally simple and based on a fixed benchmark price, the reinstatement of Russia’s fiscal rule is a major structural reform. And combined with the move towards inflation targeting, it further underscores the Russian authorities’ commitment towards enhancing macro-stability.

The draft federal budget law for 2018-2020 is largely driven by expenditure cuts.

Federal budget primary expenditures would decrease from about 17.3 percent of GDP in 2017 to 14.8 percent of GDP in 2020. In 2018, the federal budget’s primary expenditures are to decrease by 1.1 percent of GDP, a 6.6 percent decrease in real terms. Expenditures for all categories, except education, national security and intergovernmental budgetary transfers would drop in real terms in 2018 (Figure 32). In 2016, general government expenditures for education dropped by 19.6 percent in real terms compared to the level of 2013. Expenditures for health increased just by 0.9 percent in real terms in 2014-2016. Both health and education expenditures are relatively low, compared to other countries (See Box 5). Social policy²¹, national economy, and national defense would contribute the most to expenditure cuts in 2018. Expenditure consolidation should bring the primary deficit to 0.5 percent of GDP deficit in 2018, from 1.3 percent of GDP deficit in 2017, and

it should keep it at zero beginning in 2019. The non-oil/gas primary fiscal deficit is expected to reach 6.2 percent of GDP, 5.1 percent of GDP, and 5.0 percent of GDP in 2018, 2019, and 2020, respectively, compared to 7.8 percent of GDP in 2017.

Figure 32: Expenditures for all categories, except for national security, intergovernmental budgetary transfers and education, would drop in real terms in 2018



Source: Ministry of Finance.

²¹ Social policy spending cuts are largely attributed to the one-time payment to pensioners, conducted in 2017.

Table 4: The draft federal budget law for 2018-2020 is driven by expenditure cuts

	2017	2018	2019	2020
	Expected	Forecast		
Revenues	16.0	15.7	15.1	14.8
Expenditures	18.1	17	15.9	15.6
Balance	-2.2	-1.3	-0.8	-0.8
Primary expenditures	17.3	16.2	15.1	14.8
Primary balance	-1.3	-0.5	0.0	0.0
Oil and gas revenues	6.3	5.6	5.1	4.9
Non-oil and gas revenues	9.7	10	10	9.8
Non-oil and gas balance	-8.5	-6.9	-5.9	-5.7
Non-oil and gas primary balance	-7.6	-6.2	-5.1	-5.0
Oil price (Urals)	49.9	43.8	41.6	42.4

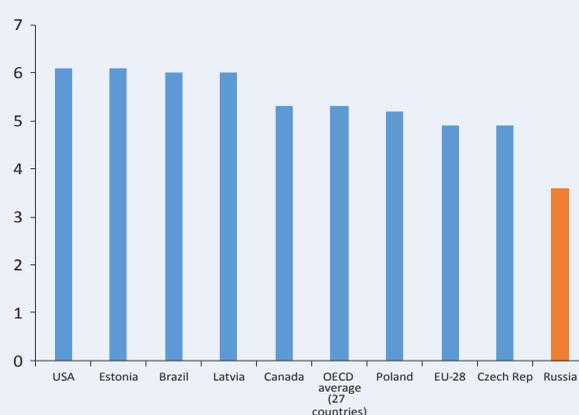
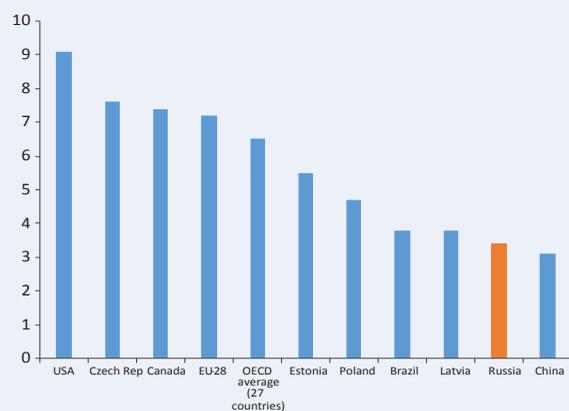
Source: Ministry of Finance.

Box 5 Public health and education expenditures are relatively low in Russia

Public health spending in Russia is relatively low. At around 3.4 percent of GDP in 2015 and 3.6 percent of GDP in 2016, it is well below the EU average of 7.2 percent of GDP and 6.5 percent for OECD countries (Figure B5-1a). Compared to the BRIC countries, in 2014, Russia's public health spending (3.2 percent of GDP) only exceeded health expenditures in China (3.1 percent of GDP) and India (1.4 percent of GDP). Relatively low public health spending in Russia results in high out-of-pocket spending on health for its citizens.

In addition to its low levels, with an emphasis on expensive, tertiary care, Russia's health care spending is also inefficiently allocated. Additional resources are needed to improve health outcomes, but these resources must be accompanied by reforms to increase the value for money spent. The current configuration of health care provision emphasizes high-cost hospital and specialist care, limits the capacity of the system to adapt to emerging patient needs and reduces both its efficiency and its effectiveness. Despite a gradual reduction of hospital capacity in the last decade, the number of hospital beds per 1,000 population in Russia is 1.6 times higher than the EU average and the average length of stay is 1.5 times longer. The difference in public spending on education is slightly less. Russia allocates 3.6 percent of GDP compared to the OECD average of 5.3 percent of GDP and 4.9 percent of GDP for EU countries. (Figure B5-1b)

Figure B5-1: Russia's public expenditures on health and education as % of GDP are low compared to other countries
(a. Health) (b. Education)



Source: OECD, Federal Treasury of the RF, Eurostat, WDI.

Note: The latest available data for Canada, Brazil and China is 2014.

Source: OECD, Federal Treasury of the RF, Eurostat, WDI.

Note: The latest available data for Canada, Brazil and China is 2014.

Source: Ministry of Finance.

PART II

OUTLOOK FOR THREE YEARS: MODEST GROWTH AHEAD



2. Outlook for Three Years: Modest Growth Ahead

Global growth is expected to remain stable. Oil prices are anticipated to average \$53/bbl in 2017 and rise to \$56/bbl in 2018 on strong oil demand and restraint in OPEC and non-OPEC production. The medium-term growth forecast for Russia has been slightly increased since the last Russia Economic Report (May 2017) following a somewhat stronger-than-expected recovery of domestic demand and higher exports.

Global growth is expected to remain stable. Global growth outlook is expected to remain broadly stable at 2.9 percent in 2018-19 (Table 5). An acceleration in Emerging Markets and Developing Economies, especially commodity exporters, is expected to offset the moderation of advanced economies. For Russian trade partners, growth in the Euro Area is expected to slow as policy accommodation is gradually unwound and labor market slack continues to diminish. Because of tighter policies and a rebalancing of the economy, China will see a slight slowdown in growth in 2018-19. A sudden tightening of global financial conditions and rising geopolitical risks remain important downside risks. The possibility of stronger-than-expected growth in large advanced economies, notably in the United States and the Euro Area, poses an upside risk to the outlook.

Oil prices are expected to average \$53/bbl in 2017 and rise to \$56/bbl in 2018 on strong oil demand and restraint in OPEC and non-OPEC production (despite projected increases in U.S. shale production). There are some risks to

the forecast. Supply to the global market from politically stressed oil producers, including Iraq, Libya, Nigeria, and Venezuela, could be volatile. The agreement among OPEC and non-OPEC countries to cut production more deeply could materially tighten markets—the next OPEC meeting is on November 30. Conversely, failure to extend the agreement could exert downward pressure on prices. Efficiency gains among U.S. shale producers could boost global oil supplies.

The medium-term growth forecast for Russia has been slightly increased following higher exports and a somewhat stronger-than-expected recovery of domestic demand. In an environment of relatively high oil prices, macro stabilization, and improved business and consumer confidence, we expect Russia's economy to continue to grow. Compared to the forecast from spring 2017, our growth estimates of 1.3 percent, 1.4 percent, and 1.4 percent in 2017, 2018, and 2019, respectively, have been upgraded to 1.7 percent, 1.7 percent and 1.8 percent. (Figure 33 and Table 6).

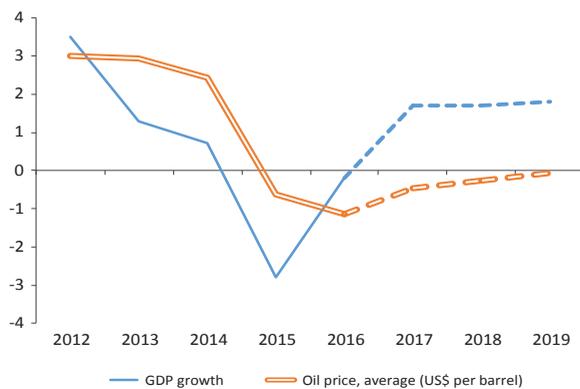
Table 5: Global growth is broadly stable
(GDP growth projections, percent)

	2014	2015	2016	2017f	2018f	2019f
World	2.8	2.7	2.4	2.7	2.9	2.9
Advanced economies	1.9	2.1	1.7	1.9	1.8	1.7
United States	2.4	2.6	1.6	2.1	2.2	1.9
Euro Area	1.2	2	1.8	1.7	1.5	1.5
Emerging and developing economies	4.3	3.6	3.5	4.1	4.5	4.7
China	7.3	6.9	6.7	6.7	6.3	6.3
Russia	0.7	-2.8	-0.2	1.7	1.7	1.8
Crude oil (Brent, WTI and Dubai average, US\$/bbl)	96.2	50.8	42.8	53.0	56.0	59.0
Crude oil (Urals, US\$/bbl) ²²	97.6	51.2	41.7	51.6	54.6	57.5

Source: World Bank staff projections.

²² Growth rates for crude oil average WB price are applied to Urals oil price.

Figure 33: In the firming global environment, Russia's economy is expected to grow at a modest pace
(Real GDP growth, percent)



Source: Rosstat, World Bank.

Consumer demand is expected to be the main engine of GDP growth in 2017-2019. With headline inflation stabilizing around 4 percent in 2018-2019, real wages are expected to be on an upward growth trajectory. Resumed indexation of public employees' salaries, frozen in 2015-2017, will also support real incomes and consumption. Other sources of income, such as informal wages, are expected to grow as economy recovers. In 2018, consumption is

likely to benefit further from the soccer World Cup hosted by 11 Russian cities.

In 2018-2019, growth in gross fixed capital formation is expected to slow down after strong growth in the second quarter of 2017. Public investment in several big infrastructure projects is expected to decelerate in 2018-2019, and fiscal consolidation is expected to take its toll on public-sector investment expenditures. Meanwhile, growth in fixed capital investment in big state energy companies should continue. Cheaper credit is expected to support fixed capital investment in 2018-2019, and with a recovering economy, improved business sentiment and a stable macroeconomic environment, investment growth is expected to become more broad-based.

The economy's adjustment to the terms-of-trade shock of 2014 and the sanctions regime increased the role of export as a GDP growth driver. In 2015-2016, domestic demand shrank, absorbing the terms-of-trade shock and increased geopolitical uncertainty resulting from the introduction of sanctions. This brought a drop in the shares

Table 6: Modest growth rates are projected
(Major macroeconomic Indicators)

	2016	2017f	2018f	2019f
Oil price (US\$ per barrel, WB average)	42.8	53	56	59
GDP growth, percent	-0.2	1.7	1.7	1.8
Consumption growth, percent	-3.5	2.1	1.9	1.9
Gross capital formation growth, percent	1.5	5.2	3.4	1.6
Gross fixed capital formation growth, percent	-1.8	3.6	3	3
General government balance, percent of GDP	-3.7	-2.2	-1.2	0.2
Current account (US\$ billions)	25.5	31.9	32.9	40.5
Current account, percent of GDP	2	2	2.1	2.4
Exports (GNFS), bln US\$	332.4	392.2	415.5	441
Imports (GNFS), bln US\$	266	318.7	338.6	356.8
Trade balance (GNFS), bln US\$	66.4	73.5	76.8	84.2
Trade balance (GNFS), percent of GDP	5.2	4.7	4.8	5.1
Capital and financial account (US\$ billions)	-16.2	-22.6	-15.3	-23.8
Capital and financial account, percent of GDP	-1.3	-1.1	-1	-1.4
CPI inflation (average)	7.1	3.7	4	4

Source: CBR, Rosstat, World Bank staff calculations.

of consumption and gross capital formation in GDP in 2015-2016. Domestic demand is not expected to go back to the 2013 levels during the projection period. Meanwhile, as some exporting companies managed to benefit from the relative price adjustment, exports experienced growth in 2014-2016. Their share of GDP increased in 2015-2016 and is projected to increase in 2017-2019. We anticipate some slowdown in export volume growth in 2018 on the back of flat oil production. Growth of exports is expected to accelerate in 2019 with higher oil production. Meanwhile, the increased importance of exports as a growth driver amplifies government policies aimed at improvement of the external trade regulatory environment (See Table 6).

Non-tradable sectors are expected to drive growth in the medium term. Supported by transportation, construction, real estate, wholesale trade and the financial sector, services are set to resume growth in 2017 (Figure 34). With the banking sector's performance gradually stabilizing, its near-term outlook is also improving. Reviving credit growth, however, especially in the corporate and SME segment, will remain a key challenge. Growth in the retail segment is expected to be largely driven by mortgages, given a strong demand and declining mortgage interest rates. Due to an anticipated flat oil production in 2018 and high base of gas production in 2017,

industrial production growth is expected to slowdown in 2018, and bounce back in 2019 as the oil production increases.

The current account surplus is set to increase.

An increase in the current account surplus is expected as moderately strengthening oil prices support exports and growth of imports slows down in 2018-2019 (Table 6). Growth in export volumes will also support the current account.

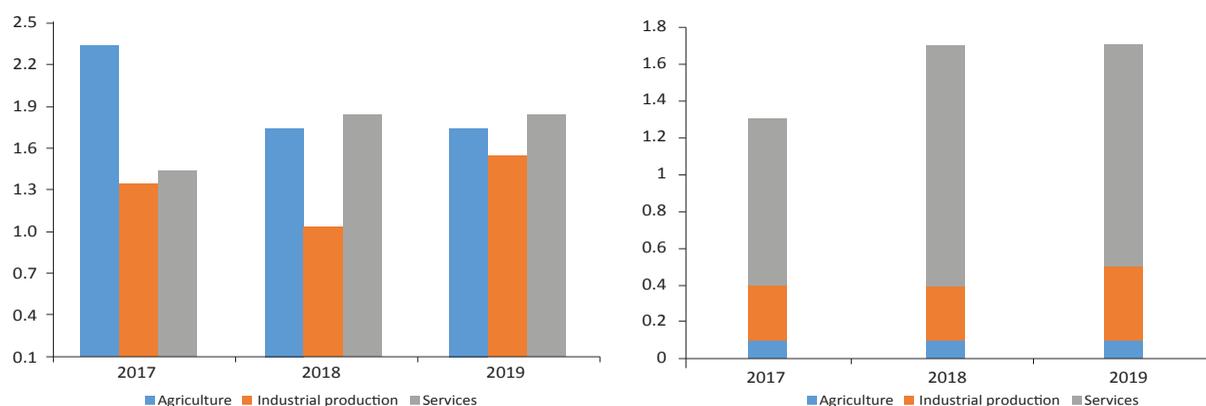
The poverty rate is expected to decrease slightly on the back of decelerated inflation and recoveries in private income and consumption.

Driven by a rebound in disposable income and consumption, the poverty headcount is projected to decline in 2017 to 12.9 percent in the baseline scenario after reaching 13.5 percent in 2016 (Figure 35). The poverty rate should continue declining in the baseline scenario in 2018 and 2019 to 12.6 and 12.2 percent, respectively, as income and consumption grow further. Among the factors that could fuel real income growth are a deceleration in inflation and a general recovery in the economy. As to public transfers, they may see additional support with the upcoming presidential election in early 2018. Figure 35 also shows the sensitivity of poverty projections to the minus/plus 15-percent change in oil prices (scenarios 2 and 3) compared to the baseline.

Figure 34: Non-tradable sectors are expected to drive growth in the medium-term

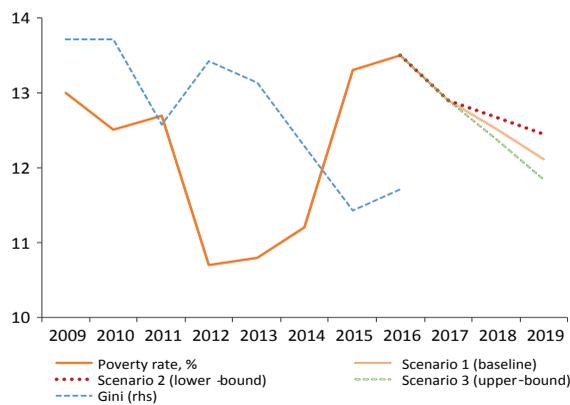
(Projected growth by sector, percent)

(Contribution to GDP, pp)



Source: World Bank staff calculations.

Figure 35: The poverty headcount is likely to decline in 2017 and beyond (Percent)



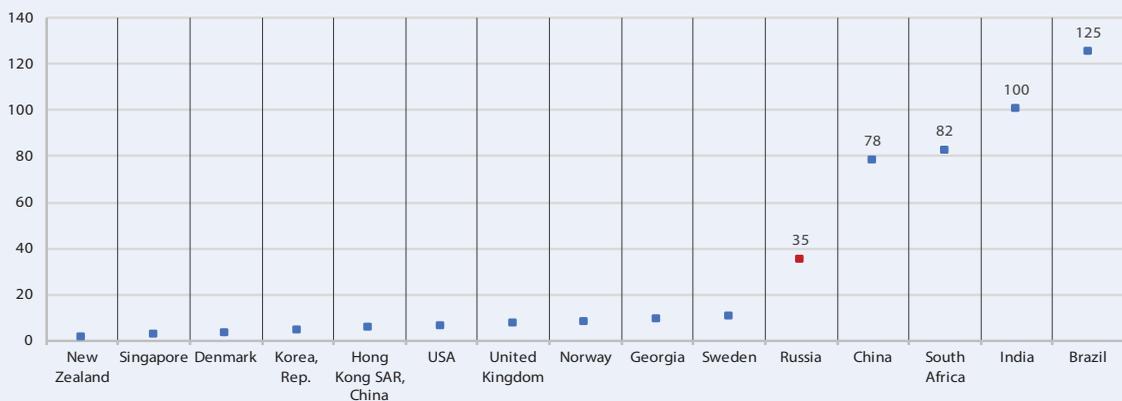
Source: Rosstat, World Bank staff calculations.

Weak growth in Total Factor Productivity (TFP) and a shrinking labor force constrain GDP growth in the medium to long term. As noted in Russian Economic Report #37 “From Recession to Recovery,” TFP growth in Russia has been declining over time. Addressing this constraint will require deeper and speedier structural reforms. While Russia continues its progress in improving its regulatory environment (Box 6), priority policy objectives remaining include limiting the role of the state in the economy, improving institutional and regulatory frameworks, and promoting fair competition (See “Russian Federation—Systematic Country Diagnostic: Pathways to Inclusive Growth”).

Box 6 Russia is 35th out of 190 in the Doing Business 2018

Doing Business (DB) is a flagship World Bank project that provides an objective measure of business regulations and their enforcement across 190 economies around the world (Figure B6-1). The report tracks the business regulations across ten indicators²³ that apply to firms throughout their lifecycle—from entering the market to operating the business and, when necessary, enforcing contracts and exiting.

Figure B6-1: Top 10 economies, Russia and BRICS in Doing Business 2018 ranking



Source: Doing Business database.

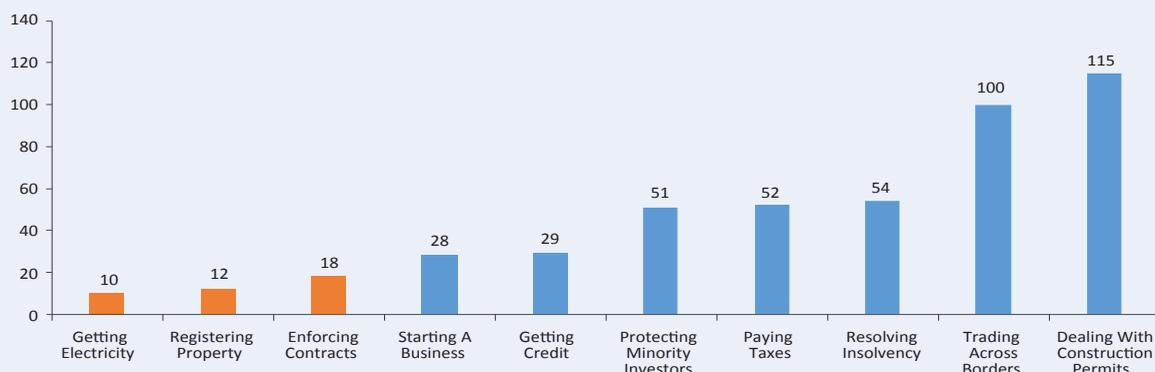
This year, Russia ranked 35th in the Doing Business 2018 report out of 190 economies—an improvement of 5 points over last year.²⁴ Russia ranks in the top 20 globally in three indicators—**Getting Electricity (10th)**, **Registering Property (12th)** and **Enforcing Contracts (18th)**. It is in the top 30 in two more—**Starting a Business (28th)** and **Getting Credit (29th)** (Figure B6-2). Russia gained recognition in the Doing Business ranking thanks to three positive reforms in 2016/17. In Registering Property, Russia made it easier to transfer property by reducing the time needed to obtain state registration of title transfers. Russia also improved in **Getting Credit** by adopting a law that improved the collateral registry. Finally, Russia’s performance on **Trading Across Borders** also improved significantly, moving from 140th to 100th position between DB 2017 and DB 2018 as a result of opening a new deep-water port on the Gulf of Finland, which increased competition and reduced the cost of border compliance at the Port of St. Petersburg. Another factor that led to improved DB performance was the continuing

²³ The Doing Business indicators: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency.

²⁴ Beginning with Doing Business 2018, previous year country ranks are no longer being adjusted. The DTF (Distance to frontier) for the immediate prior year is still adjusted to reflect data corrections

improvement in implementation of reforms. It is important to highlight that the Doing Business report is based on feedback from firms, so for most indicators, improvements in legislation are not enough—they must be enforced so that firms see improvements on the ground.

Figure B6-2: Russia ranks in top 20 globally on three indicators



Source: Doing Business database.

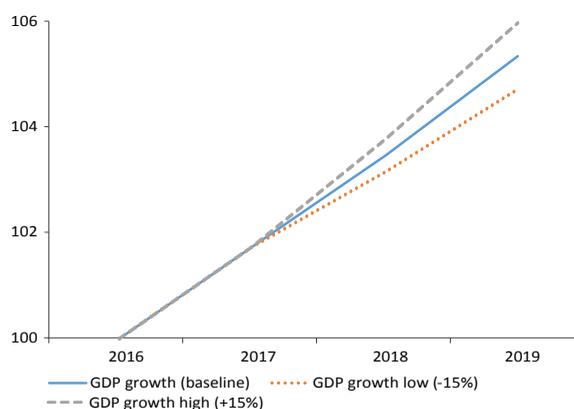
Over the past years, Russia has made great strides in Doing Business, but there are still a number of important areas where more work must be done. Of the ten indicators, Russia's worst performers are **Dealing with Construction Permits**²⁵ (115th) and **Trading Across Borders**²⁶ (100th). Both these areas have seen major improvement over the past six years, but they continue to lag OECD averages for the number of procedures, time, and cost involved with compliance for firms.

Risks and challenges: The outlook is subject to both downside and upside risks. The upside risk comes from a possible stronger-than-expected growth in large advanced economies and hence higher Russian exports other than crude oil, which is limited by the OPEC+ agreement on production cuts. External downside risks stem from a significant drop in oil prices, a sudden tightening of global financial conditions and possible negative impacts from the expansion of sanctions. Domestic downside risks stem primarily from a growing discrepancy between real wages and disposable incomes (as discussed in Box 2), and a vulnerable banking sector (as discussed in Box 3). Though it should be emphasized the banking sector risk is not deemed systemic, given the recent failures of some large banks, preserving its stability and maintaining public confidence will be a key challenge.

The fiscal rule and the lead-up to it suggest future reduced sensitivity of GDP growth to oil price volatility. A simulated decrease of 15 percent in

oil prices would reduce growth to 1.4 percent in 2018 and 1.5 percent in 2019. A simulated rise of 15 percent in oil prices would increase growth to 2.0 percent for 2018 and 2.1 percent in 2019 (Figure 36). The introduction of the fiscal rule helps shield the federal budget from oil price volatility, and that suggests reduced sensitivity of the economy to oil price variations.

Figure 36: Government policy made the GDP growth rate less sensitive to oil price volatility
(GDP growth, percent)



Source: World Bank staff calculations.

²⁵ Dealing with Construction Permits evaluates procedures, time and cost to complete all formalities to build a warehouse and the quality control and safety mechanisms in the construction permitting system.

²⁶ Trading Across Borders considers time and cost to export the product of comparative advantage and import auto parts.

PART III

RUSSIA'S AGRICULTURE SECTOR: PROFITS, PERFORMANCE, AND PRODUCTIVITY



3. Russia's Agriculture Sector: Profits, Performance, and Productivity

Agricultural support policies have helped transform Russian agriculture. In the past five years, not only has Russia become the world's largest exporter of wheat, but it has reached self-sufficiency in pork and poultry. However, policies to further broaden productivity, market infrastructure and research and development could lead to stronger competitiveness of the sector in the long-term.

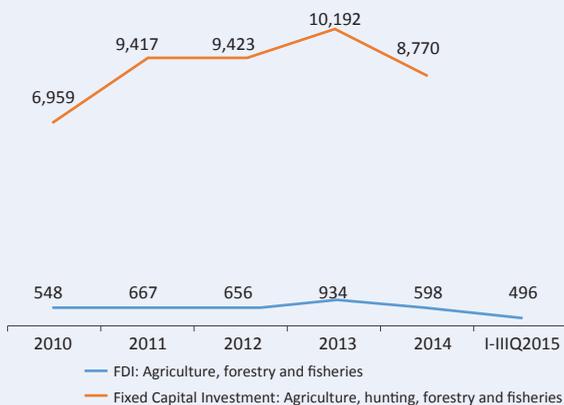
Russia is a major producer of agricultural commodities and plays an important role in global grain markets.²⁷ It has the largest expanse of agricultural land in the world. Russia is ranked fifth in the world by agriculture value-added and seventh by total foreign direct investment (FDI) inflows in the agriculture sector (see Box 7). The country is the world's largest producer of barley; the fourth-largest producer of wheat, and most recently its largest exporter; the second-

largest producer of sunflower seeds; the third-largest producer of potatoes and milk, and the fifth-largest producer of eggs and chicken meat. Domestically, the share of the agriculture value added is 4.3 percent of GDP. Agriculture and food manufacturing value-added together comprise 6.3 percent of GDP. The agri-food processing sector contributes 13.5 percent of the value-added of the country's total manufacturing, but less than 2.0 percent of its GDP.²⁸

Box 7 Foreign Direct Investment in the agri-food sector

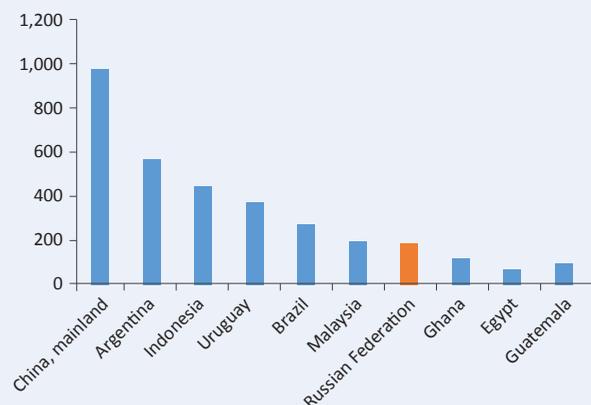
The Russian agri-food sector has attracted considerable investment in the recent decade (Figure B7-1). The food manufacturing sector, including beverages and tobacco, received around 4.0 percent of all FDI, and the agriculture sector received around 0.4 percent of FDI. Such FDI performance compared positively with other countries, and Russia has been consistently in the top 10 countries with the most FDI in its agriculture sector (Figure B7-2). However, experts suggest that a considerable part of agri-food sector FDI was due to round-tripping—that is, Russian investments undertaken by Russian investors from foreign jurisdictions. Given the large market size, the majority of FDI in the food manufacturing sector has been market-seeking, therefore limiting potentially larger scale trickle-down effects for technology transfer and productivity gains (Kuznetsov 2012).

Figure B7-1: FDI and Fixed Capital Investment
(US\$, millions)



Source: Bank of Russia and ROSSTAT database.

Figure B7-2: Top 10 countries with FDI inflows in agriculture, 2000–13
(US\$, millions)



Source: FAOSTAT database.

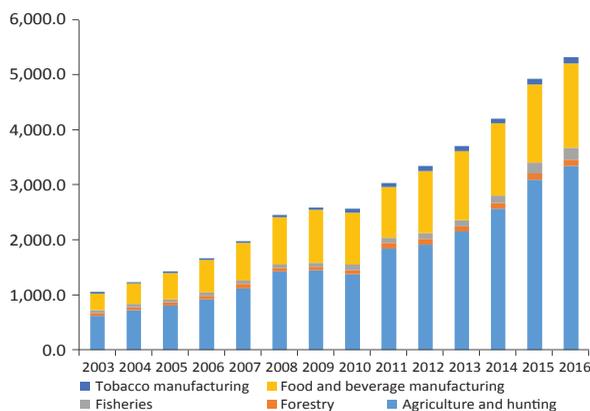
²⁷ The data presented are from the FAOSTAT database.

²⁸ ROSSTAT database.

The agriculture sector has shown resilience to the recent economic crisis. The sector had a gross value-added (GVA) growth rate of 3 percent in 2015 and 3.6 percent in 2016, and an expected growth rate of 1.7 to 2 percent in 2017, against a general decline of the economy of 2.8 percent and 0.2 percent in 2015 and 2016 respectively (Figure 37). The food and beverage manufacturing sector recorded an impressive 4.7 percent growth in 2016, albeit after two consecutive years of decline (Figure 38).

Since 2015, Russia has had bumper harvests of grains, becoming the largest exporter of wheat in the world. The devaluation of the ruble, the Russian response to Western sanctions—the so-called countersanctions, and restrictive trade measures—through sanitary and phytosanitary border controls, boosted production and broadened domestic market access (Box 8). The key policy challenges faced by the authorities will be how to boost export performance and how to ensure that the agri-food industry is competitive in the long run. To achieve this, the sector requires a different approach to government support programs, such as policies that broaden the gains beyond the large corporate farming sector; policies that attract FDI, which brings new technologies and market access; and policies that boost investments in market infrastructure, research and development.

Figure 37: Overall continuous growth in food and agriculture sector value-added, 2003-16



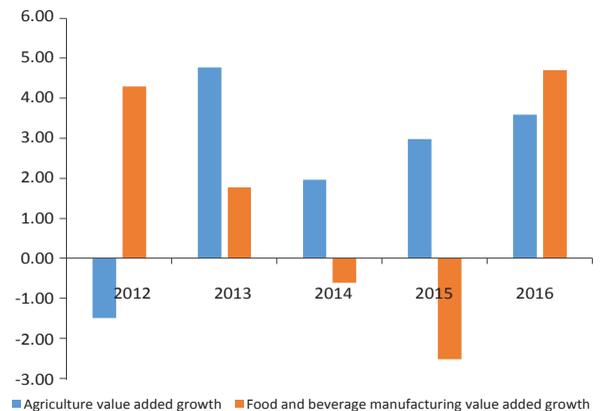
Source: ROSSTAT database.

Export performance and overall sector competitiveness are among the most important challenges for the agri-food sector's long-term performance. For long-term growth performance, the sector needs to boost its competitiveness and access to new markets, including with value-added production. Two central facts characterize the Russian agri-food trade.

First, despite recent positive export trends, agri-food exports have remained mainly concentrated in the grain sector. Exports have picked up overall since 2007. The annual rate of growth in agri-food exports since 2007 is impressive, at 7.7 percent, compared to agri-food imports at 0.2 percent during these years. However, moving beyond grains, exports of poultry meat products and some processed food products (mainly confectionary and condiments) are relatively limited, even though domestic production surpasses domestic demand. It is important to highlight the fact that net agri-food trade flows have always been negative. The trade patterns depicted from 1998 to 2015 in Figure 39 show the trade balance to have narrowed in 2014 and 2015.

Second, the country is a net food importer. The average share of agri-food exports in total exports has remained close to 2 percent in 2007-15, whereas agri-food imports continue to hold a sizeable share in total imports (averaged

Figure 38: However, growth rate in value-added of food manufacturing sector is mixed, 2012-16 (Percent)



Source: ROSSTAT database.

Box 8 How the Russian agri-food sector responded to recent economic shocks

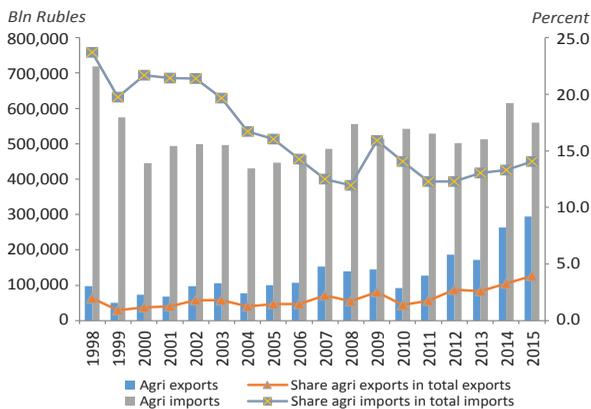
A recent combination of economic shocks resulted in a deterioration of terms of trade for the Russian agri-food sector over the course of the past three years. The first shock was the depreciation of the ruble exchange rate resulting from the drop in global oil prices. The Russian ruble lost 46 percent of its value between July and December 2014. The decline boosted the price competitiveness of commodity exports (Shagaida and Uzun 2016), which registered a record volume in the 2015-16 export seasons, pushing Russia to the top place in grain exports. At the same time, major agri-food producers and exporters complained that their costs of production suffered because their inputs and technology investments became more expensive. According to the Bank of Russia's survey in May 2016, more than 80 percent of agri-food producers interviewed would have preferred a stronger ruble in order to reduce the costs of imported technology and other inputs for their production (Bank of Russia 2016).

The second shock was the decline in consumer incomes, which led to reduced consumption. Food purchases constitute significant share of average household expenditures, and the average share of food expenditures in total expenditures rose to 38 percent for the whole population in 2014. Consumers switched to less expensive food products. The net effect from consumption decline has been difficult to measure, but recent research suggests that food retail trade declined considerably.^[a]

The third shock was the decision by the government to embargo imports from countries that imposed sanctions on Russia as a result of the political crisis around Ukraine. According to some experts, the effects of these measures were significant in that they reduced the availability of certain food items (fresh fruits and vegetables, cheeses and other dairy products, and so on). Russian suppliers shifted to alternative markets in the search for substitute channels for food products. The domestic sector response has been relatively quick, expanding production, but with a time lag required to substitute domestic supply in absence of investment growth (World Bank 2017b). This is probably the biggest shock, which created market imbalances and significantly reduced the availability of key food products. Domestic prices responded. As a result, food prices increased; they are still above international levels for several key food products. Such imbalance created a favorable environment for key domestic subsectors (dairy, pork and poultry, beef), which in turn benefited from more directed government support programs.

Note: ^[a] Based on the data from the Analytical Center for the Government of Russian Federation. 2015 "Results of Food Embargo". World Bank Group. 2017b. Russia Economic Report, No. 37, May 2017: From Recession to Recovery. World Bank, Washington, DC

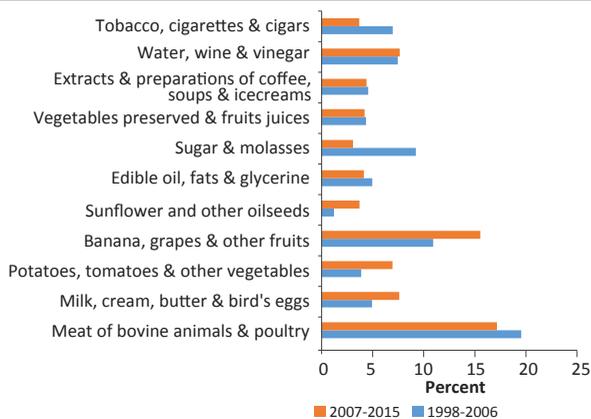
Figure 39: The agri-food trade balance average has been negative but Narrowing, 1998–2015
(Percent share in total value of agriculture exports)



Source: Authors' estimates, based on COMTRADE data.

16 percent in the same period), indicating the country's high level of demand for food imports (Figure 40). This demand remains high even though there has been a consistent decline in the share of agri-food imports in total imports—from a high of 24 percent to almost 14 percent since 2009. Moreover, the composition of the agri-food trade has not shown any significant change over time. Commodities have a relatively higher share in total agri-food exports; they include cereals (43 percent) and edible oils (12 percent) (Figure 41). However, Russian commodities are priced lower, due to their low grades and the lower quality of the commodity products supplied (e.g. wheat). On the other hand, the agri-food import basket is shifted towards

Figure 40: Agri-food imports: High-value food products



Source: Authors' estimates, based on COMTRADE data.

higher value products, such as beef, fruits, and vegetables, whose combined share in total agri-food imports has varied from 5 to 20 percent.

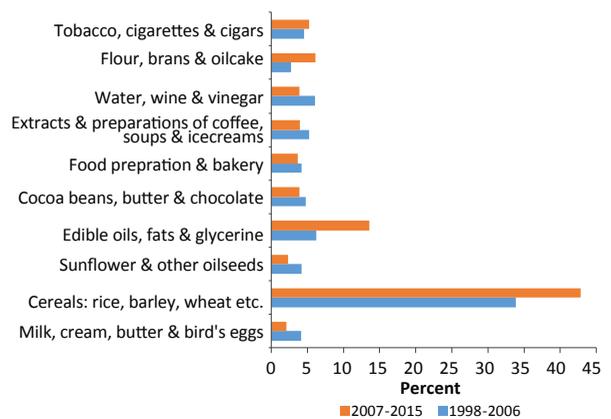
To boost export performance, and to ensure that the industry is competitive both domestically and internationally, structural reforms are needed.

The Russian agri-food sector needs to continue to improve productivity, to expand food processing and manufacturing with much stronger linkages to agricultural production, and to substantially increase value addition in agricultural production. Policies to further broaden productivity, market infrastructure and research and development could lead to stronger competitiveness of the sector in the long term.

The agri-food sector is faced with several challenges, when looking at the long-term performance opportunities:

Competitiveness: *The overly protective market environment results in high domestic prices for food commodities. In the short-term, high prices may attract investments only in primary agriculture, where the length of the project payoff period is lower than in downstream sectors. In the long-term, agricultural sector growth would increasingly depend on how downstream sectors would generate domestic demand by creating value-addition opportunities.*

Figure 41: Agri-food exports: commodities



Source: Authors' estimates, based on COMTRADE data.

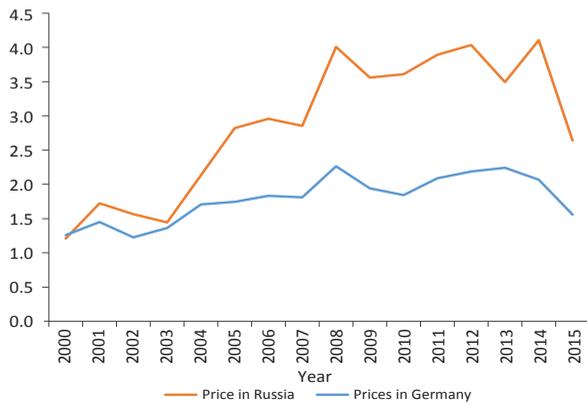
In the short term, market-protection measures may deter investments in the agri-food processing industry.

This is because high domestic farm prices (Figures 42 and 43) incentivize investing in primary agriculture, making it more attractive than investing in food manufacturing (all other factors held constant). However, as experience in other countries shows, in the long term, demand for processed food will continue to increase, primarily because of dietary transitions and the increasing incomes of the urban middle class (Minten, Reardon, and Chen 2017). Public policy may consider gradual steps for promoting investments in the food manufacturing industry with a view to improving the competitiveness of both primary and processed food sectors. Progressively raising the quality and targeting of public expenditure in agricultural services (extension, research, education, and food safety and quality) and supporting infrastructure development to the levels like those of Russia's closest comparators (The EU, the BRICs, and the G-20) would do much to increase the competitive edge of the sector.

The key distinguishing characteristic of government support policies has been that public expenditure has been heavily directed at private goods to the possible detriment of public goods (Box 9). Concessional credit has been the major support instrument in the form of subsidies on

Figure 42: Pork prices in Russia are higher than in Germany

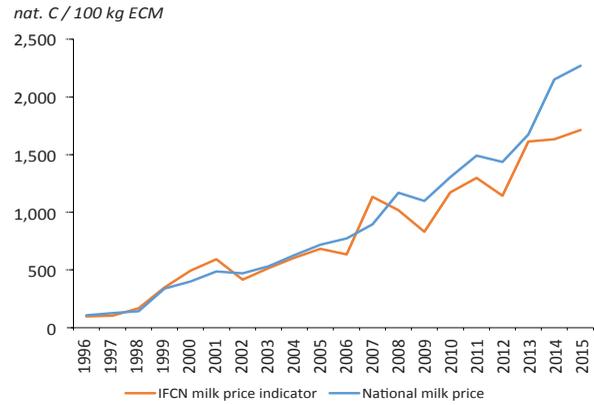
(Slaughter weights, USD per kg CW)



Source: Agribenchmark.

Figure 43: Milk prices in Russia are higher than the world prices

(Ruble per 100 kg ECM)



Source: International Farm Comparison Network.

interest-rate payments. Starting in 2005, support measures also included direct capital grants (from 25 percent to 35 percent of investment, depending on the activity) for funding investments in priority sectors, to some extent supporting some value-adding productions, such as slaughterhouses and milk processing.

Overall, the level of investment in public goods has been consistently low compared to OECD and BRIC comparators. A comparison of general services support estimates of Russia (Figure 44a)

and OECD countries (Figure 44b) reveals that Russia is consistently underperforming OECD comparators in the types of public investments in agriculture that normally generate productivity gains throughout the industry. Investment levels in extension, education, research and development, and other public goods are persistently low. Another interesting characteristic of public investments in agriculture is that they are heavily skewed toward so-called miscellaneous categories—that is, those categories that do not fit the general description of public investments.

Box 9 Types of agriculture support measures in the Russian Federation

Interest-rate subsidies. There are two types of interest-rate subsidies: (1) working capital, and (2) investment loans. These subsidies comprise the largest share of funding of agricultural support measures.

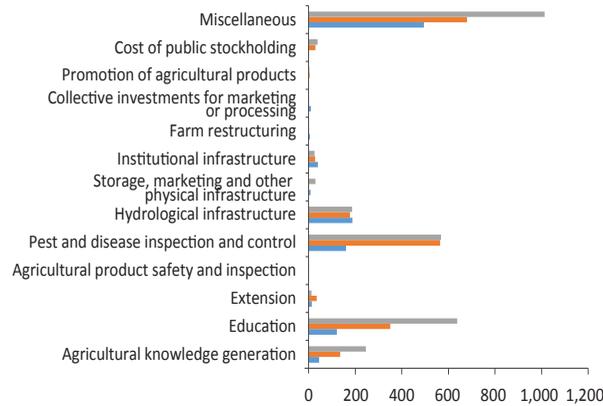
Area payments. Area payments were introduced in 2012. They are provided by the federal government via regional administrations to all commercial agricultural producers as a decoupled subsidy. This procedure was triggered by Russia's World Trade Organization (WTO) accession as an attempt to repackage direct WTO amber box production subsidies into the green box. However, it seems that many regional governments began to incorporate various additional conditions to eliminate "negligent" farmers.

Direct subsidies to agricultural machinery manufacturers for selling machinery to domestic farmers. These subsidies were introduced in 2012. They include a discount of 15 to 30 percent for farmers if they acquire domestically manufactured agricultural machinery. This is an indirect subsidy to domestic agricultural producers and is provided as a support measure to domestic manufacturers. If agricultural machinery is produced abroad but assembled in Russia, under this scheme it qualifies as "domestically" manufactured.

There are also less-sizable, indirect farm support programs. They involve melioration and soil conservation, rural development, breeding activities, and so on. These programs, however, make up only a small portion of government support to agriculture.

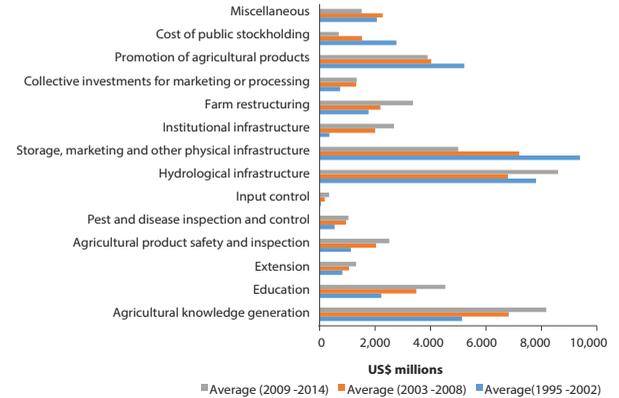
Figure 44: General services support estimates, 2009-14

(a. Russia)



Source: OECD Production Support Database, <http://www.oecd.org/tad/agriculturalpolicies/producerandconsumerssupportestimatesdatabase.htm>

(b. OECD)



Source: OECD Production Support Database, <http://www.oecd.org/tad/agriculturalpolicies/producerandconsumerssupportestimatesdatabase.htm>

Most countries that achieved significant results in agriculture and agri-food sector productivity boosted their agriculture and food industries by investing considerably in public goods, such as agricultural advisory services and education, veterinary and animal health, research and development, and so on. The literature has many empirical examples that demonstrate such successes in China (Jin, Huang, and Rozelle 2010), Australia and New Zealand (Mullen 2010), Canada (Veeman and Gray 2009), and many other countries. In the case of Russia, however, as evidenced by the analyses of factors that impact TFP in food manufacturing²⁹, the amount of public spending and expenditure on agriculture support services does not seem to significantly impact productivity in the food manufacturing sector. Going forward, more in-depth analysis of impact of public investments in agriculture and food industry productivity may be required.

Despite trends showing that the Russian agri-enterprises are catching up with those of competitors in terms of productivity, overall agricultural productivity continues to remain below international benchmarks. Considerable investments have been made in new technologies that have replaced old and obsolete ones as more financial resources became available, both from public and private investments. However, these investments have not yet resulted in broad-based productivity gains for the whole industry, although some enterprises have successfully outperformed their peers. Going forward, more broad-based productivity gains could be achieved and growth maintained by introducing policies that support the spread of innovation and technology throughout the entire industry.

Productivity: Russian farms are less productive and less profitable than their foreign comparators. In the short-term, they are benefiting from government support, high market prices and low land costs and wages. But they face low labor and capital productivity, even with the same technologies as their comparators in other countries. With increasing labor costs and scarce labor, a growing economy can put pressure on competitiveness of agri-food enterprises and farms. Policies that support agricultural education, research and development and public-private advisory services could help improve labor skills and access to better technologies (such as seeds and machinery).

²⁹ See World Bank. Russia: Policies for Agri-Food Sector Competitiveness and Investment. Washington, DC: World Bank, 2017.

Agricultural enterprises (especially those in the livestock sector) are profitable in the short term mostly because of two factors: low-cost feed production and high domestic prices for meat and milk. A closer look at the cost structure of meat and milk production suggests that around 50 to 60 percent of costs go to buying feed, where Russia has a comparative advantage; these costs reduce the overall costs compared with benchmarked farms in North America and Europe. Typical Russian farms have quite high labor costs, even though farm wages are much lower than wages in other comparator countries (see Box 10 for the description of the Russian farming sector).

There is potentially scope to improve labor productivity by a factor of three to five

through improved management and improved mechanization. On the other side, the capital input of Russian farms is almost twice as high as it is in comparable farms in Europe and the United States; clearly such high capital investments are not needed for the optimal combination of labor intensity and capital intensity. When typical farms in Russia are compared with similar countries (using a methodology developed by Agribenchmark and the International Farm Comparison Network), Russian farms normally lag behind in key physical productivity indicators such as land, labor, and capital productivity indicators (Figures 45a, b, and c). For dairy farms, labor productivity levels in Russia are about 30-40 kilograms of energy-corrected milk (ECM) per hour. The labor productivity levels in Germany are

Box 10 Russian farming sector

Russia's agrarian structure may help explain some of the successes of recent agricultural sector performance and the challenges it faces. The agrarian structure in Russia is based on three types of farms: (1) agri-enterprises—large industrial farms with large land and livestock holdings; (2) emerging family farms—individual farms operated by family farmers and limited hired labor; and (3) household plots—small land plots adjacent to rural homes. Around half of agricultural output is produced by agri-enterprises. Although many agri-enterprises are nearly the same in terms of the area farmed and in management and technology used as the collective farms of Soviet times, since 2000 more-advanced agri-enterprises have emerged. These enterprises can mobilize investments, utilize advanced technology, and import better management practices in the agriculture sector. They are sometimes called agro-holdings and are perceived to be the driving force behind productivity (Davydova and Franks 2015) and production growth. They also dominate the export of commodities. In many respects, these large agro-holdings are extremely concentrated vertical businesses that own the most-advanced technology. The value chains are limited to each individual agri-holding, and spillovers of technology beyond the borders of the holding are rare.

Agri-enterprises and family farms tend to specialize in the production of grain, oilseeds, and other industrial crops that require high levels of mechanization, while household plots generally produce potatoes, vegetables, fruit, and milk for self-consumption and sale in local markets.³⁰ The largest share of household plots (78 percent) specializes in the production of potatoes, but these farms sell only 17 percent of their production. The share of household plots in vegetable production was 68 percent in 2015, of which 16 percent was sold. By contrast, agri-enterprises sold 83 percent of their production and family farms 77 percent.³¹ In livestock, specialization has also emerged. Poultry is produced mainly by agricultural enterprises. Pork production is gradually specializing in agri-enterprises by pushing household pig farming out of business as a result of animal health and bio-safety concerns. Nevertheless, households were responsible for 39 percent of all livestock production, of which 46 percent was commercialized. They were also responsible for 46 percent of total milk production, of which 31 percent was commercialized. In general, the share of output of agri-enterprises has increased in total production. For example, in 2013 agri-enterprises contributed 47.6 percent of gross agricultural output. Their contribution increased to more than 52 percent in 2016.

³⁰ This discussion is based on Grosclaude 2016.

³¹ Agri-enterprises and family farms are fully commercial. The statistics show only the share of primary production sold. If the primary production is processed on farm, it is not reflected in the statistics. Most agri-enterprises are integrating up in the value chain and are acquiring processing facilities, which allows them to process their own production.

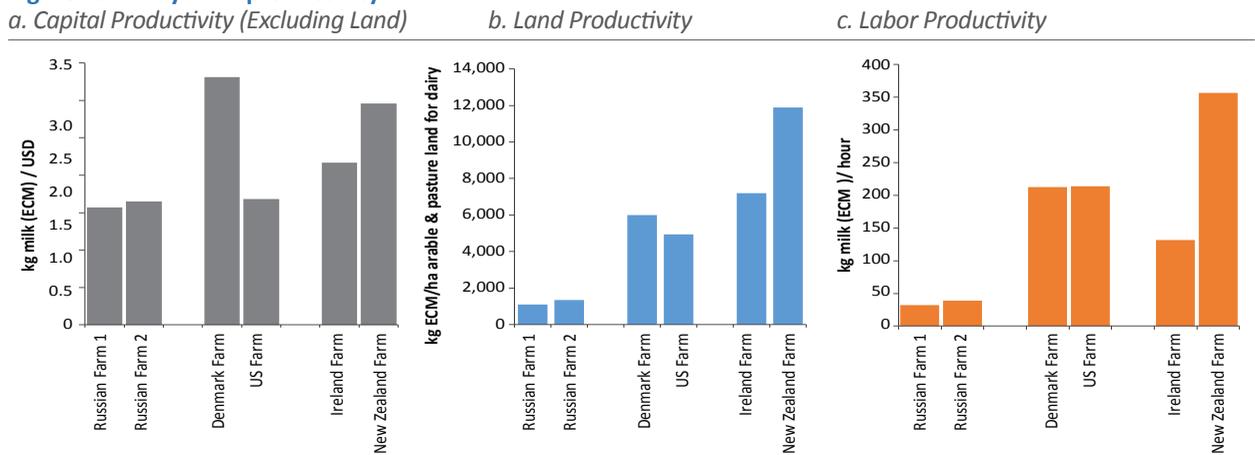
210 kilograms of ECM per hour; in New Zealand it is 355 kilograms of ECM per hour. The high levels of labor productivity in Germany and New Zealand are explained by good management and the efficient use of mechanization by highly skilled farm labor.

However, when it comes to costs, Russian farms tend to have a more favorable position than their foreign comparators. Land costs in Russia are the lowest among the countries compared, leading to extensive land-use practices as reflected in a very low stocking rate. This makes milk productivity per unit of land use low, at around 1,000 kilograms of milk per hectare. Land productivity levels in other countries are 5 to 12 times higher. However, with low costs of production, farms can sustain low

productivity rates, at least for the time being. Going forward, there is great scope to improve land use for dairy development, but because land is not yet a constraining factor, such potential may not be fully realized.

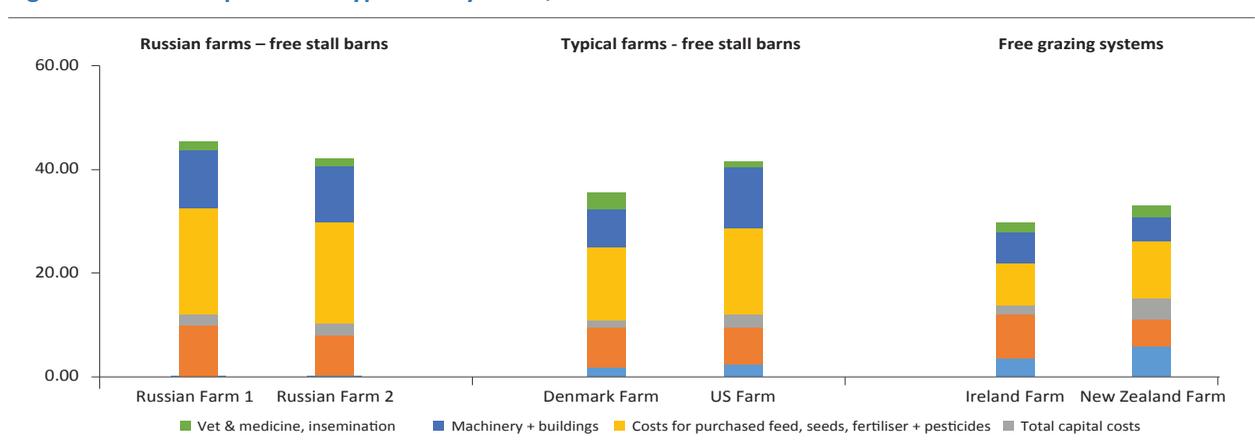
But when total costs are compared with benchmarked farms in advanced European and North American comparator countries, the combination of low physical productivity and low costs results in total costs that are still higher than those of foreign comparators on a per-unit basis (Figure 46). In the short-term, there is little incentive to reduce costs by improving productivity as market protection yields favorable prices, and demand continues to grow. The only limiting factor in the short-term for Russian agri-food enterprises

Figure 45: Dairy farm productivity



Source: IFCN International Farm Result Database 2016 Comparison Network (IFCN), <http://ifcndairy.org/>
 Note: ECM = Energy-corrected milk; ha = hectare.

Figure 46: Cost comparison of typical dairy farms, barns



Source: IFCN International Farm Result Database 2016 Comparison Network (IFCN), <http://ifcndairy.org/>
 Note: ECM = Energy-corrected milk.

seems to be capital. Capital investments in Russian dairy enterprises are almost twice as high as they are in comparators due to several factors, including low-quality infrastructure, high financial-market risks, geography and distance. For this reason, the greatest scope for improvement is in achieving capital efficiency in the short-term, including through public support policies that can help eliminate or reduce some of the external costs that put pressure on capital investments. In this situation, capital seems to be the only constraining factor.

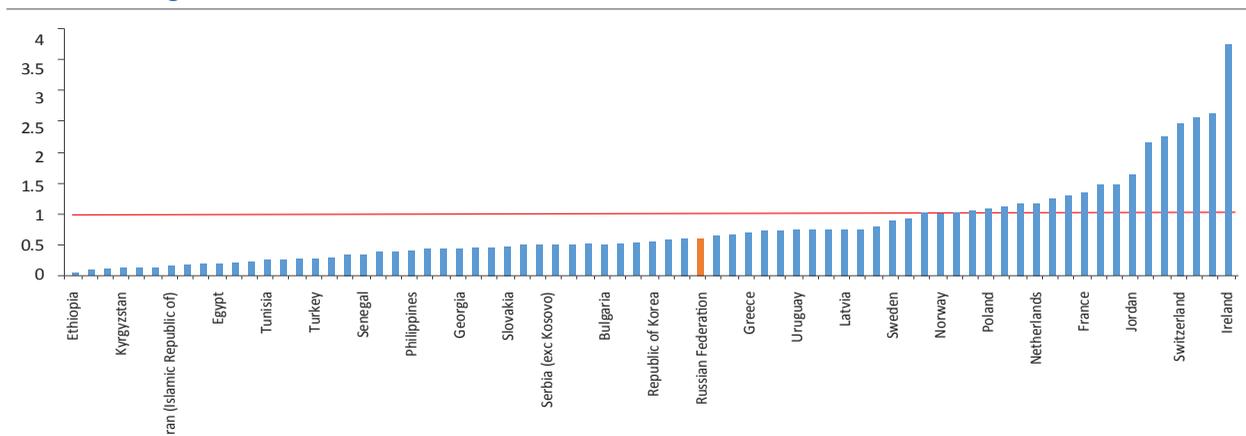
In the short term, incentives to improve labor productivity might not exist, but they would be required for long-term competitiveness. The favorable configuration of relative price factors poses medium- to long-term risks. Wages are likely to rise over time, as they have elsewhere (for example, in East Asian markets). Market-protection measures do not benefit the economy overall, are harmful to the consumers, and may not be enduring. Therefore, policies should gradually shift toward spreading innovation and technology throughout the agriculture sector and helping farms to stay profitable in the long term.

Russia's food manufacturing industry has grown over the past decade at a higher rate than primary agricultural production. However, the share of food manufacturing in the economy is still

Food processing and manufacturing: *The food-processing sector is relatively small for an economy the size of Russia's, and it has weak linkages with agricultural production. While the size and backward linkages of food processing and agriculture sectors vary from one region to another and depend on the structure of the Russian agri-food sector, overall the agri-food processing sector has the potential for higher growth if it can attract more investments. However, the sector has demonstrated good productivity growth. Improving value chains, boosting quality, helping access to markets and expanding exports, could help further grow the food processing industry. Such growth can have positive effects on the whole economy in terms of jobs and general economic growth.*

far below that share in countries at similar income levels, indicating that there are still opportunities for developing value-addition in the agri-food sector. Furthermore, the so-called depth of the food manufacturing sector—an indicator that measures the extent to which agri-food processing is developed in a country compared to primary agriculture—is also quite low in Russia (Figure 47). Relative to comparators, Russia's indicator is closer to that of commodity producer and exporter countries rather than to technologically advanced food manufacturers. Russia's food, beverage, and tobacco industry (farming and agribusiness taken together) constitutes a smaller share of the economy than in other OECD countries.

Figure 47: Depth of food manufacturing sector: Food manufacturing value-added/agriculture value-added, 2005–14 average



Sources: FAOSTAT data and authors' calculations.

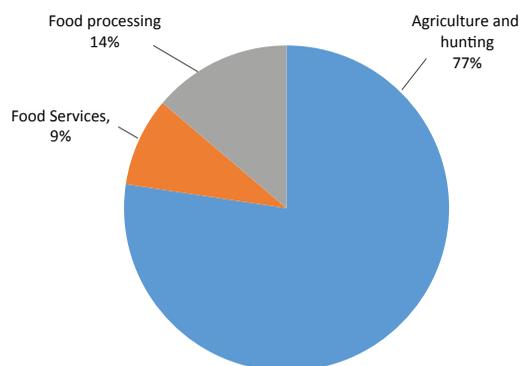
In general, Russia's food-sector employment (employment generated by the agriculture, food manufacturing, and food-service sectors) is skewed toward agriculture (Figure 48). A more desirable structure in food-sector employment would include more jobs in value-added sectors such as food processing and food services. In high-income countries, within the food system, agriculture accounts for a smaller share of jobs, while food services accounts for most jobs. For example, in the United States, agriculture accounts for about 20 percent of overall food system jobs and food manufacturing accounts for 14 percent of jobs, while food services accounts for about two-thirds of the jobs in the food system. Such transformation is achieved by upgrading the skillsets of rural labor, both in primary agriculture and in other food sectors. Modern agricultural production demands highly skilled labor, with workers who have knowledge of modern practices and tools, such as information and communication technologies. In addition, skills beyond agricultural production—including in food storage, grading, processing, and alternative energy—also need to be developed to facilitate food systems transformations and investments, including FDI, in response to changing consumer demand (Townsend et al. 2017).

Salaries in the food-manufacturing sector (as well as in other food sectors) have been declining in the last 15 years, compared with average salaries

in the economy (Figure 49). This indicates that the food manufacturing industry may be losing its appeal. It also indicates that, as the industry becomes more technologically advanced, it is not attracting enough higher-skilled (and therefore higher-paid) workers.

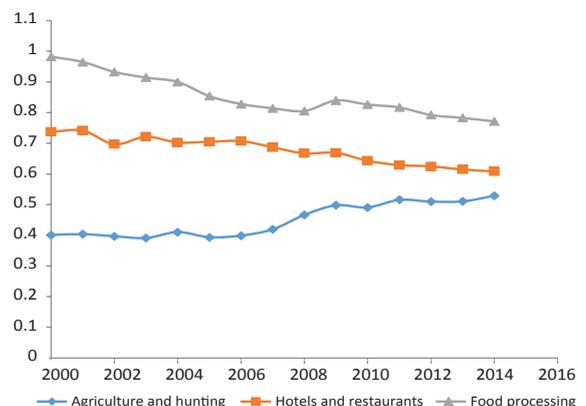
Production and output-per-factory in the food-processing sector have grown quite rapidly in recent years, primarily because of an increase in the scale of operations, i.e the output per factory (Figure 50). However, the number of enterprises grew at a much slower pace and employment per factory has barely increased. The sector has not demonstrated notable employment generation, despite the relatively low exit rate of enterprises in recent years. Although the average number of workers is much higher in food processing than in beverage and tobacco, labor productivity per employee is significantly lower in food processing, at 1,475,000 rubles compared to 1,946,000 and 7,875,000 rubles in beverage and tobacco respectively. This shows that the food processing sector has a diverse technological base: there are some advanced manufacturing enterprises with new technologies and some old, Soviet-era legacy enterprises. In contrast, the beverage and tobacco subsectors enjoy higher-level technological advancement because FDI in these sectors has been rapid and comprehensive—the beverage and tobacco segments have aimed to quickly establish themselves in the domestic market.

Figure 48: Composition of food-sector employment, 2010-2015 average



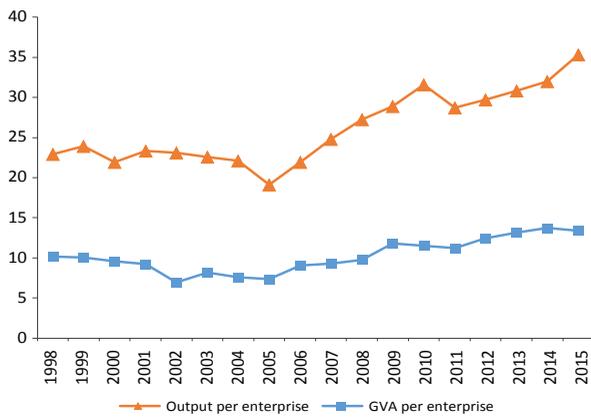
Source: ROSSTAT database.

Figure 49: Ratio of the average wage in the industry to the country's average wage, 2000-2015



Source: ROSSTAT database.

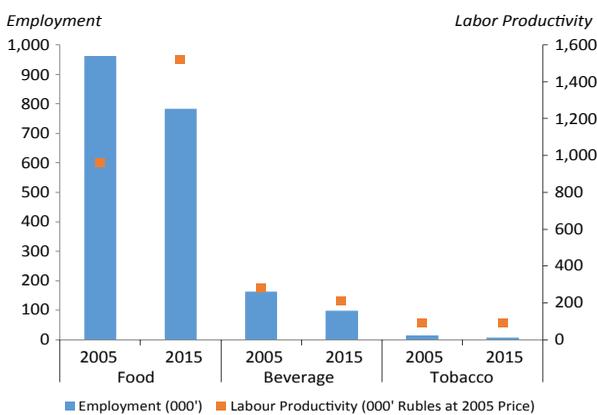
Figure 50: Output and gross value-added per enterprise in food enterprises, millions of rubles at 2005 prices



Source: Authors' calculations based on ROSSTAT database.
 Note: GVA = gross value-added.

From 2005 through 2015, employment in each of these three subsectors fell at an annual rate of 2.27, 5.25, and 6.15 percent respectively (Figure 51). However, labor productivity grew at 3.67 percent per annum only in the food sector, which has been able to upgrade technology. Labor productivity increased more rapidly in food only after 2012. The key subsectors within food include meat and dairy processing, bakery, fish preserving, and the vegetable oil industry. Both the beverage and tobacco segments have declined at the rate of 4.36 and 0.59 percent respectively. Figure

Figure 51: Changes in employment and labor productivity in food enterprises, 2005 and 2015



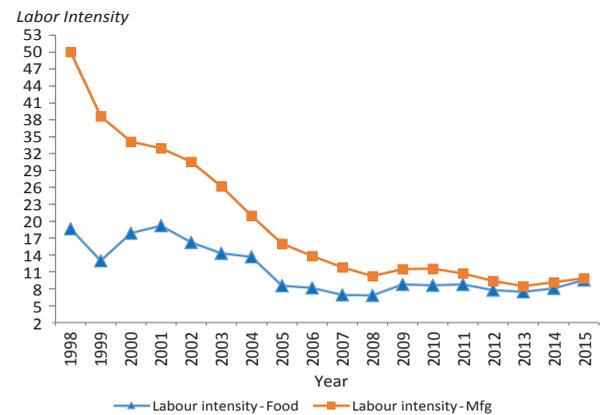
Source: Authors' calculations based on ROSSTAT database.

51 depicts changes in employment and labor productivity in each sector at two points in time: 2005 and 2015.

As Figure 52 shows, the fall in labor intensity in food enterprises was less steep than that in total manufacturing until 2007, after which the two moved at the same rate. Such a fall in labor intensity is consistent with the investments made in technology; after 2013, some signs of improvement are visible in both.

Consistent with this trend, labor productivity has risen, as have the levels of wages—albeit at a declining rate compared with the rest of the economy—while capital intensity declined and capital productivity increased. It is important to mention that labor productivity has risen faster in the food processing, but wages have increased more rapidly in the overall manufacturing sector. Like labor productivity, capital intensity³² is much higher in food—1.5 to 2 times more than in total manufacturing. Capital productivity and the wage rate have almost converged, but significant gaps remain in labor productivity and capital intensity in favor of food enterprises, thereby suggesting its high growth potential in the country.

Figure 52: Trends in labor intensity in total manufacturing and food enterprises, 2005 Prices

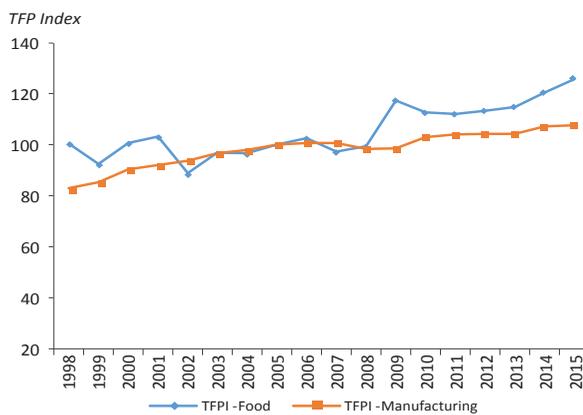


Source: Authors' calculations based on ROSSTAT database.

³¹ Capital intensity is the amount of fixed or real capital present in relation to other factors of production, especially labor. At the level of a production process or the aggregate economy, it may be estimated by the capital to labor ratio. Labor intensity is the relative proportion of labor (compared to capital) used in a process. Its inverse is capital intensity.

Like partial productivity measures, TFP tends to be much higher in food than in total manufacturing. The TFP index in the food sector was 97.98 during 1998-2006; it jumped to 112.6 during 2007-15, growing significantly at an average rate of 1.51 percent per annum. A higher rate of growth in TFP is identified only in the second period. This contrasts with total manufacturing, which witnessed a higher rate of growth in the first period at 2.43 percent and a decline at 1.08 in the period that follows (Figure 53).

Figure 53: TFP index in food enterprises and total manufacturing, 1998-2015, 2005 prices



Source: Authors' calculations based on ROSSTAT database.

These results show that the food-processing sector is undergoing technological modernization and improving labor productivity. However, lower wages and stagnation in the movement of workers from one sector to another may indicate that labor is not moving from agriculture or other lower productivity sectors to food manufacturing. There could be constraints to the movement of labor as a result of infrastructure, geography or major skill gaps. The lack of skilled labor could be one of the main impediments to further labor productivity growth in food manufacturing. As firms improve their technologies, they drive out unskilled labor and demand a more skilled labor force. Training and re-training would be costly for these firms, putting pressure on their profitability and competitiveness. Government policies should focus on promoting vocational education and

worker training and retraining, and on improving the availability of a skilled labor force in the food processing industry.

Policies to unleash the potential of the agri-food sector

With the caveat that further analysis would be merited to identify such policy and programmatic interventions, public policy in three areas could improve the performance of Russia's agri-food sector:

First, investing in broadening productivity gains in priority sectors. Russian agricultural subsectors are catching up with those of competitors in terms of productivity and are close to achieving competitiveness with international comparators. Considerable investments have been made in new technologies, which replaced obsolete technologies as more financial resources became available both from public and private investments. However, these investments have not yet resulted in broad-based productivity gains for the whole industry, although selected individual enterprises have successfully outperformed their peers. More broad-based productivity gains could be achieved and growth maintained by introducing policies that support the spread of innovation and technology throughout the entire industry.

In addition, profitability in priority subsectors (pork, poultry, dairy, grains) is largely a result of low labor costs, and the cost structure of key priority commodities shows that physical labor productivity is low compared with comparators in North America and Europe. Farms also benefit from favorable market conditions because market prices for most agricultural products are high in Russia thanks to market protection measures. In this situation, capital seems to be the only constraining factor: capital costs are high and investments depend on many externalities. In the short term, incentives to improve labor productivity might not exist, but labor productivity

would be required for long-term competitiveness. The favorable configuration of relative price factors poses medium- to long-term risks. Wages are likely to rise over time, as they have elsewhere (for example, in East Asian markets). Market protection measures do not benefit the economy overall; are harmful to the consumers, and may not be enduring. Therefore, policies should gradually shift toward spreading innovation and technology throughout agriculture industry, and in helping farms to stay profitable in the long term.

Second, strengthening value chains and value-addition in the food industry. The food manufacturing industry is small compared to the agriculture sector and to the rest of the economy. But it is productive, with productivity growth showing some good prospects for sector expansion. However, the sector is not expanding. One reason is that backward linkages of food manufacturing to the agriculture sector are not as strong. Adequate infrastructure and effective modern public policies that support food manufacturing-agriculture linkages and stronger value chains could therefore strengthen its performance, as that of agriculture and the rural economy in general. The key question is whether the food manufacturing sector has the potential to grow, or is it unique to Russia to have a relatively small food manufacturing sector compared with other competitors? There are both short-term and long-term factors. In the short term, market protection measures may deter investments in the agri-food processing industry because high domestic farm prices incentivize investing in primary agriculture, making it more attractive than investing in food manufacturing (all other factors held constant). However, as the

experience in other countries shows, in the long term, demand for processed food will increase, primarily because of dietary transitions and the increasing incomes of the urban middle class (Minten, Reardon, and Chen 2017). Public policy may therefore consider gradual steps for promoting investments in food manufacturing industry with a view to improving the competitiveness of both primary and processed food sectors.

Third, support small and medium farms by reducing the bias of public support towards larger farms. There is considerable literature that underscores the benefits of supporting small- and medium-size farms (see for example Hazel *et al*^[1]; Reardon *et al*^[2]). Apart from key benefits such as poverty reduction, job growth, and social inclusion, there are two major public goods that warrant public support to small and medium farms. First is technology transfer. Large agribusinesses possess critical mass of technologies that are largely import-dependent. Import dependence tends to benefit large firms, limiting technological spillovers to small and medium farms. Public programs can therefore support diffusion of advanced technologies to reach small and medium ones. Second, public programs could support the inclusion of small and medium farms in value chains, when small and medium farms dominate the production sub-sector. Currently, federal and regional government agricultural support programs and efforts are mostly directed to supporting large agribusiness—even in sectors where production is dominated by small and medium farms (e.g. dairy, fruits, and vegetables). Redressing this bias in public support programs towards larger firms would be helpful.

^[1] Hazell, Peter BR, Colin Poulton, Steve Wiggins, and Andrew Dorward. "The future of small farms for poverty reduction and growth." Vol. 42. Intl Food Policy Res Inst, 2007.

^[2] Reardon, Thomas, Christopher B. Barrett, Julio A. Berdegue, and Johan FM Swinnen. "Agrifood industry transformation and small farmers in developing countries." World development 37, no. 11 (2009): 1717-1727

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WORLD BANK GROUP

The World Bank in Russia

36/1 Bolshaya Molchanovka st.,

121069, Moscow, Russia

+7 (495) 745-7000

moscow@worldbank.org

www.worldbank.org/russia