Russia Economic Report #42

Weaker global outlook sharpens focus on domestic reforms

Special topic: How Wealthy is Russia?
Measuring Russia's comprehensive wealth from 2000-2017

Acknowledgements

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Abbreviations and Acronyms

BACI	Base pour l'Analyse du Commerce International
BRICS	Brazil, Russia, India, China, and South Africa (emerging economies)
BP	British Petroleum
BSCF	Banking Sector Consolidation Fund
CBR	Central Bank of the Russian Federation
CDS	Credit Default Swaps
CEPII	Centre d'Etudes Prospectives et d'Informations Internationales
CPI	Consumer Price Inflation
DTI	Debt-to-Income
EAEU	Eurasian Economic Union
ECA	Europe and Central Asia
ECI	Economic Complexity Index
EMDEs	Emerging Markets and Developing Economies
EU	European Union
EUROMOD	Tax-Benefit Microsimulation Model for The European Union
EXPY	Index on Export Sophistication
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
FX	Foreign Exchange
GDP	Gross Domestic Product
GNFS	General Number Field Sieve
HBS	Household Budget Survey
HSE	Higher School of Economics
ICT	Information and communications technology
IEA	International Energy Agency
IMF	International Monetary Fund
INPY	Index on Import Sophistication
IPC	Individual Pension Capital
LNG	Liquified natural gas
LTVS	Loan-to-Value
MFO	Microfinance Organizations
NPL	Non-Performing Loan
NWF	National Welfare Fund
OECD	Organization for Economic Co-operation and Development
OFZ	Federal Loan Bonds
OPEC	Organization of the Petroleum Exporting Countries
PISA	Program for International Student Assessment
PIT	Personal Income Tax
PMI	Purchasing Managers' Index
PPF	Private Pension Funds
PPP	Purchasing Power Parity
REER	Real Effective Exchange Rate
RER	Russia Economic Report
RF	Russian Federation
RLMS	Russia Longitudinal Monitoring Survey
Rosstat	Russian Federal State Statistics Service
RUSMOD	Tax-Benefit Micro Simulation Model for Russia
SMEs	Small and Medium-Sized Enterprises

SOE	State Owned Enterprise
UN COMTRADE	United Nations International Trade Statistics Database
VAT	Value-Added Tax
WB	The World Bank
WITS	World Integrated Trade Solution
WTI	West Texas Intermediate
WTO	World Trade Organization

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The World Bank's Russia Economic Report (RER) analyzes recent economic developments; presents the World Bank's medium-term economic outlook; and provides an in-depth analysis of a thematic issue. Specifically, Part 1 covers external sector developments; real sector trends in Russia; balance of payments; labor market, wages, productivity and poverty trends; monetary policy; financial sector developments and fiscal policy. Part 2 contains the World Bank economic outlook for Russia and growth and poverty projections for Russia. In Part 3 the special focus of this edition is on Russia's wealth, measured comprehensively to include produced capital, natural capital, human capital, and net foreign assets.

Executive Summary

Subdued economic performance in 2019

After a weak performance in the first half of 2019, helped by monetary easing, faster public spending and some one-off effects, economic growth in Russia picked up in the third quarter at 1.7 percent, y/y. Consequently, our 2019 forecast has been revised upwards to 1.2 percent (from its previous reading of 1 percent).

Globally, growth has weakened substantially in 2019, reflecting a broad-based slowdown in industrial activity and global trade. Slowing external demand and the OPEC+ agreement weighed on Russia's exports performance. Crude oil prices fell 14 percent in January-September 2019, y/y, reflecting a downturn in the world economy.

Domestically, relatively tight monetary policy in the first half of 2019, weak real disposable-income dynamics due to higher inflation on the back of the VAT rate hike, and a slow start in the implementation of national projects dampened growth in 2019. A decline in the labor force and in the number of employed people, due to population aging, continues to be a drag and has not been yet compensated by the recently increased retirement age.

Macro-fiscal buffers remain strong, with Russia enjoying twin fiscal and current account surpluses (5.0 percent of GDP and 4.7 percent of GDP in the first nine months of 2019, respectively). Now at 28th place, Russia continued its advance in the latest World Bank's Doing Business ratings. After peaking in March at 5.3 percent, the 12-month consumer price inflation of 3.8 percent declined below the CBR's target of 4 percent in October. Unemployment – at 4.5 percent – has been declining and stays at historic lows. The Russian banking sector has been largely stable; however, credit expansion has been uneven, with retail lending leading this expansion. To mitigate financial stability risks from the retail loan sector, CBR has been gradually introducing regulatory measures to curb households' excessive debt burden.

Projected growth at 1.2 percent in 2019 and between 1.6 and 1.8 percent in 2020 - 2021; poverty expected to decline modestly

Growth in Russia is expected to be 1.2 percent in 2019; 1.6 percent in 2020; and 1.8 percent in 2021. A less restrictive monetary policy and increased spending on the national projects is expected to help foster growth. National projects are expected to contribute about 0.1 pp to GDP growth in 2020 and about 0.2 to 0.3 pp in 2021.

The moderate poverty rate is expected to continue to decline in 2019 and through 2021, although vulnerability needs to be monitored. Increasing the existing means-tested programs and expanding their

reach would help to reach the goal of halving poverty by 2024.

Downside risks to the growth forecast prevail

Key risks to the growth forecast include a weaker global economy, elevated trade tensions, and domestic factors. External adverse shocks could spill over into Russia through trade, financial, and commodity market channels. Russia also remains exposed to the possibility of additional economic sanctions, which may further dampen domestic and foreign private investment. Investment growth relies on the successful and efficient implementation of government infrastructure investment initiatives. Rapid expansion in household credit has triggered a regulatory response, but more measures may be required to mitigate risks to financial stability from the sector. The liquid part of the National Welfare Fund (NWF) should exceed 7 percent of GDP in 2020, creating a legal opportunity for the government to invest part of the NWF in domestic infrastructure projects. However, substantial domestic investments of the NWF could render the economy more dependent on energy prices and heighten inflation risks.

Increasing export diversification, boosting FDI, and broadening sources of financing require more attention

Russia's export diversification has been progressing, but only slowly. Driven largely by higher oil prices, in 2018, energy exports accounted for 65 percent of total exports (compared to 59 percent in the previous year). In comparison to other regional oil exporters, Russia has also seen lower numbers of new export lines in the past four years. New trade agreements of the Eurasian Economic Union (EAEU), such as with Serbia, Singapore and Iran, could expand Russia's export opportunities.

Inbound FDI to Russia has decreased drastically, dropping from an average of US$54.5 billion in the 2011-2013 period to US$19.2 billion in the 2015-2018 period. Adjusted for potential round-tripping destinations, FDI from Europe dropped by about 88 percent, from America 41 percent, and Africa 90 percent. Asia was the only destination from which FDI increased, by about 4 times from a relatively low base. The Russian anti-offshore law adopted at the end of 2014 seems to be reducing the scale and scope of round-tripped FDI: for example, from 2013 to April 2019, the FDI stock of Cyprus in Russia decreased by 25 percent. FDI is also distributed unevenly between the Russian regions. About 71 percent of all FDI is absorbed by just 10 regions with a population of less than 20 percent of Russia's total (Yamalo-Nenets Autonomous Okrug, Moscow, and Krasnoyarskiy Krai are the top three).

The non-banking financial sector remains small compared to the banking sector (the banking sector's assets account for about 91 percent of GDP). Private pensions funds – a source of long-term financing for the economy – account for only 4 percent of GDP, which is significantly lower compared to the OECD average of 50 percent. A more developed non-banking financial sector could help broaden sources of longer-term financing. Additionally, measures such as increasing tobacco taxation[1] and cutting tax expenditures (by reconsidering and reducing preferential tax rates), currently estimated at about 3 percent of GDP, could help mobilize more revenues and expand fiscal space.

[1] Reducing tobacco use through taxation in the Russian Federation: modelled assessment of two policy options, World Bank, 2018 http://documents.worldbank.org/curated/en/873551539183125023/pdf/130697-REVISED-3-12-2018-18-22-6-WBGTobaccoRussianFedPolicyNoteFinalweb.pdf

Special Focus: GDP is not wealth. How wealthy is Russia?

The special focus of the report is on Russia's wealth, measured comprehensively to include produced capital, natural capital, human capital, and net foreign assets. Russia experienced strong growth in wealth from 2000 to 2017. However, its total wealth per capita is more than three times lower than the OECD average and lags the averages of other upper middle-income and high-income commodity exporters. 5 key findings that emerge are:

1. A typical Russian citizen was 1.8 times wealthier in 2017 than in 2000. However, this is only about a quarter of wealth of a typical OECD resident.
2. Around 7 percent, Russia's return on wealth is similar to upper middle and high-income countries but lower than that of certain Eastern European countries. However, in recent years, this return to wealth has been less evenly distributed than in the past.
3. Human capital, at 46 percent, comprises the largest share of wealth in Russia, however, much less than the OECD average of 70 percent. Russia's natural capital share stands at 20 percent. As a rough approximation, Russia's forests provide global carbon absorption benefits of over US$ 500 billion[2].
4. Despite its significant growth, Russia's human capital wealth per capita is one-fifth the OECD average. At current rates, Russia would only catch up after almost 100 years.
5. Russia's large share of carbon-based wealth facing increased risk due to future price uncertainty and large-scale attempts at global decarbonization.

Rebalancing the portfolio and mitigating the risks of stranded assets will require Russia to diversify its wealth portfolio away from its fossil fuel sector and towards other productive capital. This will involve, in the short-term, lowering the environmental footprint of heavy and polluting industries through adopting modern environmental management systems. Maintaining the fiscal rule is a necessary though not sufficient condition for diversification. The payoffs are likely to be imminent. For example, Russian aluminum already enjoys a low carbon footprint by relying on hydro power, and this may give it a price and market access premium.

In the medium- to long- term, and with the necessary political backing, it would be important to increase fuel excise taxes and differentiate tax rates by the social and environmental cost of fuel use. Exploring the use of carbon taxes or other forms of carbon pricing harmonized within broader trade and technology agreements with prospective trading partners would also help. This could include, among other things, eliminating non-transparent subsidies to producers and consumers, which can be regressive and distort incentives for efficient consumption, and replacing them with more targeted cash transfers to the poor and vulnerable. Russia can also engage more proactively in international climate policies to access support (technology, finance, and access to market) for asset diversification, as well as leverage such cooperation to facilitate global market access for knowledge-intensive and environmentally sustainable goods and services made in Russia. The recent adoption of the Paris agreement by Russia is a welcome step in this direction.

[2] This is the net present value of future annual sequestrations for the life of the forest, using a conservative social cost of carbon of US$ 33 per ton CO2 eq emitted in 2017 at 2017 prices. The estimation is sensitive to assumptions of the lifetime, discount rate, and future carbon sequestration levels and prices.

PART 1. Recent Economic Developments

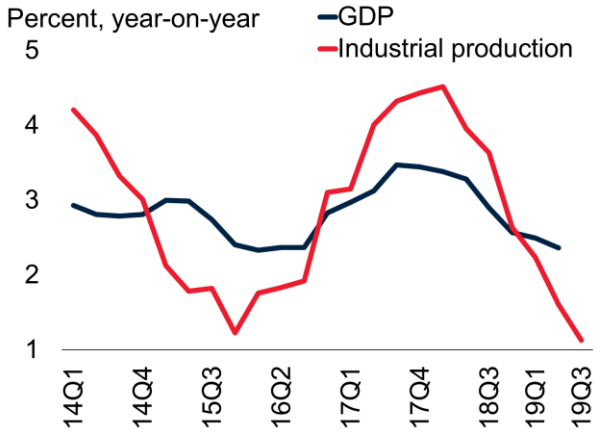
1.1 Global growth: a broad-based slowdown in industrial activity and global trade

Global growth has weakened substantially in 2019, reflecting a broad-based slowdown in industrial activity and global trade. While much of the deterioration in activity has been contained to the manufacturing sector, there are tentative signs that services activity is starting to slow. Alongside weakening global demand, the prices of most commodities have fallen in 2019. Crude oil prices are projected to average US$60 per barrel in 2019, which is 9 percent lower than previous projections.

Global growth continues to weaken, amid decelerating trade and investment. Global activity continues to show signs of weakness as trade and investment decelerate, with GDP growth estimated to have slowed to a three-year low of 2.4 percent, y/y, in the second and third quarter of 2019 (Figure 1). Manufacturing activity, as measured by the Purchasing Managers' Index (PMI), has remained in contraction since May 2019, with weakness observed in new export orders.

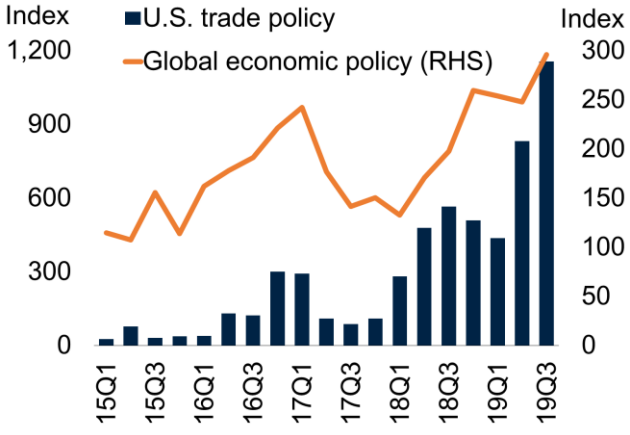
Global goods trade has continued to contract and reached a new post-crisis low in 2019, with notable weaknesses in advanced economies and Asia. The sustained weakness in global trade reflects ongoing trade tensions between major economies, such as the United States and China, which has led to unprecedented highs in U.S. trade policy uncertainty (Figure 2). Incoming data suggest that the slowdown in goods trade has started to spillover to services, with the services PMI export orders decelerating in 2019Q3.

Figure 1: Global activity continues to show signs of weakness



Source: World Bank.
Note: Aggregate growth rates calculated using 2010 constant U.S. dollar GDP weights. Last observation is 2019Q3.

Figure 2: U.S. trade policy uncertainty is high



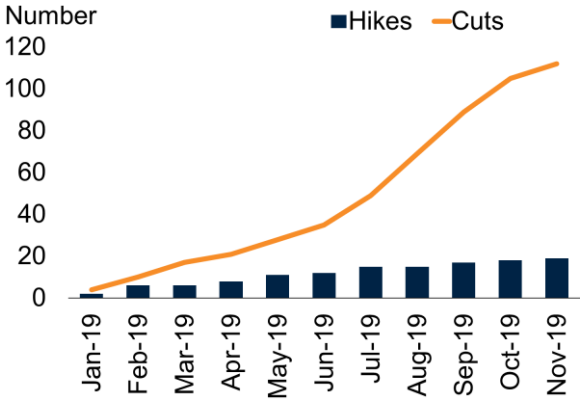
Source: Baker, Bloom, and Davis (2016); World Bank.
Note: Last observation is 2019Q3.

After rising through most of the first half of the year, global inflation has moderated in the second half of 2019, reflecting subdued energy prices. Softening inflation has allowed many major central banks, including in emerging market and developing economies (EMDEs) to provide more accommodative monetary policy to support flagging economic growth (Figure 3).

Global financing conditions continue to ease as borrowing costs fall, but volatility has reemerged. Long-

term yields have fallen across advanced economies, in some cases to historical lows, as investors continue to flock to the safety of advanced-economy sovereign bond yields. Bouts of volatility, however, reemerged in global equity markets in the third quarter of 2019, but receded somewhat following the temporary trade truce between the United States and China in early October (Figure 4). Capital outflows to EMDEs have tentatively abated in the third quarter of 2019, as some investors' search for yield continued to support the issuance of new debt.

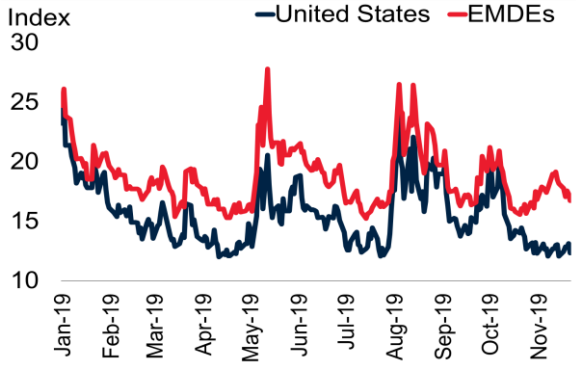
Figure 3: EMDEs provided more accommodative monetary policy



Source: Haver Analytics, World Bank.
Note: Figure shows the cumulative sum of all interest rate changes since January 2019 for 70 EMDEs.

Activity in the Euro Area, Russia's largest trading partner, has further decelerated, with the weakness spreading beyond the industrial sector. Activity in the Euro Area continues to surprise on the downside, with the industrial sector remaining in contraction and the manufacturing PMI hovering near its seven-year low in October. Germany continues to be the epicenter of the area-wide manufacturing recession, as industrial production remains in contraction and economic sentiment deteriorates. Indicators suggest that the weakness may have begun to spread to the wider economy, with the services PMI continuing to fall in October and consumer expectations of the general economic situation remaining at a nearly six-year low. The continued uncertainty surrounding the United Kingdom's exit from the European Union also weighs on trade and investment activity in the region. The United Kingdom and European Union have agreed to a revised withdrawal agreement that will entail a customs border in the Irish sea as a compromise to the contentious Irish backstop, but the deadline has been extended to January 31st, 2020.

Figure 4: U.S. and EMDE volatility has reemerged



Source: Haver Analytics, World Bank.
Note: Figure shows CBOE Volatility Index for the United States and EMDEs. Last observation is November 22, 2019.

Growth in China, Russia's second-largest trading partner, continues to decelerate, falling to 6 percent, y/y, in the third quarter of 2019—a 30-year low. Consumer prices have accelerated to a seven-year high of 3.8 percent in October, but this was mostly driven by the near doubling in pork prices as African swine fever continues to ravage the country's pig population. Trade flows have remained weak throughout most of the year, with both exports and imports contracting. Equity markets, however, have strengthened somewhat following the temporary trade truce in early October that averted U.S. tariffs from rising to 30 percent (from 25 percent) on US$250 billion worth of imports from China on October 15th.

Commodity Market Developments

Crude oil prices fell 8 percent in the third quarter of 2019, q/q, following a 7-percent decline in the previous quarter (Figure 5A). The weakness in prices reflects a broad-based downturn in the world economy. Indicators of global activity, including manufacturing output, trade volumes, and vehicle sales, have all deteriorated sharply this year. Expectations of demand growth have been revised down repeatedly by forecasters, and oil demand is now projected to grow just 0.9 million barrels per day (mb/d) in 2019.

The decline in prices occurred despite a major attack on two of Saudi Arabia's oil plants, which resulted in the largest ever conflict-driven reduction in oil production. The attacks led to the shutdown of 5.7 mb/d of output — around half of Saudi Arabia's production capacity and 6 percent of the global oil production. The price of the benchmark Brent crude jumped 15 percent, from US$60 to US$69/bbl, in the aftermath of the attacks. However, prices returned to their pre-attack levels by the end of September, as Saudi Arabia rapidly restored lost production. In the end, production in Saudi Arabia fell by 0.7 mb/d in September, substantially less than the original reduction (Figure 5B).

Along with other large producers, Russia's production softened in the middle of 2019 as a result of the contamination of the Druzhba pipeline. However, the issues were broadly resolved by August and production recovered. In the United States, quarterly growth in crude oil production slowed over 2019, and the level of production in September was unchanged from January. In part, weaker production is due to shale oil companies coming under pressure from investors to improve returns on capital by focusing on profitability rather than growth. Production has also been disrupted by adverse weather, particularly in the Gulf of Mexico.

Most non-energy commodity prices also fell in the third quarter of 2019. Metal prices dropped 2 percent, largely reflecting concerns about demand and trade tensions. A notable exception was nickel, whose price surged after Indonesia, the world's largest nickel ore producer, announced a ban on nickel exports from the start of 2020. Precious metal prices surged in response to trade tensions and monetary policy loosening in advanced economies. Overall agricultural commodity prices fell in the third quarter as production expectations were revised upward and global stocks of key grains, notably rice and wheat, remained at multi-year highs.

Figure 5. Decline in oil prices and reduction of oil production

Figure 5A: Crude oil prices fell 8 percent in the third quarter of 2019, q/q

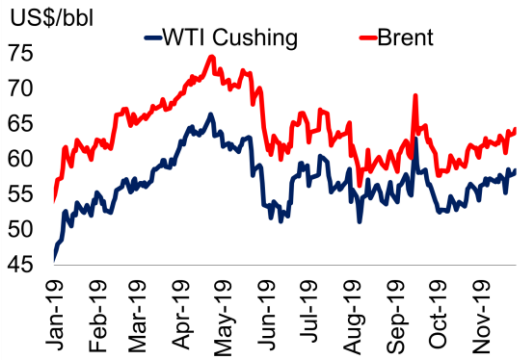
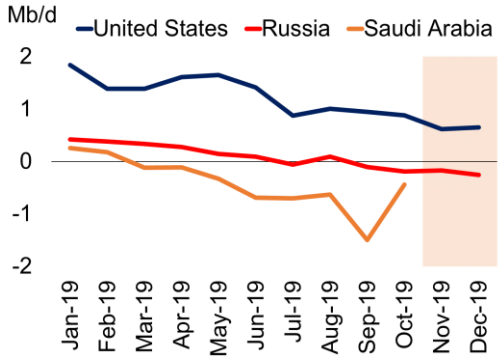


Figure 5B: The attacks on two of Saudi Arabia's oil plants led to the shutdown of around half of Saudi Arabia's production capacity



Source: Bloomberg.
Note: A. Last observation November 26, 2019.
B. Last observation is October 2019. Shaded area indicates IEA forecast. Forecast not available for Saudi Arabia.

Box 1: Russia plays a major role in global commodity markets

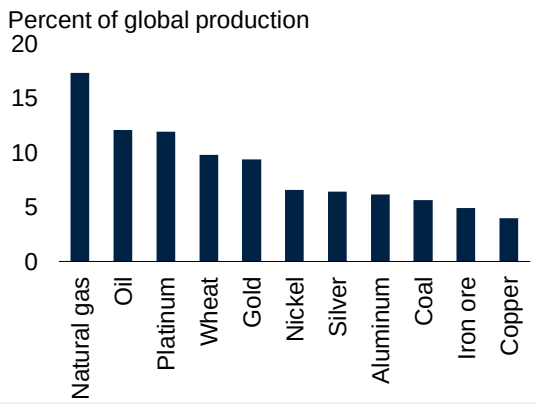
Russia plays a major role in global commodity markets. It is the second-largest producer of aluminum, crude oil, natural gas, and platinum, and accounts for a considerable share of the production of several other commodities (Figure B1-A). Its importance in energy markets is particularly substantial, accounting for 18 percent and 12 percent of natural gas and crude oil production, respectively. Russia's production of commodities, particularly in energy, has also grown rapidly over the past 20 years, with coal production up 102 percent, crude oil rising 87 percent, and natural gas growing 24 percent.

Commodities are also a key source of export revenue for Russia. Exports of fuels account for almost 60 percent of Russia's goods exports, compared to 50 percent in 2000 (Figure B1-B). Within this, crude oil accounts for 28 percent and refined crude oil products account for 17 percent. Exports of natural gas are smaller, with the majority sent by pipeline to Europe. However, exports of liquefied natural gas (LNG) rose sharply last year and are expected to continue to grow, to meet burgeoning demand growth, particularly in Asia (Figure B1-C). In contrast, exports of metals have fallen, reflecting weaker production and rising domestic consumption.

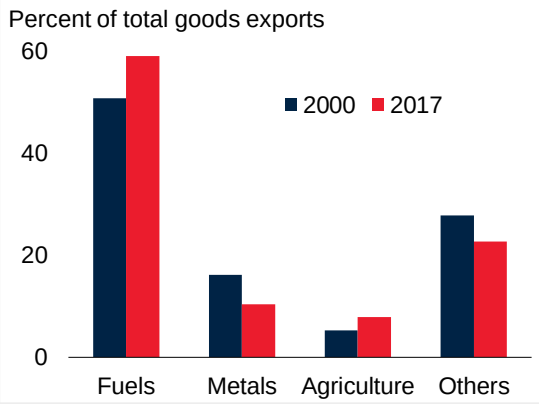
Looking ahead, commodity markets are facing major structural changes that will alter the demand for different commodities. First, growth in China is expected to continue to slow and shift toward less commodity-intensive services. China currently consumes half of the world's metals and coal, so a slowdown in growth will have a major impact on their demand. Second, a shift to a low-carbon economy, as outlined in the Paris Agreement, may reduce the market for fossil fuels, but increase demand for metals. Reducing the carbon-intensity of the economy will require a shift away from carbon-intensive fuels, such as coal and oil, to renewables (the consumption of natural gas, a cleaner, lower-carbon fuel, may rise as the world transitions). However, this will likely lead to an increase in demand for metals, as renewable technologies are typically very metals-intensive (World Bank 2017). For example, to generate 1 kw hour of electricity from wind power requires three times as much copper as generating it from natural gas (Figure B1-D). Electric vehicles are similarly more metals-intensive than traditional vehicles. These shifts will provide both challenges and opportunities for Russia.

Figure B1: Russia plays a major role in global commodity markets

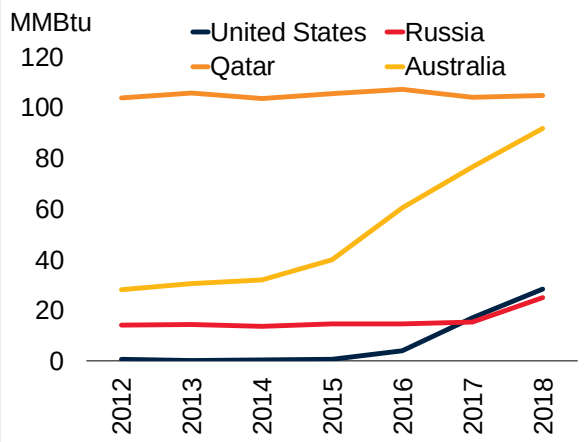
A. Russia is the second-largest producer of aluminum, crude oil, natural gas, and platinum



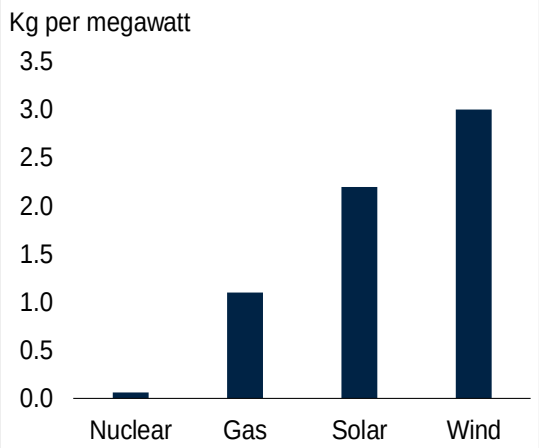
B. Commodities are a key source of export revenue for Russia



C. Exports of liquefied natural gas rose sharply last year



D. One kw hour of electricity from wind power requires three times as much copper as generating it from natural gas



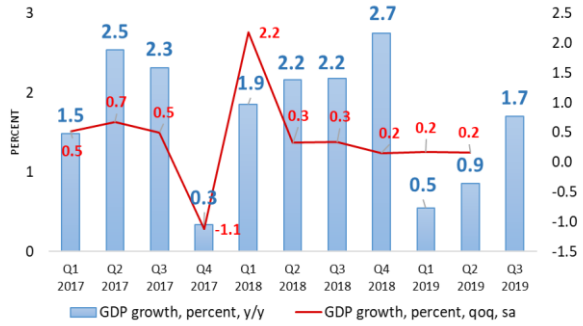
Source: BP Statistical Review, British Geological Society, IEA, UN Comtrade, USA, World Bank, World Bureau of Metal Statistics.
Notes: A. 2018 data, except for platinum and iron ore, which are from 2017.
B. Fuels includes crude oil and refined oil products. Agriculture includes animal, vegetable, and wood products.
D. Figure shows the amount of copper required to produce one megawatt of electricity, from different methods of electricity generation. Data are taken from: World Bank 2017, "The Growing Role of Minerals and Metals for a Low Carbon Future." Washington, D.C.: World Bank Group.

1.2 Russia: subdued growth with some acceleration in the third quarter

In the second quarter of 2019, GDP growth strengthened slightly in annual terms to 0.9 percent of GDP, y/y, from 0.5 percent, y/y, in the first quarter of 2019. In the third quarter of 2019, monetary easing, somewhat faster public spending and one-off effects strengthened growth further to 1.7 percent, y/y.

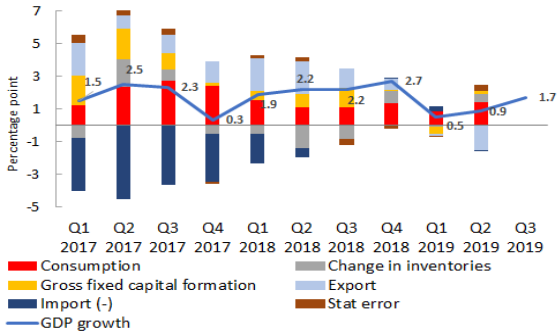
In the second quarter of 2019, GDP growth slightly increased in annual terms to 0.9 percent, y/y, and stayed at the same level on a q-o-q basis adjusted for seasonality (Figure 6). The slowing growth of the global economy weighed down on growth, as did contamination of the Druzhba pipeline, relatively tight monetary policy, weak real disposable income dynamics, responding to higher inflation on the back of the VAT rate hike, and a slow start in the implementation of national projects.

Figure 6: Growth momentum stayed flat in the second quarter of 2019
(on a q-o-q basis adjusted for seasonality)



Source: Rosstat.

Figure 7: Exports dropped in the second quarter of 2019

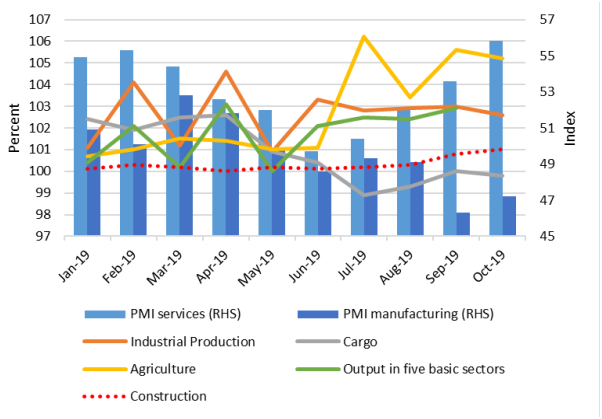


Source: Rosstat.

Supported by retail credit growth, consumption remained the main growth driver in the second quarter of 2019. Its contribution to GDP growth increased, compared to the first quarter of 2019, as real disposable incomes somewhat stabilized (Figure 7). After contracting in the first quarter, gross fixed capital formation growth accelerated to 1 percent, y/y. According to high-frequency statistics on large and medium enterprises, the acceleration was driven by the mineral resource extraction sector and the public sector (for which investment dropped less than in the first quarter). Yet, gross fixed capital investment growth remained subdued, given an environment of relatively tight monetary conditions and a slow start of national projects. Exports, an important growth driver since 2014, when Russia received a relative advantage based on currency devaluation, declined by 4.9 percent, y/y. Slowing global growth and the contamination of the Druzhba pipeline were the principal factors explaining this contraction. In the second quarter of 2019, imports grew marginally on an annual basis as the ruble depreciated and domestic demand growth remained subdued. In the second quarter of 2019, negative contribution to GDP growth from contracting exports (-1.5 pp of GDP) was the main drag on growth. Contracting exports were the main factor behind the growth slowdown, compared to last quarter of 2018.

Economic growth momentum accelerated in the third quarter of 2019, helped by monetary easing, faster public spending and one-off factors (Figure 8). In the third quarter of 2019, GDP growth registered 1.7 percent, y/y. Industrial production grew by about 0.4 percent, q/q, sa. Mineral resource extraction was supported by non-oil mineral extraction and services. Oil production increased in August when the contamination of Druzhba pipeline was largely resolved and oil exports resumed. Growth in agriculture accelerated on a good harvest. On the demand side, growth was supported by monetary easing, faster public spending and stronger exports. Accoriding to high-frequency staistics, revived growth momentum rolled over to October with industrial production expanding in m/m basis, robust growth in agriculture, and somewhat stronger growth in construction and retail trade.

Figure 8: Economic growth picked up in the third quarter of 2019

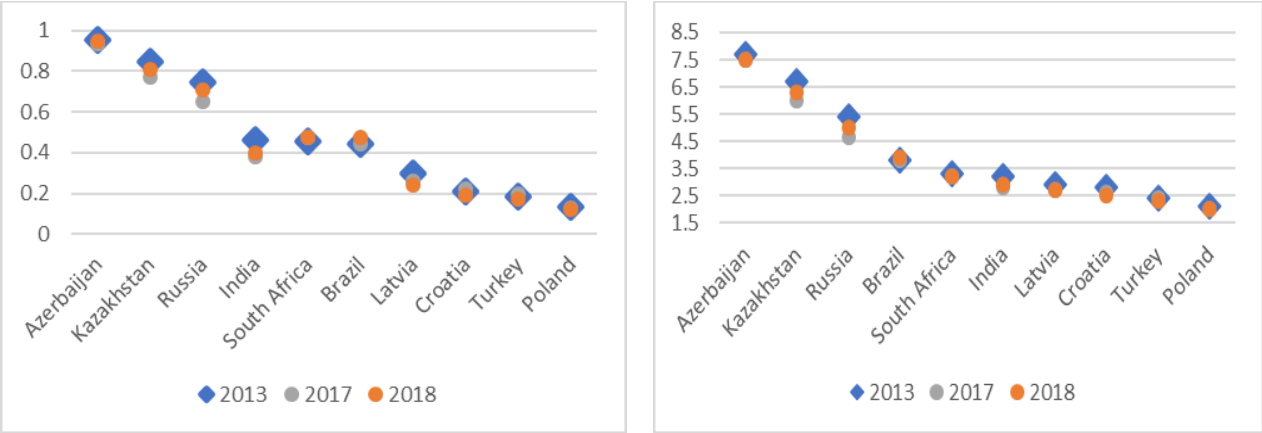


Source: Rosstat, HSBC.

Russia's export diversification has been progressing slowly. In terms of export diversification, there has been small improvement, as seen from the share of the top 10 goods in total exports and Theil value[3] in 2018 compared to 2013 (Figure 9). In 2018, energy exports accounted for 65 percent, compared to 59 percent in the previous year (Figure 10). The renewed increased share of energy products in Russia's export portfolio was driven by higher oil prices in 2018. In comparison to other regional oil exporters, Russia has seen lower numbers of new export lines[4] in the past four years (Figure 11), although Azerbaijan, and to a lesser extent Kazakhstan, have a lower base number of export lines (Figure 12).

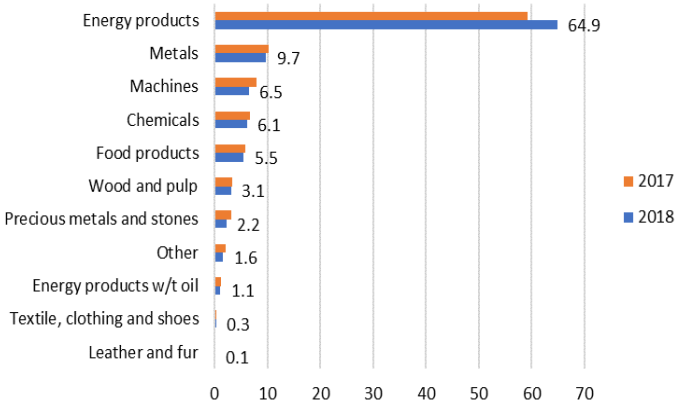
Figure 9: Progress in export diversification remains limited (2013-2018)

Share of top 10 products in total export of goods **Theil Index for exported goods (HS2012)**



Source: Comtrade, WB staff calculations.

Figure 10: The share of energy products increased in 2018, compared to 2017 (percent)

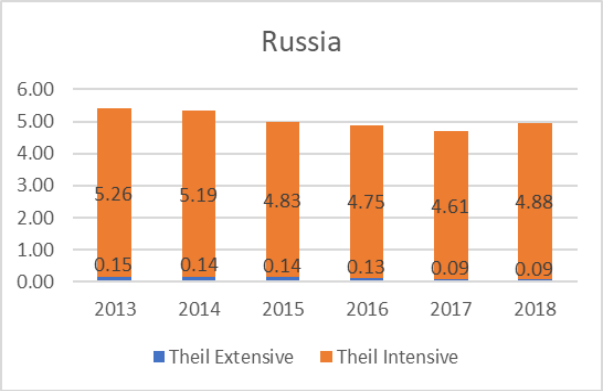


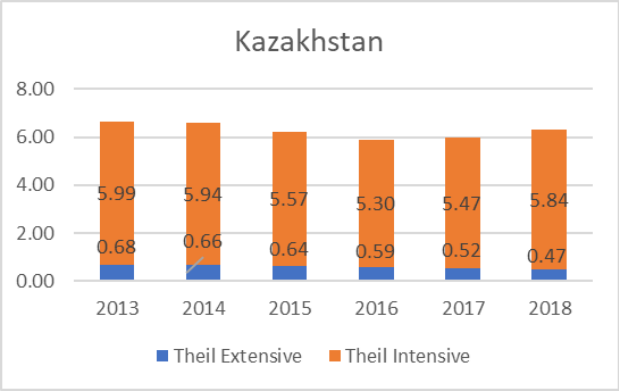
Source: Russian Customs Statistics.

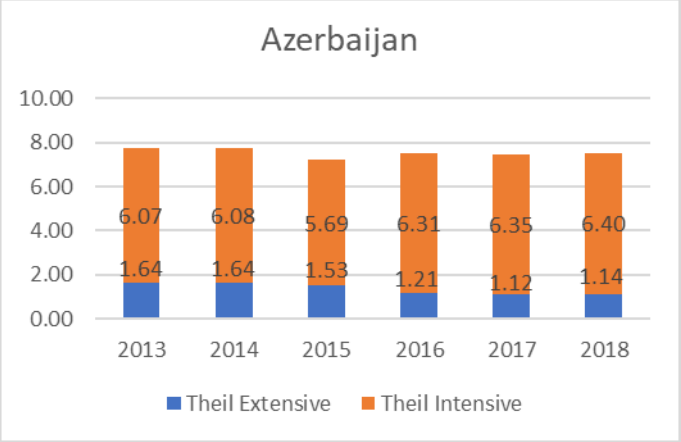
[3] Index of Export Diversification differentiating intensive and extensive margin following Cadot et al. (2011).

[4] New Export Lines for Russia include: Escalators and moving walkways, Niobium, tantalum, vanadium ores and concentrates, and Coal or rock cutters and tunnelling machinery.

Figure 11: Russian export diversification is driven by existing rather than new production lines

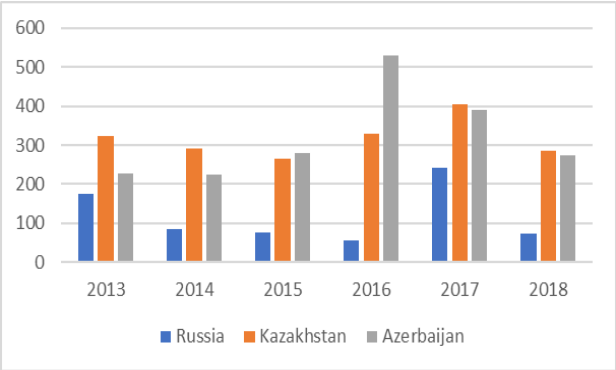






Source: Comtrade, WB staff calculations.

Figure 12: The number of new export lines remains relatively low in Russia, compared to Azerbaijan and Kazakhstan



Source: Comtrade, WB staff calculations.

The sophistication of Russia's export basket, as measured by EXPY[5], slightly increased in 2017, compared to 2013 (Figure 13). In essence, this measure indicates the level of income associated with a country's export basket, following the idea that a country that exports products associated with higher productivity levels will

[5] EXPY - Index on export sophistication by Hausmann et al. (2007).

be more likely to experience higher growth rates. Among the BRICS, Russia's EXPY levels are comparable to those of South Africa and India (Figure 13). Meanwhile, despite lower oil prices[6], EXPY levels slightly increased for Russia in 2017, compared to 2013 (Figure 14).

Figure 13: Russia's exports are relatively less sophisticated than its levels of GDP per capita implies

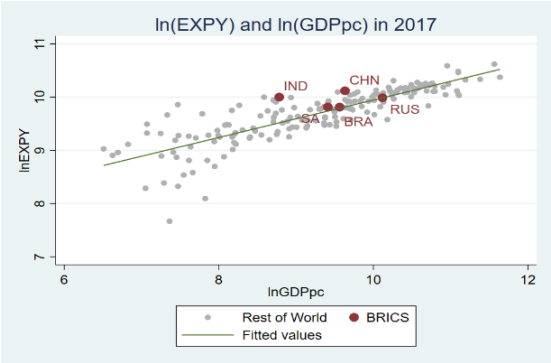
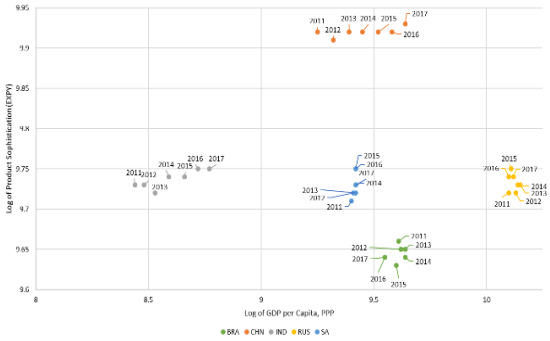


Figure 14: In 2017, EXPY levels slightly increased for Russia compared to 2013



Source: WITS, CEPII BACI Database, WB staff calculations.

Russia's import sophistication has risen compared to 2013 (Figure 15). Following the EXPY methodology, an index for import sophistication (IMPY)[7] could be computed. If a country imports goods that are exported by richer countries, this index will be higher. Russia's import sophistication is high, exceeding levels of export sophistication, which is common for primary resource exporters and developing countries (Figure 16). The rising trend of import sophistication is supported by the fact that these imports mostly do not consist of intermediate products.

Figure 15: In 2017, IMPY levels increased for Russia, compared to 2013

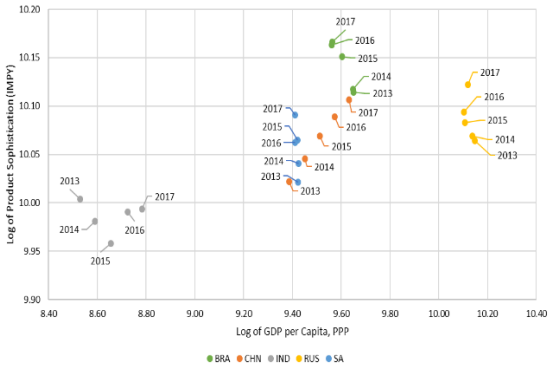
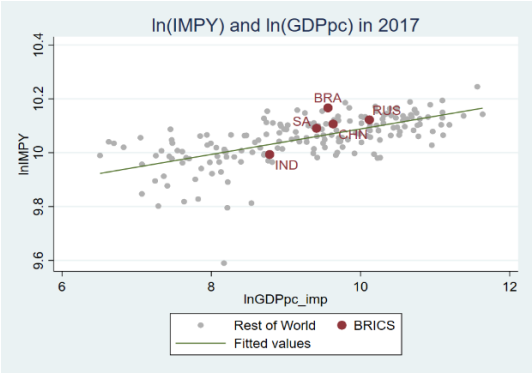


Figure 16: Russia's imports are relatively more sophisticated than its levels of GDP per capita implies



Source: WITS, CEPII BACI Database, WB staff calculations.

[6] EXPY is inflated by higher oil prices (Weldemicael 2012)

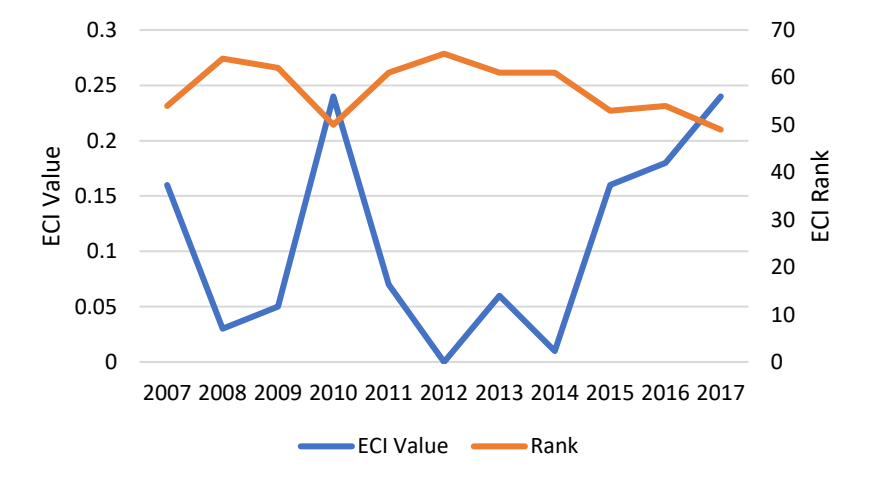
[7] IMPY then measures the productivity associated with a country's import basket, based on PRODY values weighted against total import share, as applied by Marvasi (2013).

Box 2: Russia reached its best Economic Complexity Index (ECI) ranking in the past 10 years, although demonstrating only modest improvements in export diversification (**Figure B2- 1**).

According to the Atlas of Economic Complexity, compiled by Harvard University, Russia has improved its position in the index to 49th of 133 countries in 2017, up from 54th in 2016. The ECI considers the capabilities and know-how a country possesses based on the diversity, ubiquity, and complexity of exported products. Russia's principal exports, minerals and metals, constitute "low and moderate complexity" goods. The latest ECI report shows that the principal contribution to export growth has been provided by moderate-complexity products, such as cereals and wood products, while processes of structural transformation remain largely absent. Yet, some diversification has been achieved, as 18 new products (HS4 categorization) have been added to Russia's export basket, accounting for US$35 of per capita income in 2017. However, the overall export volume of these new products remains limited. Moreover, the largest share of new products is constituted by mineral products (with three additional products accounting for 51 percent of new products) and agricultural products (13 products accounting for 47 percent). Nonetheless, moderate improvement is reflected in a rising ECI value over the past five years, from 0 in 2012 to 0.24 in 2017.

According to the Growth Lab at Harvard, Russia, having considerable room to diversify, should thus focus on transitioning into new products that use capabilities and know-how related to already existing ones. Thus, the ECI considers existing know-how, complexity, and further potential to drive future diversification as factors in determining which product groups a country may ideally add to its export basket to increase export complexity. In Russia's case, this includes industrial machinery and vehicles. Estimating future dynamics, based on the complexity and income level of a country, Russia's growth is projected to remain slow. The Growth Lab estimates growth to be faster/slower as countries have more/less complex export baskets than expected for their income level. The latest estimates suggest the growth rate for Russia until 2027 will lie at 2.5 percent per year, placing it in the lower half of all countries ranked.

Figure B2- 1: In 2017, Russia achieved best ECI ranking in the last ten years



Source: Harvard Atlas of Economic Complexity.

1.3 Balance of payments: the current account surplus narrowed

The current account surplus narrowed in the second and third quarter of 2019, mainly on lower export receipts. Net capital outflows dropped on the back of easing monetary conditions in the advanced economies and relatively comfortable oil prices. Continued accumulation of international reserves in the fiscal rule framework strenghtened the external position.

After registering a strong surplus of 9.1 percent of GDP in the first quarter of 2019, the current account weakened in the second (2.6 percent of GDP) and again in the third quarter (2.9 percent of GDP), mainly due to a weaker trade balance (Figure 17). In the first three quarters of 2019, the current account narrowed to 4.7 percent of GDP from 6.2 percent of GDP in the same period last year.

Lower export receipts were the main reason for the narrowing. In the second quarter of 2019, in view of several one-off factors and a slowing global economy, both export volumes and export prices for produced energy and non-energy goods registered negative growth, compared to the same period last year (Figure 18). The decrease in energy goods export value contributed the most to the drop in goods exports receipts to US$101.7 billion from US$108.8 billion last year (

Figure **19**). It was partly attributed to the contamination of the Druzhba pipeline, which negatively affected crude oil exports in April-June 2019. The decrease in oil products (gasoline, paraffin oils, fuel oil, etc.) exports in 2019, compared to last year, is partly explained by the slowdown of the export of such product to Belarus. After robust growth in 2014-2018, the non-energy goods export volume dropped by 9.1 percent y/y in the second quarter of 2019 compared to -4.6 percent, y/y, in the first quarter of 2019 (

Figure **20**). A drop in the value of metals and metal products contributed the most to the non-energy exports decrease. It was mainly due to lower demand and to a high base in 2018. In the third quarter of 2019, lower prices for energy products weighed the most on exports receipts. After the Druzhba pipeline was largely fixed in July 2019, crude oil export volumes increased in real terms in the third quarter of 2019. Non-oil exports value grew by 6.5 percent, y/y, though detailed statistics are not avalable yet. The value of imported goods decreased in the second quarter of 2019 (-2.1 percent, y/y) on the back of the REER depreciation and subdued domestic demand. Imports slightly picked up in the third quarter (+3.5 percent, y/y) as the REER appreciated (Figure 17).

Figure 17: *A* weaker trade balance was the main reason for the current account surplus decrease in the second and third quarters (percent of GDP)

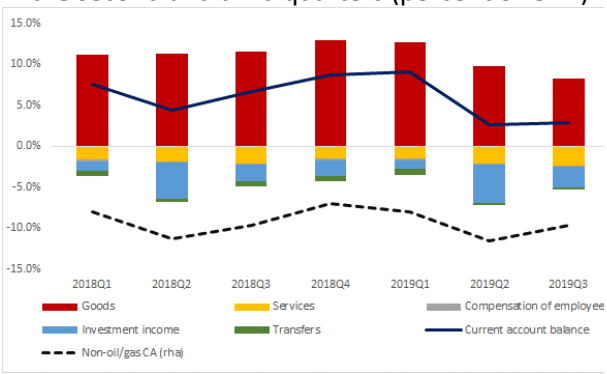
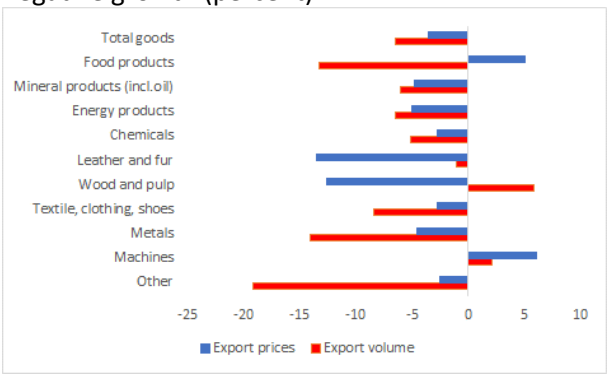
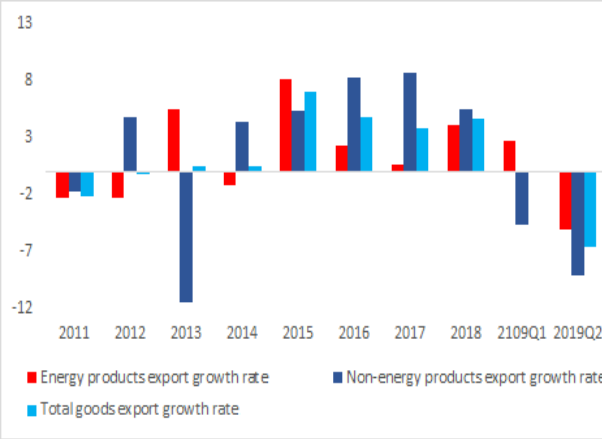


Figure 18: Both export volumes and export prices for produced energy and non-energy goods registered negative growth (percent)



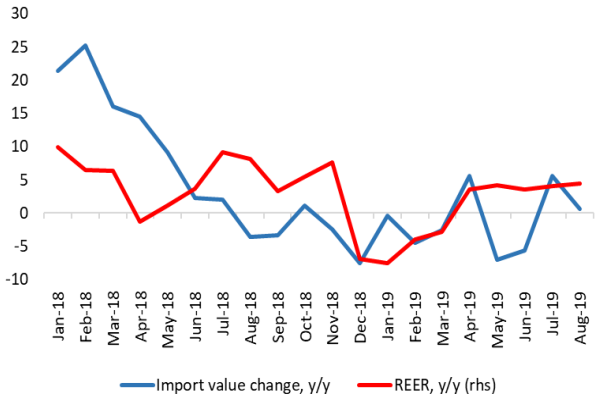
Source: CBR, Russia Customs Service.

Figure 19: Non-energy goods export volume dropped in the first and second quarters of 2019 (percent)



Source: CBR, Russia Customs Service.

Figure 20: Imports value slightly picked up in the third quarter as the REER appreciated (percent change, y/y)



In the first three quarters of 2019, the non-oil/gas current account deficit remained at about the same level as last year: minus 9.8 percent of GDP, with non-oil/gas export covering about 69 percent of imports. This supports the finding of limited change in the diversification of the economy.

Net capital outflows dropped on the back of the easing of monetary conditions in advanced economies and relatively comfortable oil prices (Figure 21). In the second and third quarters of 2019, net capital outlows from the private sector dropped by US$13.4 billion to US$0.5 billion as net capital outflows decreased substantially in the third quarter of 2019 from a high base in the previous year, when geopolitical tensions and tightening in the advanced economies put pressure on capital outflows in Russia. The banking sector continued deleveraging in view of restricted access to international markets because of sanctions. The non-banking sector registered a net capital inflow both in the second and third quarters, largely through the FDI channel. Net FDI inflows in the private sector reached US$11.5 billion in the second and third quarters of 2019, compared to -US$2 billion in the same period last year (See Box 3). According to available information, higher FDI inflows were due to higher reinvestment of profits in the second quarter of 2019 (with 88 percent of inbound FDI originating in Cyprus). Gross external financing needs[8] dropped to almost zero in 2018 on the back of a strong current account. In 2019, they are expected to reach about 2.3 percent of GDP as the current account narrows.

Russia's public sector registered net capital inflows in the second and third quarters of 2019. Non-residents resumed federal government bonds (OFZ) purchases in the secondary market from the beginning of 2019, and they peaked in the second quarter.

The REER has been largely sheltered from oil price volatitlity since the fiscal rule framework has been in place (Figure 22). Despite lower oil prices in the first three quarter of 2019, compared to the same period last year, the REER appreciated by 1.3 percent, as geopolitical pressures subsided and monetary conditions in the

[8] Current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

advanced economies eased.

Figure 21: Net capital outflows dropped in the second and third quarters of 2019 on the back of easing monetary conditions in the advanced economies and relatively comfortable oil prices

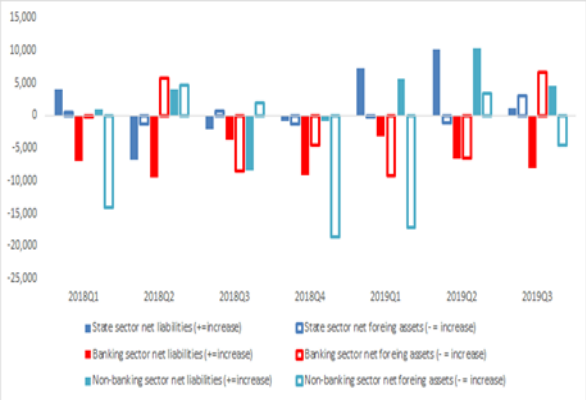
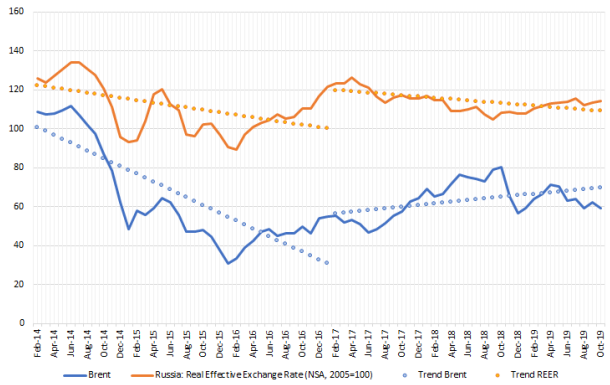


Figure 22: The REER has been largely sheltered from oil price volatility since the fiscal rule framework has been in place



Source: CBR, World Bank.

International reserves gained US$51.1 billion as a result of the economy's operations with non-residents in the first three quarters of 2019. They stand at a comfortable US$530.9 billion, exceeding the pre-crisis level of end 2013. This increase was largely due to foreign-currency purchases under the fiscal rule framework and deferred purchases of foreign currencies from 2018. The import cover increased to 18.5 months from about 16 months in the end of 2018. By the end of June 2019, the net international investment position increased to US$378.5 billion from US$370.9 billion at the end of 2018. The continued accumulation of external buffers strengthened Russia's external position. The Central Bank refrained from intervening on its own, in line with its flexible exchange-rate regime.

New trade agreements of the Eurasian Economic Union (EAEU) could expand Russia's export opportunities. On October 1, 2019, the EAEU-Singapore FTA was signed. It incorporates trade in goods as well as regulation of trade in services and terms of investment. A provisional agreement with Iran entered into force on October 27, 2019, for the duration of three years, with limited reduced customs duties that only include about half of total volume of trade between the parties. It mainly provides for lower duties for industrial and agricultural goods. An 'economic cooperation agreement' with China also entered into force at the end of October, which focuses on simplified trade procedures. On October 25, 2019, the EAEU-Serbia FTA agreement was signed, which was largely based on already existing bilateral trade agreements Serbia had with Russia, Belarus, and Kazakhstan. These agreements follow after the EAEU-Vietnam FTA agreement that was signed in 2015 in conjunction with separate bilateral agreements with Russia and Belarus on supporting automotive manufacture in Vietnam. Since the latter agreement entered into force, the share of Russian exports to Vietnam has gradually increased, mostly accounted for by exports in grain, mineral resources, and iron ore.

Table 1: Balance of payments accounts, bln US$

	2015	2016	2017	2018	Q1 2019	Q2 2019	Q3 2019e	9m 2019e
Current account balance	67.8	24.5	32.4	113.5	33.7	10.6	12.9	57.2
Trade balance	111.2	66.3	83.5	164.5	41.1	31.1	26.1	98.2
Non-oil current account balance	-135.6	-129.5	-161	-148.4	-29.5	-46.9	-42.7	-119.3
Capital and financial account	-68.3	-9.3	-12	-75.4	12.6	-2.8	-1.8	8
Errors and omissions	2.9	-5.4	2.6	2.4	-2.6	3.8	1.3	2.6
Change in reserves (- = increase)	-1.7	-8.2	-22.6	-38.2	-18.6	-16.6	-15.9	-51.1

Source: CBR, WB staff calculations.

Box 3: Inbound FDI to Russia has decreased drastically in 2015-2108 (Figure B3- 1 and Figure B3- 2). Average inbound FDI dropped from US$54.5 in 2011-2013 to US$19.2 billion in 2015-2018. In 2015-2018, inbound FDI was mainly targeting the mineral resource extraction sector (61.5 percent of total[9]), manufacturing (24.6 percent), and finance (20.8 percent). In 2011-2013, inbound FDI were aimed at the retail and wholesale trades (29.7 percent), finance (22.2 percent), and manufacturing (17.9 percent). In terms of FDI origin, adjusted for round-tripping destinations, FDI from Europe dropped by about 88 percent, from America – 41 percent, and Africa – 90 percent. Asia was the only destination from which FDI increased by 420 percent.

Round-tripping of capital remains an important problem for Russia. It has mainly taken place through Cyprus and OFCs, which account for 70 percent[10] of inward/outward FDI stock of Russia. Cyprus leads as the main destination of FDI inflows and outflows for Russia, followed by the Netherlands.

The factors that drive the round-tripping by Russian companies are not necessarily related to the preferential treatment granted to foreign investors, since many Russian regional authorities, rather than aiding foreign investors, have erected barriers in order to protect incumbent firms from outside competition. Rather, system escape motives, such as the avoidance of domestic regulatory uncertainties, play a more prominent role for the round-tripping activities by Russian companies and investors. Companies may try to overcome the institutional weaknesses in their home economies through this kind of capital round-tripping, which allows them to engage in institutional and regulatory arbitrage.

The Russian anti-offshore law adopted at the end of 2014 is reducing the scale and scope of round-tripped FDI: from 2013 to April 2019, the FDI stock of Cyprus in Russia decreased by 25 percent.

[9] Due to Rosneft privatization deal.

[10] What to do when foreign direct investment is not direct nor foreign. World Bank, 2017.

Figure B3- 1: FDI as a share of GDP has been on a downward trend in Russia (percent).

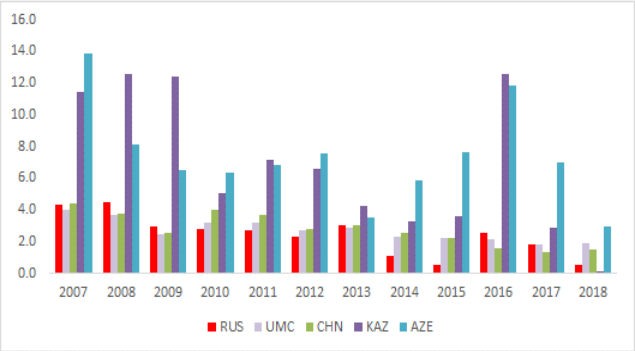
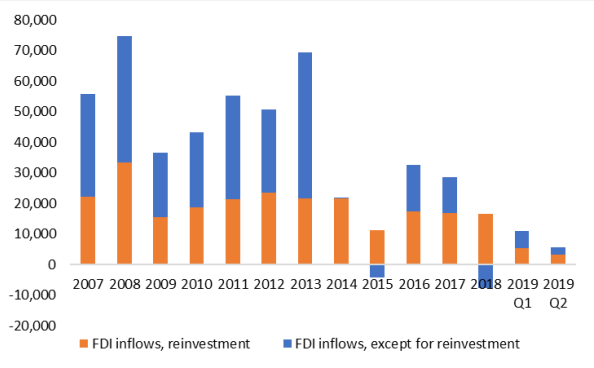


Figure B3- 2: Adjusted for reinvestment, FDI in Russia fell substantially since 2014 (mln US$).



Source: CBR, WDI.

FDI is distributed unevenly among Russian regions. 70.5 percent[11] of all FDI is absorbed by just 10 regions with population less than 20 percent of Russia's total. The three regions that accumulated the highest amount of FDI per capita are Yamalo-Nenets Autonomous Okrug, Moscow, and Krasnoyarskiy Krai. Meanwhile,[12] the ability of Russia's regions to attract FDI is one of the strongest single predictors of the growth of their per capita income. These results suggest that maintaining a good business climate and being attractive to FDI are important for growth prospects. Russia has recovered from the recession of 2014-2015, but GRP in about 20 regions has not recovered to 2013 levels (in comparable prices).

1.4 Labor market and poverty trends: Unemployment declined, real wages increased, but real disposable income dynamics remain volatile

Unemployment declined further in the third quarter of 2019 to a current 4.4 percent, while real wages increased, and inflation remained subdued. After a period of growth, real disposable incomes almost did not change in the first three quarters of 2019 compared to the same period of previous year. The poverty rate under the national definition increased slightly in the first half of 2019.

The employment and labor-force participation rates declined slightly while unemployment was close to a minimum. The absolute number of employed people decreased by 800,000 to 72.3 million in the third quarter of 2019, compared to a year earlier (Figure 23). The labor force decreased during the same period even more, by 1 million people, to 75.6 million. Employment and labor force participation rates declined in the third quarter of 2019 compared to the same period a year ago by 0.5 and 0.7 percentage points respectively. These rates were at 59.7 and 62.5 percent respectively. The decline in economic activity was mostly driven by the aging of the population because the older age cohorts have lower employment and participation rates. As the

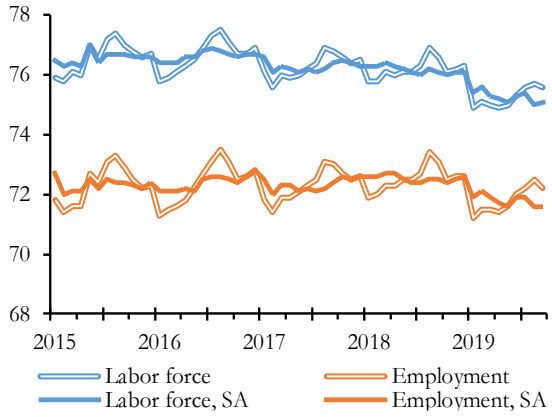
[11] Adjusted for potential round-tripping.
[12] Export competitiveness and FDI performance across the regions of Russian Federation, World Bank, 2016.

share of these cohorts increases, the total rate goes down. This is also consistent with unemployment rates that continued to decline by another 0.2 percentage points in the third quarter of 2019 (to 4.4 percent). (Figure 24).

Currently, the total labor force decreased by 1.6 million and total employment by 0.9 million people from their peak values in 2015-2016. This corresponds to a 1.5 to 2 percent contraction. The decline in the labor force could last until 2027 despite the increase in retirement age. Compared to the no-retirement age increase scenario, however, potential labor force growth could increase by up to 0.9 percentage point per year[13]. As a result, the potential growth rate could be expected to increase by 0.3 to 0.4 percentage point over 2020-2028.

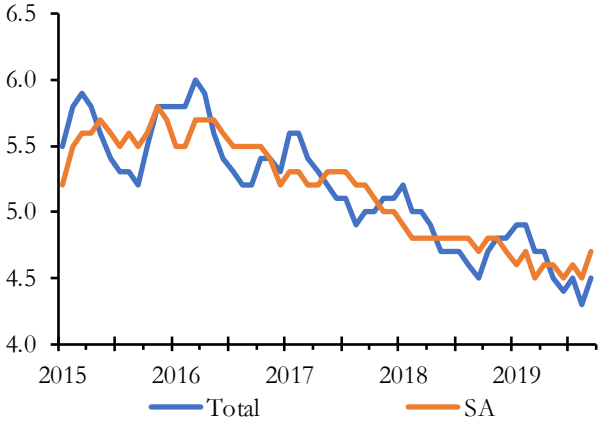
The composition of employment and unemployment has not been overly affected. The structure of unemployment by age and gender remained broadly the same, while the average time of job search decreased slightly from 7.6 months in the first half of 2018 to 7.2 months in the first half of 2019. Most of the unemployment is still long-term: 25 percent of the unemployed had been looking for a job for over a year. The gaps between male/female employment rates did not change, while the gap between urban and rural employment expanded slightly from 7.8 percentage points in first nine months of 2018 to 8.4 percentage points in the same period of 2019. Unemployment by regions remained unequal and followed the declining national trend. The lowest unemployment rates in the cohorts aged 15+ were in Moscow and St. Petersburg. Both were below 1.5 percent in the third quarter of 2019, while the highest rates were to be found in the Altai and Tuva republics, as well as in the North Caucasus regions (all above 10 percent, with the highest in Ingushetia, at 26.7 percent).

Figure 23: The employment and labor-force participation rates declined in the third quarter of 2019, mln people



Source: Rosstat and Haver Analytics.

Figure 24: Unemployment rate was close to a minimum in the third quarter of 2019, percent



Source: Rosstat and Haver Analytics.

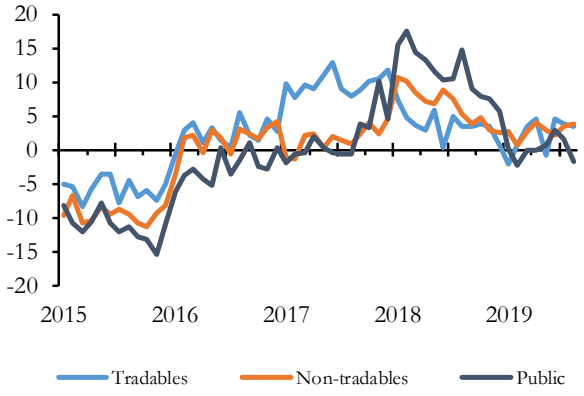
Real wage growth decelerated in all sectors. Real wage growth in the first nine months of 2019 decelerated compared to 2018. This can partly be explained by the effect of a high base a year ago (Figure 25). The fastest

[13] Potential growth. Outlook and options for the Russian Federation. World Bank, 2018.

real wage growth was in agriculture (10 percent in March-August 2019 compared to the same period of 2018) and the non-tradable sectors of finance (11.6 percent) and trade (9.8 percent) as well as R&D (9.3 percent). Real wage growth in the public sector was much lower: 2.6 percent in public administration and 5.5 and 5.8 percent in the education and health sectors respectively. Real wage growth in manufacturing was 6.7 percent in March-August 2019, compared to the same period of 2018.

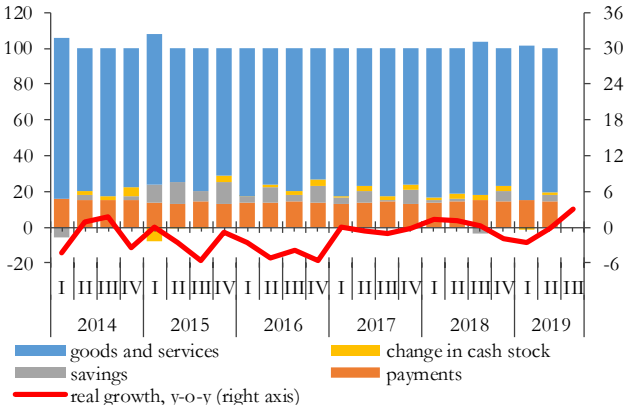
Real disposable income dynamics remain volatile[14]. After a period of growth, real disposable income in Russia contracted by 1.3 percent in the first half of 2019 compared to the same period of 2018 (Figure 26). This contraction was driven by components that are not directly observed in income statistics or in the increased share of mandatory payments (the decline of total income in real terms was only 0.2 percent). In the third quarter of 2019, real disposable incomes increased by 3 percent compared to the same period of 2018. Labor pensions were indexed at 7.05 percent in January 2019 – above the current rate of inflation – and social pensions were indexed at 2 percent in April 2019. This led pensions to grow by 1 percent in real terms in the first nine months of 2019, compared to same period of 2018. How Russian households used their income remains quite stable. The biggest share (above 80 percent) went to the purchase of goods and services, 15 percent was used for taxes and various mandatory payments, including loan repayments, and around 3 percent was saved.

Figure 25: Real wage growth decelerated in all sectors, (percent, year on year)



Source: Rosstat and World Bank staff estimates.

Figure 26: Real disposable income decreased in the first half of 2019 compared to the same period of 2018 *(percent, year on year)*



Source: Rosstat and World Bank staff estimates.

The official poverty rate increased slightly in the first half of 2019. Despite growth in real wages and pensions, the poverty headcount increased in the first two quarters of 2019 by 0.2 percentage points compared to the same period of 2018. The number of poor people increased by 0.2 million to 19.8 million (Table 2). The increase was mainly driven by a contraction of real disposable income at the bottom of the distribution, as well as a raising of the poverty line in real terms. The subsistence minimum that serves as a poverty line in Russia increased by 7.1 percent in the first half of 2019, compared to the same period of 2018, while inflation was only 5.1 percent. The regional variation in poverty rates remained high. The difference between the region with the highest poverty rate – the Tuva republic, with 40.1 percent in 2018 – and the

[14] Rosstat recently changed the methodology of this indicator. Among the most important differences are the decreased share of unobserved incomes (from 26 to 11 percent) and changes in the accounting for foreign currency operations.

lowest one – the Yamalo-Nenetskiy AO (6.2 percent) – is more than six times. Other regions with highest share of population with incomes below the subsistence minimum were concentrated in the North Caucasus (Ingushetia, Karachay-Cherkessia and Kabardino-Balkaria republics) and the South of Siberia and Far East (Altai republic and Jewish Autonomous Oblast).

Table 2: Poverty (cumulative)

	2010	2011	2012	2013	2014	2015	2016	2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019
Poverty rate, percent	12.5	12.7	10.7	10.8	11.2	13.3	13.3	13.2	13.9	13.3	13.0	12.6	14.3	13.5
Number of poor, million people	17.7	17.9	15.4	15.5	16.1	19.5	19.5	19.3	20.4	19.6	19.1	18.4	20.9	19.8

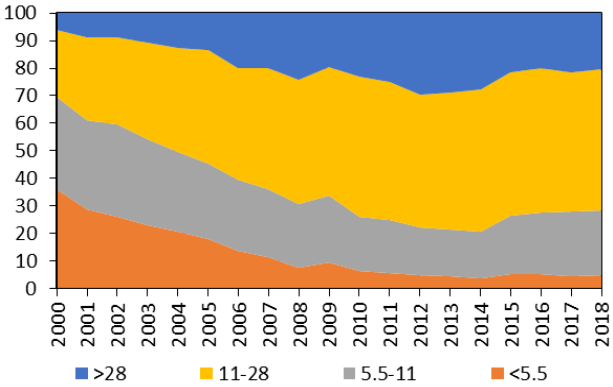
Source: Rosstat.

The government has committed to the national goal of decreasing poverty by half by 2024. It recently introduced a comprehensive plan to achieve the national goals. The following measures were announced among those that are related to poverty reduction:

- indexation of minimum wages, pensions and other social transfers above the inflation rate;
- growth of wages in the public sector and especially for the most vulnerable categories of people and households;
- increased support for families with children;
- support of employment for women with children and development of the child-care system;
- improving the targeting of social assistance;
- introducing the regional rosters of poor families and developing various regional initiatives to support such families.

These measures are broadly in line with the policy needs to achieve the ambitious goal for poverty reduction. However, the actual effectiveness of these measures would depend on the details of the design and implementation mechanisms (Box 4).

Figure 27: The share of the economically secure population stayed unchanged in 2018 (Welfare groups in Russia by expenditures per capita, percent of population)



Source: World Bank staff estimates using RLMS-HSE data.
Note: Welfare is defined as total expenditures per capita in 2011 PPP US$ per day. This numbers should not be compared to the World Bank number on International poverty line, which are produced based on Household Budget Surveys (HBS). However, the levels and trends calculated here are consistent with those sources.

The share of the economically secure population stayed unchanged in 2018. The threshold of 11 US$ a day or more in 2011 PPP is used to define the lower bound for an economically secure population.[15] Using this criterion and based on the Russia Longitudinal Monitoring Survey of HSE (RLMS-HSE), Russia's population had become more vulnerable in 2015, with the situation deteriorating further in 2016, but remaining unchanged in 2017 and 2018 (Figure 27). The share of the economically secure population (with consumption higher than the threshold mentioned above) decreased by 5 percentage points from 79 percent in 2014 to 74

[15] The World Bank. Towards a New Social Contract.
https://openknowledge.worldbank.org/bitstream/handle/10986/30393/9781464813535.pdf

percent in 2015, and further to 72 percent in 2017 and 2018. This contraction was driven by a massive reduction of disposable incomes and wages in 2015-2017. It stabilized when disposable incomes started to recover.

Box 4: Redistributive power of the tax-benefit system in Russia is moderate in comparison with EU countries.

The redistributive power of the tax-benefit system in Russia is moderate, by international standards. To assess the redistributive power of the tax-benefit system in Russia, we constructed a detailed microsimulation model and calibrated it to the Russia context based on EUROMOD approach. RUSMOD is the first full-scale model in Russia that simulates most of the existing monetary tax-transfer policies implemented at federal and regional levels for a nationally representative sample of the population.[16]

The Russian system of direct taxes and benefits is less redistributive than any system in the European Union in terms of reducing inequality (Figure B4- 1). The overall effect of direct taxes and transfers is close only to the least redistributive countries in the EU, such as Latvia and Bulgaria. Moreover, the Russian system is almost entirely dominated by pensions, with other components having little effect on the reduction of the Gini index, while in many EU countries the direct taxes (mostly the progressive PIT) and means-tested benefits have a significant impact on reducing income inequality.

Figure B4- 1: The Russian system of direct taxes and benefits is less redistributive (marginal contribution to reduction in the Gini index)

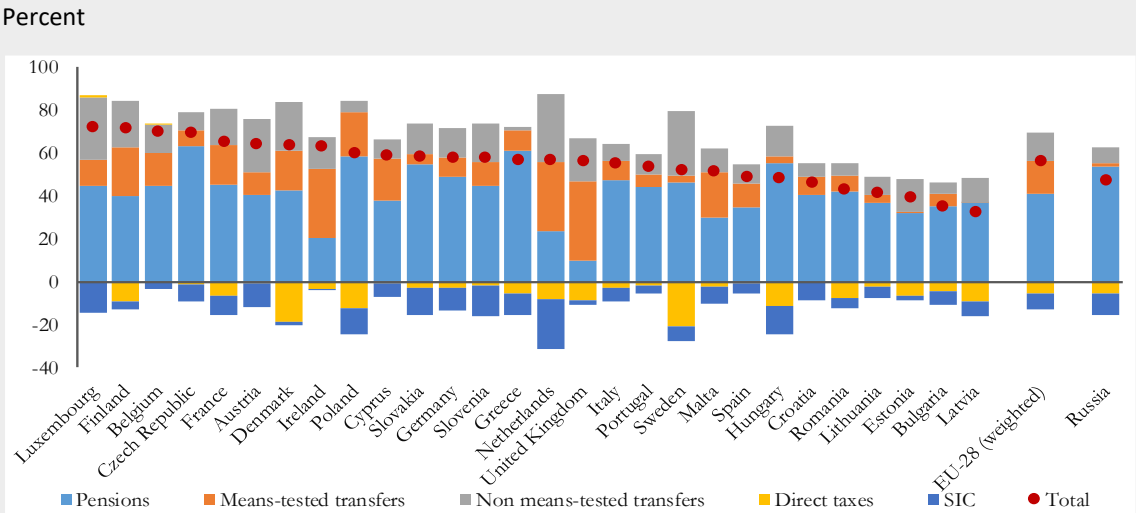
Source: EUROMOD-2017 statistics and authors' calculations using RUSMOD for 2017 policy year and 2016 RLMS-HSE data.
Note: Incomes are equivalized using the (modified) OECD equivalence scale.

The effect of the tax-benefit system on poverty reduction in Russia is moderate compared with the EU countries. The relative poverty rate, defined for comparability with the EU method as a share of population

[16] More details of the model can be found in Matytsin, M., Popova, D., & Freije, S. (2019). RUSMOD — A Tool for Distributional Analysis in the Russian Federation. World Bank Policy Research Working Paper, (8994).

with equivalized disposable incomes below 60 percent of the median income, drops by a half after fiscal interventions. While this is a less-than-average performance for EU standards, it is still better than nine of 28 EU countries (Figure B4- 2). Again, this effect is almost entirely driven by pensions, whereas in the EU other benefits (means-tested and non-means-tested) have typically a significant effect on poverty reduction.

Figure B4- 2: The effect of the tax-benefit system on poverty reduction in Russia is moderate (marginal contribution to reduction in poverty)



Source: EUROMOD-2017 statistics and authors' calculations using RUSMOD for 2017 policy year and 2016 RLMS-HSE data.
Note: Relative poverty is defined as the share of population with income per adult-equivalent below 60 percent of the median disposable income. Incomes are equivalized using the (modified) OECD equivalence scale.

Comparison with EU countries shows that Russia benefit system could benefit from better targeting accuracy. Currently, the means-tested component in Russia is smaller than in most of the EU countries. Increasing the existing means-tested programs and extending means-testing to some of the currently not means-tested programs would allow spending resources more efficiently and would help to reach the goal of reducing poverty by half by 2024.

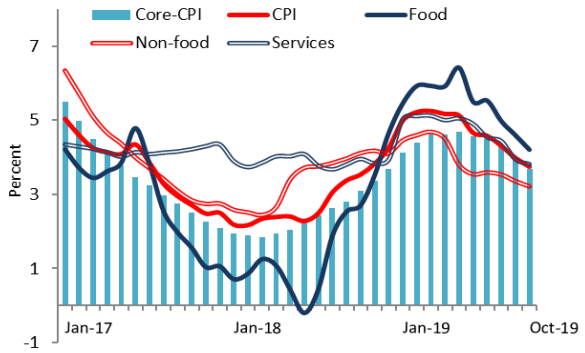
1.5 Monetary Policy: the CBR continues easing of monetary conditions

The CBR's monetary policy remained consistent with the inflation-targeting regime. After peaking in March, the headline inflation declined below the CBR's target of 4 percent in October. As inflation decelerated, the CBR has continued loosening monetary conditions. Meanwhile, household inflation expectations and corporate price expectations remained elevated and unanchored.

Inflation is on a downward trend since April 2019. After peaking in March at 5.3 percent (fueled by the effects of the VAT rate increase), 12-month consumer price inflation (CPI) has been declining and decelerated to 3.8 percent in October, y-o-y, below the CBR's target (Figure 28). Food inflation was the major contributor to the headline inflation, 1.6 percentage points (pp), while non-food inflation and inflation in services contributed by 1.1 pp and 1.0 pp, respectively. Core inflation, which excludes food and gasoline, also dropped to 3.7 percent, down from its high of 4.7 percent in May 2019. The decrease in inflation related to three factors.

First, the VAT rate hike's pass-through to consumer prices has mostly materialized in the beginning of the year without considerable second-round effects in the second half of the year. The second is the appreciation of the ruble in the first half of 2019, and the third is a sluggish domestic demand affected by a continued contraction of real disposable incomes. In view of the current inflation trend, the CBR has revised its end-of-year inflation projection downward from 4.0-4.5 percent to 3.2-3.7 percent. Annual inflation slowdowns create conditions for inflation expectations declines.

Figure 28: Inflation declined below the CBR's target

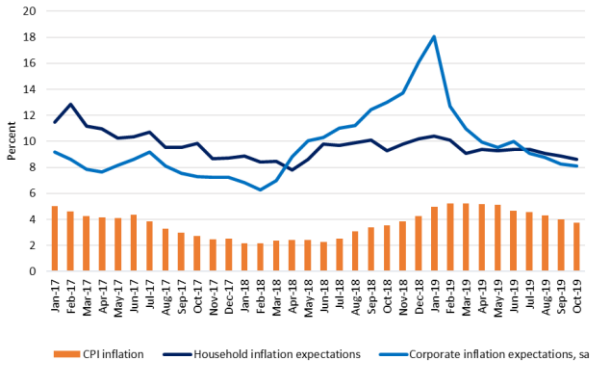


Source: Haver Analytics.

Source: Rosstat and Haver Analytics.

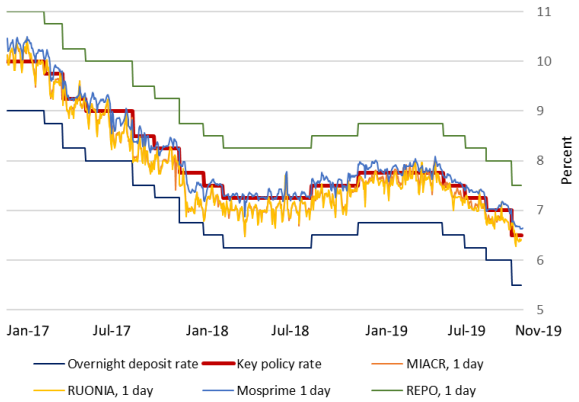
Household inflation expectations and corporate price expectations have been declining throughout 2019, although remain elevated. Both household inflation expectations for the twelve months ahead and corporate-sector price expectations for the next three months[17] have been on a downward trend since June 2019 (Figure 29). In October, household inflation expectations declined to 8.6 percent compared to 10.4 percent in the beginning of the year. Corporate price expectations decreased to 8.1 percent from 18.1 percent. Among the key factors contributed to this decline are weak household and corporate activity and a stronger ruble exchange rate. Although expectations are at their lowest level, they are unanchored to the CBR's target, and pro-inflationary risks persist. Among the key internal risks are the budget execution uncertainties in the second half of 2019-beginning of 2020 and spending of the liquid part of the National Welfare Fund (NWF) in 2020, which could result in faster price growth. The external factors are deterioration of global growth prospects, geopolitical factors, commodity and financial markets volatility, which affect the exchange rate, and inflation expectations.

Figure 29: Inflation expectations have been declining, but remained elevated and unanchored



Source: CBR.

Figure 30: The interbank short-term interest rates stayed close to the key policy rate



Source: CBR.

As inflation decelerated, the CBR has continued loosening monetary conditions. Since the beginning of the year, the CBR cut its key policy rate four times, in June, July, September and October. It lowered it by 125 basis points, to 6.5 percent in

[17] This is the balance of corporates' answers on the question "whether the company is going to increase prices in forthcoming three months", which reflects prevalence of expectations of changes in prices.

annual terms, which is inside of the CBR's neutral[18] rate range of 6 to 7 percent. The key factors behind these decisions were the continuing deceleration of inflation and weak economic growth (below the CBR's expectations). The interbank short-term interest rates remained close to the key policy rate, in the lower limit band (overnight deposit rate) (Figure 30). In the context of the banking sector structural liquidity surplus, which increased from 2.9 billion Rub in the beginning of January to 3.4 billion Rub in the middle of November, it was supported by the CBR's operations of liquidity absorption. Moreover, the CBR signaled that the range of 6 to 7 percent for the key rate is likely neutral, but that these estimates could be revised in the future, based on both external and internal factors. Hence, we expect that the CBR will continue its cautious lowering of the key policy rate keeping in mind the global financial conditions and inflation dynamics.

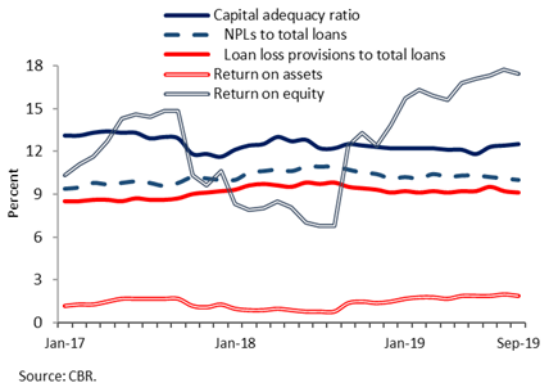
For the period of January-October 2019, the ruble nominal exchange rate appreciated by 4.6 percent with respect to the US dollar, supported by a softening of financial conditions for emerging markets. The CBR continued its forex interventions in the fiscal rule framework, which it resumed starting January 15th, 2019, on the back of the foreign exchange (FX) market stabilization. In the first ten months of 2019, the CBR's FX purchases amounted of about US$ 39.4 billion, compared to US$ 34.8 billion in 2018[19] overall.

1.6 Financial sector: in a relatively stable position, but challenges remain

The Russian banking sector has been largely stable. The CBR has continued its clean-up of the sector by revoking the licenses of some smaller banks and focusing on the financial rehabilitation of large financial institutions. Credit expansion has been uneven across the segments, and the effect of the CBR measures on unsecured consumer lending is yet to be seen. The CBR has continued to develop the digital financial infrastructure in order to foster competition in various market segments and improve financial inclusion.

The Russian banking sector has returned to a relatively stable position, but NPLs are still high and credit growth uneven. Lending by banks returned to growth since 2017, but pace still differs significantly by market segment, mainly led by the retail segment. Nonperforming loans (NPLs) remained high at 10 percent in September, but were adequately provisioned, according to CBR data. Based on the regulator's Asset Quality Review, the general quality of the asset portfolio has stabilized, especially in the corporate sector. Profitability has been strong and aggregate returns on assets and equity continued to rise in 2019, mainly driven by the largest banks. The banking sector capital adequacy ratio (CAR) has been stable at around 12 percent (Figure 31). The banking system's funding and liquidity profiles are stable, with deposits remaining as banks' main funding source and about 80 percent of customer deposits in the local

Figure 31: Key credit and financial sector performance indicators demonstrated stability



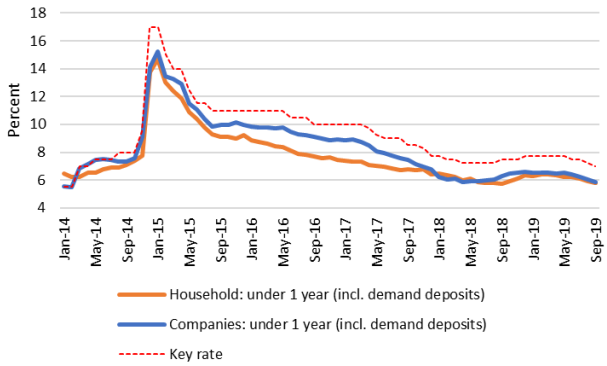
Source: CBR.

[18] A neutral key rate would not either decelerate or accelerate inflation, relative to the target level of 4 percent.
[19] In order to reduce the volatility in the FX market, the CBR suspended FX interventions from August to December 2018.

currency. Deposits accounted for 59 percent of total liabilities as of November 1, 2019. However, these are mainly short-term deposits, about 60 percent of all deposits.

In the first ten months of 2019, deposit trends were mixed. From January to October, household deposits increased by 5.3 percent, compared to 2.3 percent in the same period a year earlier. Growth was driven by inflation volatility and an increase in interest rates at the end of 2018 due to monetary policy decisions, notably a key policy rate increase. The inflation volatility was influenced by the upcoming VAT hike and the weakening of the ruble. Although interest rates were broadly flat during the first half of 2019 and then started to decrease, they were still attractive for households, supported by inflation's downward trend (Figure 32). The long-term deposits grew by 7.6 percent, compared to 1.2 percent in the same period a year before. Households preferred them in order to fix the current yield on deposits amid declining interest rates. Meanwhile, corporate deposits were largely stable compared to the same period of 2018. The trend towards a deposits de-dollarization continued in January-October 2019, partly because ruble deposit rates are considerably higher than foreign-currency rates. On the back of the strengthening of the ruble, the share of deposits in foreign currency (FX) decreased in both household and corporate segments from 21.5 percent and 37.0 percent, respectively, in the beginning of the year, to 20.9 percent and 34.4 percent, respectively, as of November 1, 2019. However, a further reduction in the share of FX deposits may be hindered by a decrease of the ruble deposit rates. The state-owned banks held the major share of household and corporate deposits, which account for 68 percent of all deposits.

Figure 32: Deposit interest rates were broadly flat during the first half of 2019

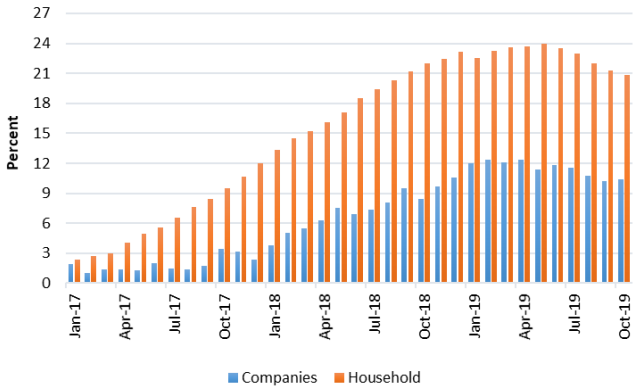


Source: CBR.

Credit expansion has been uneven, with retail lending leading the growth. Corporate loan growth remained weak, reflecting soft corporate demand for credit constrained by low economic growth. Credit demand from small and medium-sized enterprises (SMEs) has been unstable despite the massive support measures rolled out under the National Priority Project on SME support, so loans to SMEs showed modest growth rates. On the contrary, loan demand from individual borrowers has been growing, fueled by declining interest rates and stagnating incomes.

Thus, loan growth was mainly led by the retail segment, which accounts for approximately one third of total banking sector loans. In ten months of 2019, retail loans increased 20 percent (Figure 33). The ongoing consumer-lending boom indicates that households are increasingly dependent on debt to fund their spending as their real disposable incomes continued to

Figure 33: Credit growth was led by the retail sector



Source: CBR, World Bank staff calculations.

shrink over the past two years. Declining interest rates, ease of access to credit and some regulatory arbitrage between banks and microfinance organizations led to a rapid acceleration of unsecured retail lending. Rapid expansion in household credit has triggered a regulatory response, but more measures may be required to mitigate risks to financial stability from the sector as certain categories of consumers (low-income borrowers or borrowers with multiple loans) seem to be at risk of over-indebtedness.

To mitigate financial stability risks from the retail loan sector, CBR has been gradually introducing regulatory measures to curb households' excessive debt burden. To moderate the growth in the retail sector, especially in its riskiest segments, CBR introduced new macroprudential measures aimed at slowing down unsecured consumer lending. Effective October 1, 2019, all banks and microfinance organizations (MFOs) are obliged to calculate debt-to-income (DTI) ratios on all consumer loans above RUB 10,000 (US$150). The higher the DTI ratio and effective interest rate on a loan, the greater risk weight surcharge has to be applied to such loans. These measures follow a series of increases of risk weights on high-rate unsecured loans and high LTV mortgages undertaken by CBR in 2018-1H2019.

The effect of the CBR measures on unsecured consumer lending is yet to be seen. The new measures are targeting the unsecured lending segment. The double-digit growth in the mortgage loan segment does not cause similar concerns, given that the earlier regulatory measures disincentivize banks from issuing the riskiest loans – the ones with high LTVs. Since CBR introduced regulatory surcharges on loans with low down payments (below 20 percent), the share of new loans originated with low down payments has started to decline – from 41 percent at the beginning of the year to 36 percent at the mid-year. While still sizable, the declining trend is expected to continue. The share of non-performing mortgage loans (90 days +) is at historically low levels – just 1.4 percent. Since August 1, 2019, "mortgage holidays" were introduced, where borrowers facing hard-life circumstances can take a six-month break in mortgage repayments. While NPLs in the unsecured lending segment also have been stable at around 5 percent, the situation may change in case of economic deterioration. The fact that bank retail loan portfolios are almost entirely denominated in the local currency (only 0.7 percent of retail loans are forex-denominated), eliminates currency risks. The new macroprudential measures may also have the temporary effect of worsening the credit quality of the unsecured loans portfolios held by banks and MFOs. With new measures in effect, some of the borrowers who used to borrow from multiple institutions to repay their loans will no longer be able to borrow to refinance their loans and may experience difficulties with loan repayments.

The CBR continued its banking sector clean-up by revoking the licenses of some smaller banks and focusing on the financial rehabilitation of large financial institutions. The CBR has continued to remove insolvent banks, albeit at a slower pace, indicating that the sector cleanup has largely been accomplished. The number of banks in Russia has fallen from 484 at the beginning of 2019 to 454 as of November 1, 2019. Following a series of bailouts of large and Systemically Important Banks (SIBs) via the Banking Sector Consolidation Fund (BSCF) in 2017-2018, in 2019 the CBR bailed out the Moscow Industrial Bank (MInBank), 33rd by assets, and the Volgo-Oksky Commercial Bank (VOCBank), a regional bank ranked 205th by assets. The CBR spent RUB 128.7 billion on the recapitalization of MInBank and RUB 2.73 billion on VOCBank. As a result, the CBR has purchased over 99.9 percent of MInBank's and VOCBank's ordinary shares and made a decision to merge them.

While the sector clean-up was timely and necessary, it was costly and led to an even greater dominance of the public sector. Overall, since 2017, when the BSCF was established, the CBR spent RUB 2.5 trillion (US$ 39 billion), or 2.4 percent of GDP on bank recapitalization and provision of liquidity. The new bank resolution system created by CBR in 2017 allowed to avoid direct fiscal costs and turn around banks significantly faster, compared to the previous system, which relied on the Deposit Insurance Agency. In 2018-2019, a bank for core and non-core assets ("bad bank") has been set up to deal with the impaired assets of banks in open resolution, with a size (in book value) of around 2 percent of GDP. The establishment of a "bad bank" (under the umbrella of another rescued bank – the Trust Bank) allowed the central bank to clean up the balance sheets of the rescued banks. As a result of the sector clean-up, the aggregate share of banks owned by the government or by the CBR increased to about 66 percent of the banking sector's total assets as of mid-2019, from 60 percent five years ago.

Despite extensive and costly financial support to banks, some risks and challenges remain. NPLs continue to remain high at 10 percent, and corporate governance and related party lending continue to remain areas which require further attention from the CBR. Furthermore, while the CBR has been increasingly focusing on improving competition in the financial sector and plans to return rehabilitated banks to the private sector, it does not yet have a clear strategy for doing this.

The nonbank financial sector in Russia is still small compared to the banking sector (90.6 percent of GDP) and the private pension fund industry remains underdeveloped. Private pensions funds – a source of long-term money for the economy – account for only 4 percent of GDP, which is significantly lower compared to the OECD average of 50 percent[20]. Strengthening supervision by the CBR and the ongoing consolidation of the industry have led to a reduction in the number of private pension funds (PPF). As of now, there are 49 PPFs, of which more than half (35 funds) are participants in the system of guaranteeing the rights of insured persons and carry out compulsory pension insurance activities. The amount of pension savings and the proportion of individuals placing their savings in PPFs show growth, but this increase is primarily associated with the transfer of individuals' savings from the public pension fund to PPFs as part of the transitional campaign in 2017. In the absence of new income to the public compulsory pension insurance system, the increase in pension savings could be limited. Another factor limiting the inflow of pension money into the financial market is the freezing of the insurance part of the pension, which was introduced by the government in 2014 and extended to 2022. It hampers the development of the bond market and alternative financial instruments for long-term investments. In order to develop the financial market, the CBR, in coordination with the government, intends to create the individual pension capital (IPC) system[21]. However, the Ministry of Finance has recently announced that these plans will be postponed and a guaranteed pension plan (GPP) system will be proposed instead, which relies on the voluntary employee contributions instead of an auto-enrollment.

The digitalization of the economy is progressing rapidly, with the financial sector at the forefront. To foster competition in various market segments and improve financial inclusion, the CBR continued to develop the

[20] Pensions at a glance 2017: OECD and G20 indicators. OECD 2017.

[21] IPC is a pension scheme of individual public pension provision, which involves the formation of a source of pension payments from contributions of the individual himself (with the provision of tax benefits) and / or the employer. The employer will be able to co-finance the employee's contributions, in this case receiving benefits in accordance with applicable law. IPC funds will be protected by the capital of PPFs and a pension guarantee system.

digital financial infrastructure. In 2019, the CBR launched a new instant payment system to enable customer-to-customer interbank transfers 24/7/365. Twenty banks, including some of the largest public and private banks, have already joined the system. As a next step, the instant payment system will enable transfers not only between physical persons, but also legal entities, including making payments by using QR codes. The gradual introduction of biometric identification is taking place as the country-wide biometric database for financial services is being built by banks to enable remote authentication of customers. Reflecting the growing trend in Russia of increased regulation of digital economy issues, the Crowdfunding Law[22] was signed in August 2019 and will take effect from January 1, 2020 (see Box 5). Only entities registered with CBR will be allowed to operate crowdfunding platforms. Before the regulation came into force, the crowdfunding operators were reporting to CBR on a voluntary basis.

Box 5: Russia adopts Crowdfunding Law.

Globally, the crowdfunding industry is still small, but it is growing rapidly. In some countries, it is

becoming an important provider of finance for certain market segments. The share of loans facilitated by lending-based crowdfunding platforms is still very small. Even in countries with the most developed crowdfunding markets, only around 1 percent of total loans are facilitated by these platforms. In some countries' market segments (such as small-business lending or consumer lending), however, the platforms are becoming a real alternative to bank credit, and their importance is growing. For example, in 2016, business lending facilitated by United Kingdom crowdfunding platforms amounted to 15 percent of the total new loans to small businesses by banks, compared to less than 1 percent in 2012 (Havrylchyk, 2018). Given Russia's position among the top five global leaders in digital transformation of the financial sector,[23] it is well positioned technologically to grow the crowdfunding sector. While the broader enabling environment for crowdfunding is being developed under the National Digital Economy Project, the industry-specific regulation – the Law on Attracting Investments via Investment Platforms (the Crowdfunding Law) – was adopted in August 2019. It provides the framework for the operation of crowdfunding platforms in Russia.

The new law regulating crowdfunding in Russia will enter into force on January 1, 2020. Existing platforms must comply by July 1, 2020. The CBR will maintain a register of investment platform operators and monitor their compliance with the legal requirements. Only crowdfunding platforms registered with CBR can operate in that market. The new law introduces a number of requirements for operators of investment platforms:

(1) Minimum capital: an investment platform must have at least RUB 5 million in capital (own funds) or approxmately US$ 79,000;
(2) Maximum investment amount for non-qualified investors: as a general rule, an individual can invest no more than RUB 600,000 (US$ 9,500) within one calendar year using one or more investment;
(3) Restrictions on attracting investments: within one calendar year, the same legal entity or individual entrepreneur may attract investments using the investment platform for an amount not exceeding

[22] Federal Law 259-FZ of 2 August 2019 on Attracting Investments via Investment Platforms and on Amending Certain Legislative Acts of the Russian Federation.
[23] World Bank. 2018. Russia Digital Economy Report, September 2018, Competing in the Digital Age: Policy Implications for the Russian Federation.

that for which it is necessary to compile and register a securities prospectus. At the moment, this amount is 1 billion rubles (US$ 15.9 million).

(4) Introduces the mechanism of nominal accounts to operate transactions and to segregate invested funds;

(5) Investment disclosure requirements.

The key features in the Russian crowdfunfing law are in line with international regulatory trends. The law aims at achieving a balance between risks/investor protection and further sector growth, by setting minimum capital requirements, limiting the maximum invested amount, regulating the treatment of clients' money and granting access to credit bureau information. For example, setting minimum capital requirements, which helps to ensure platform solvency during financial shocks and align incentives between lenders and platforms' shareholders, is a common practice in many countries. In most countries, platforms should either respect a fixed minimum capital requirement (around 50,000 euros) or have a professional liability policy (in France). The United Kingdom is the only country where the minimum capital requirement is expressed as a percentage of loaned funds.[24]

1.7 Fiscal policy: in the first nine months of 2019, the general government fiscal surplus improved on the back of higher revenues.

In the first nine months of 2019, the general government fiscal surplus improved on the back of higher revenues. The setting up of the National Projects (which partly consist of investment expenditures) was slow in 2019, which negatively affected public investment. We expect the National Projects to contribute about 0.1 pp to GDP growth in 2020 and about 0.2 to 0.3 pp to GDP growth in 2021 as the negative impact from VAT increase somewhat diminishes and infrastructure component gets speed.

In the first nine months of 2019, Russia's general government fiscal surplus improved on the back of higher revenues. A VAT rate increase, a weaker ruble and higher non-tax revenues raised revenues at the federal level. With the VAT rate rising to 20 percent from 18 percent (though a reduced rate for socially important items, mainly food items, was preserved), the federal budget's VAT receipts increased to 6.6 percent of GDP, from 6 percent of GDP in the same period last year. The VAT growth mainly came from an uptick in domestically produced goods due to weak import dynamics. At the regional level, the increase in revenue stemmed mainly from higher receipts from the corporate income tax. In the first nine months of 2019, general government expenditures increased to 30.5 percent of GDP from 30.1 percent of GDP in the same period last year, supported by higher non-oil/gas revenues and fiscal-rule relaxation. The general government surplus widened in the first nine months of 2019 (to 5.0 percent of GDP compared to 4.7 percent in the same period last year); the federal budget surplus reached 3.5 percent in the first ten months; and the consolidated

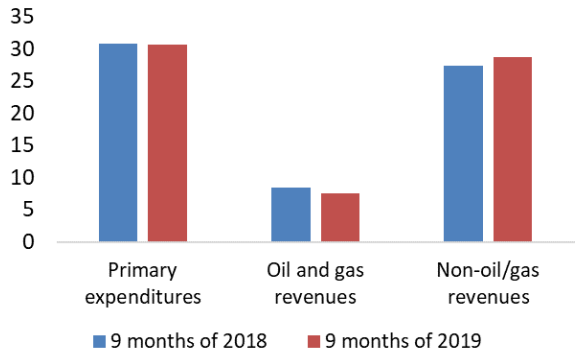
[24] 0.2 percent of the first £50 million of that total value, 0.15% of the next £200 million of that total value, 0.1% of the next £250 million of that total value and 0.05% of any remaining total value. Platforms should have either £50,000 of capital or a percentage of loaned funds, whichever is higher.

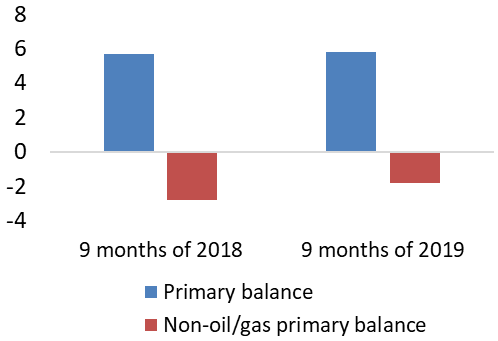
regional budget surplus totaled 0.9 percent of GDP, compared to 1.2 percent of GDP in the first nine months of 2018 (Figure 34 and Table 3).

In the period 2019-2024, the government plans to gradually substitute oil customs duties with a mineral-resource extraction tax, thus making implicit subsidies to oil refining and consumption explicit. The government also introduced a "reverse" excise tax for oil refineries in an attempt to stimulate modernization. The reverse excise tax also contains a "dampening" component that provides subsidies to oil companies for a portion of the difference between domestic and international fuel prices when the price exceeds about US$55/bbl. In the first nine months of 2019, oil and gas revenues dropped to 7.6 percent of GDP from 8.5 percent of GDP in the same period last year, mainly on lower energy prices. The share of customs duty for oil and oil products dropped to about 20 percent of oil revenues from 24 percent in the same period last year. The reverse excise tax totaled 0.3 percent of GDP. Meanwhile, the eventual leveling of domestic and international oil prices (via removed reverse excise tax) would promote investment in the oil refinery sector, increase energy efficiency and provide environmental benefits. As energy subsidies benefit mostly consumers with higher income, cutting tax subsidies while proving additional support to vulnerable groups could improve the fiscal space.

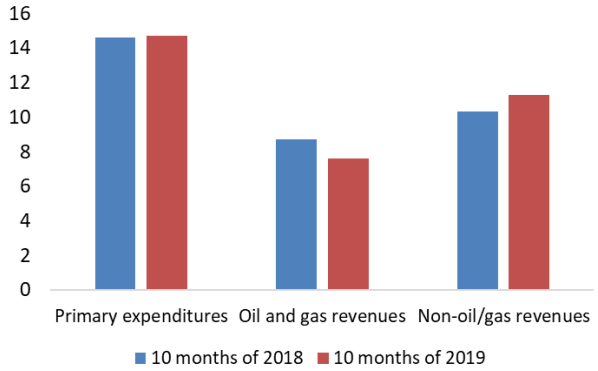
Figure 34: Budget surplus was registered at all levels of the budget system (Percent of GDP)

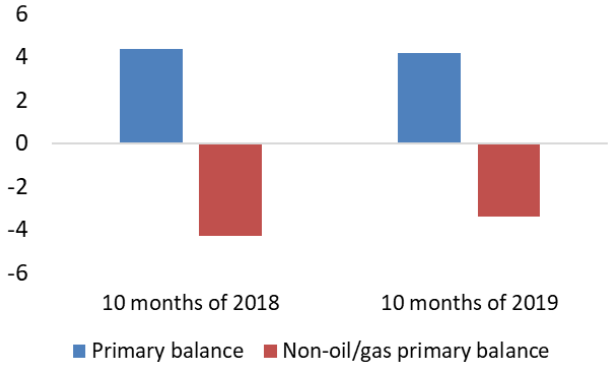
The general budget



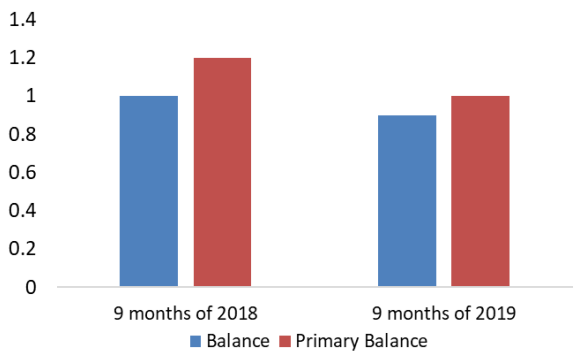


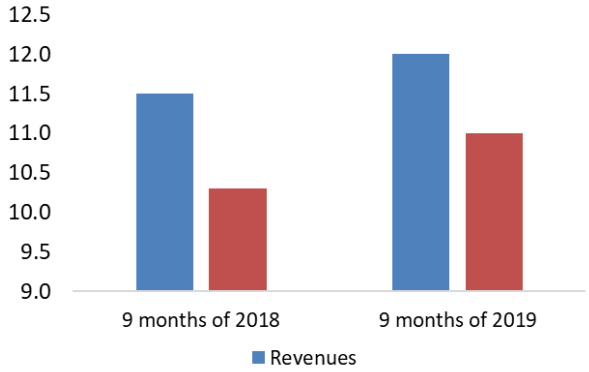
The federal budget





The regional budget





Source: EEG.

Table 3: Budget system balances

General government (% of GDP)		
	9 months of 2018	**9 months of 2019**
Revenues	35.8	36.3
Expenditures	31.1	31.3
Primary expenditures	30.1	30.5
Balance	4.7	5.0
Primary balance	5.7	5.8
Federal government* (% of GDP)		
	10 months of 2018	**10 months of 2019**
Revenues	19.0	18.9
Oil and gas revenues	8.7	7.6
Non-oil/gas revenues	10.3	11.3
Expenditures	15.3	15.4
Primary expenditures	14.6	14.7
Interest payments	0.8	0.7
Primary balance	4.4	4.2
Non-oil/gas primary balance	-4.3	-3.4
Balance	3.7	3.5
Consolidated regional government (% of GDP)		
	9 months of 2018	**9months of 2019**
Revenues	11.5	12.0
Expenditures	10.5	11.1
Primary expenditures	10.3	11
Balance	1	0.9
Primary balance	1.2	1.0
Extrabudgetary funds (% of GDP)		
Revenues	12.5	12.6
Expenditures	12.5	12.4
Balance	0.1	0.2

Source: Economic Expert Group.

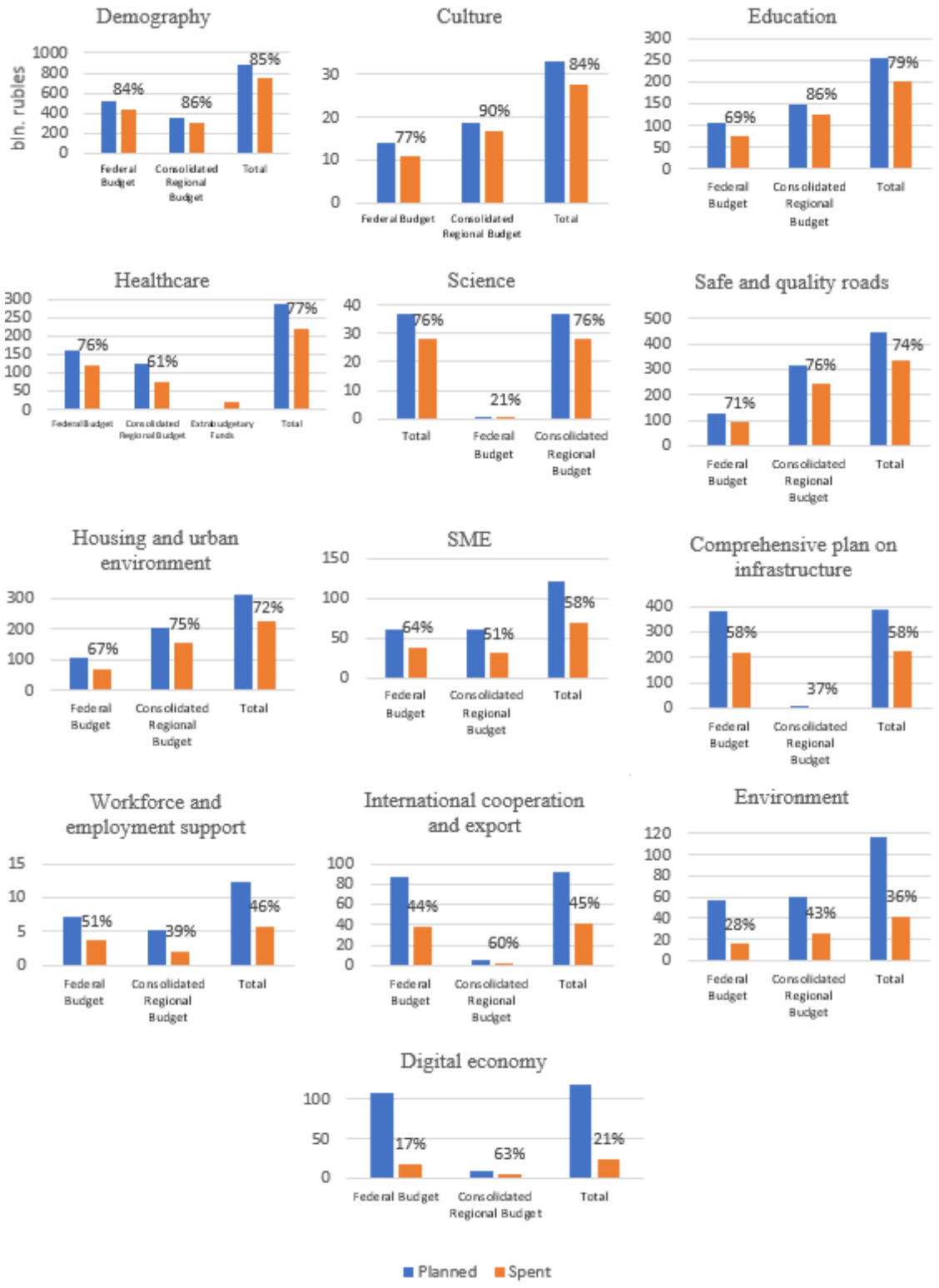
The setting up of the National Projects has been slow in 2019, negatively affecting public investment. According to the Russian Accounting Chamber, in the first ten months of 2019, spending on National Projects lagged general fiscal spending. Only 52 percent of the planned annual amount was spent on National Projects in January-September 2019 (infrastructure projects were 34 percent, and ICT ones were 12.3 percent). While

the government plans to spend about 26 trillion rubles for these National Projects, this spending will be distributed over the 2019-2024 six-year period. Thus, the annual effect on growth will be limited. [25]

Overall, the 13 National Projects involve 78 federal projects, for which the government has allocated 1.78 trillion RUB (approximately US$27.4 bln) for 2019. In October, spending on National Projects accelerated, and about 70 percent of the allocated federal budget spending was executed. The largest parts of the budget have been allocated to demography and infrastructure projects. Yet, the executed spending for four projects remains below 50 percent (Figure 36). The regions with the highest spending on national projects are Moscow, followed by St Petersburg, Sverdlovsk Oblast, Krasnodar Krai, Krasnoyarsk Krai, and the Republic of Tatarstan. We expect the National Projects to contribute about 0.1 pp to GDP growth in 2020 and 0.2 to 0.3 pp to GDP growth in 2021 as the negative impact from the VAT increase diminishes and as implementation of the infrastructure components gets underway.

[25] This calculation is based on applying fiscal multipliers to increased spending while adjusting for a drag from higher VAT rate. https://www.cbr.ru/Content/Document/File/33508/wp28_e.pdf

Figure 35: Spending on national projects remain 25 to 79 percent below allocated budgets.



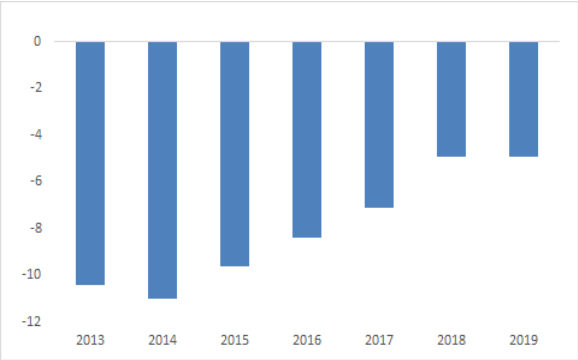
Source: Russian Accounting Chamber.

General government debt increased to 14.8 percent of GDP from 14.3 percent of GDP in the end of 2018 as federal debt increased. Regional debt remained flat as a share of GDP (see Box 6). Effective since mid-August 2019, new economic sanctions prohibit US financial institutions from buying non-ruble-denominated Russian government bonds on the primary market. The short-term implications appeared to be limited, given the government's relatively low financing needs, high international reserves, and reliance on the ruble market. Yet the sanctions could weigh on longer-term growth prospects through possibly lower levels of investment.

Supported by government efforts in establishing new macroeconomic framework, fiscal space indicators mostly improved for Russia compared to 2013. Fiscal space is broadly defined as the availability of budgetary resources for a government to service its financial obligations under different macroeconomic scenarios. Debt service capacity itself has multiple dimensions, including financing needs that are related to budget positions, access to liquid markets, resilience to valuation changes, and contingent liabilities. For commodity producers, non-resource primary fiscal balance should be considered while assessing fiscal space. In Russia, the primary non-oil/gas balance is expected to improve to 5 percent of GDP in 2019 from 10.4 percent of GDP in 2013 (Figure 36). This happened largely as a result of fiscal consolidation conducted by the government in 2014-2018. Fiscal consolidation was part of a new macroeconomic framework established by the government after the 2014 oil price plunge. The framework was aimed at gradual adjustment of the economy to the new norm of lower oil prices. It included switching to a flexible exchange rate regime, inflation targeting, fiscal consolidation and introduction of the new fiscal rule. Russia's oil fund is almost replenished, at 7.3 percent of GDP in October 2019, compared 7.9 percent of GDP at the end of 2013 (Reserve Fund, which totaled about 4 percent of GDP in the end of 2013 was completely wiped out for federal budget deficit financing in 2014 – 2017). Relatively comfortable oil prices[26] suggest further oil fund accumulation under the fiscal rule framework in the medium-term. In the cross-country database of fiscal space,[27] Russia improved its positions in the groups of government sustainability indicators (Figure 37), external and private-sector debt and balance-sheet composition indicators. In terms of government debt sustainability and external sector debt, Russia is favorably compared to other ECA EMDEs (Figure 38). The sustainability gap—as measured by the difference between the primary balance and the debt-stabilizing primary balance, assuming current prevailing interest and growth rates—remains positive in both Russia and in ECA, implying that government debt is falling along an accelerated trajectory (Figure 39).

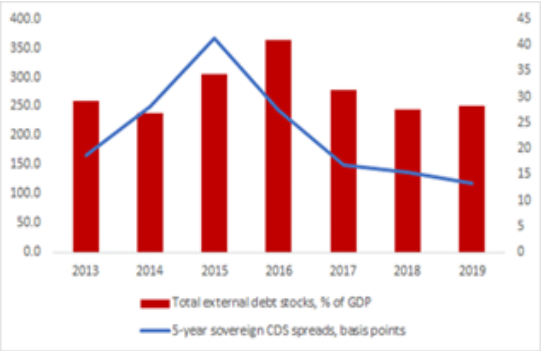
[26] The fiscal rule is based on a conservative oil price of US$40/bbl in 2017 prices.
[27] https://www.worldbank.org/en/research/brief/fiscal-space

Figure 36: Primary non-oil/gas balance is expected to improve to 5 percent of GDP in 2019 (percent)



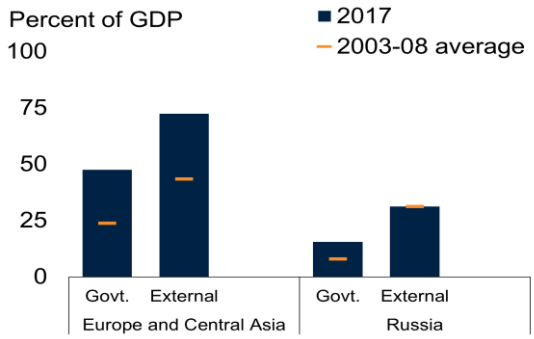
Source: Russian treasury.

Figure 37: 5-year CDS spreads returned to pre-crisis levels



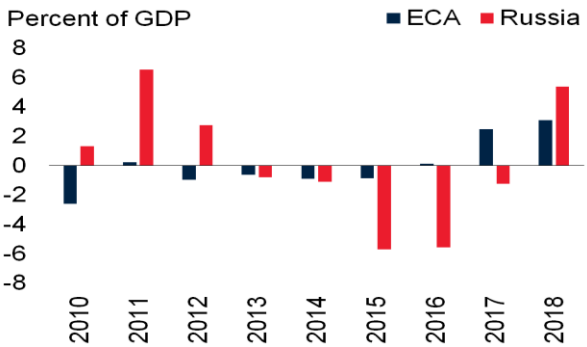
Source: Cross-country database of fiscal space, CBR.

Figure 38: In terms of government debt sustainability and external sector debt, Russia favorably compares to other ECA EMDEs



Source: Cross-country database of fiscal space.

Figure 39: The sustainability gap remains positive in both Russia and in ECA



Source: Cross-country database of fiscal space.

Meanwhile, the possible expansion of sanctions could put upward pressure on Russia's funding costs. Thus, government's fiscal policy, aimed at tackling structural constraints (improving connectivity and labor force quality) while staying in the modified fiscal rule framework seems to be appropriate.

There is room to expand the fiscal space. Such measures as increasing tobacco taxation and cutting tax expenditures (by reconsidering and reducing preferential tax rates), currently estimated at about 3 percent of GDP, can help mobilize more revenues and expand fiscal space.

Box 6: In the first three quarters of 2019, regional debt increased by 6.5 percent to RUB 2.35 trillion, but remained flat as a share of GDP.

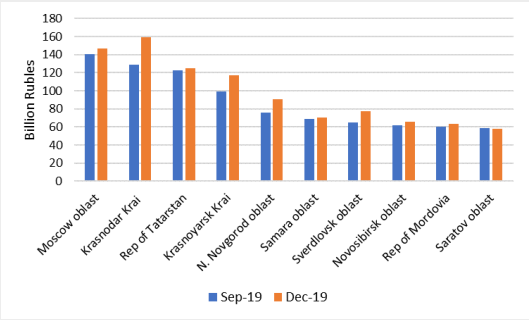
The flat share of regional debt in GDP is largely explained by the higher budget (tax and non-tax) revenues of the regions. In addition, many regions are involved in the program for restructuring of federal budget credits, which limits new debt issuance. Overall, the public debt volume rose in 20 regions (constituencies and municipalities), while declining in all other regions. Perm and Tver regions showed the greatest

improvement, lowering debt levels by 53 percent and 38.3 percent respectively. In terms of per capita public debt, the highest levels were registered in Chukotka, Magadan Oblast, and the Republic of Mordovia. The top 10 regions with the highest debt levels in absolute terms remain the same, accounting for 37.5 percent of regional public debt as of October 1st, while registering lower levels than at the beginning of the year.

In August, a new law came into place, empowering the Ministry of Finance to classify regions into three risk levels based on their debt sustainability, on their debt-to-budget-revenue ratio as well as taking into account their levels of subsidies and donations, annual levels of debt repayment and servicing taxes. According to the Ministry of Finance, 38 regions fall into the "high debt sustainability" category (notably Moscow, Moscow region, St Petersburg, Leningrad region, Sakhalin), while 43 regions fall into the "intermediate category." The Jewish Autonomous Region, Oryol Region, Pskov Region, and the Republic of Mordovia fall into the "low debt sustainability" category, which, according to the new legislation, implies that these regions are entitled to carry out market borrowing only for the purpose of refinancing debt.

The regional debt structure changed in that the share of budget loans increased by 7.6 percent, compared to the beginning of the year, thus now accounting for 47.4 percent of total debt, while the share of commercial loans decreased by 8.8 percent, thus accounting for 25.8 percent (Figure B6- 1).

Figure B6- 1: Ten largest regions in terms of absolute debt levels remain the same but with lower debt levels.



Source: Ministry of Finance.

PART 2. Russian economic growth is expected to accelerate in 2020 and 2021, reflecting easing monetary conditions and increased spending for the national projects

The global outlook remains fragile in the context of elevated economic and trade policy uncertainty, with growth projected to remain unchanged in 2020, at 2.5 percent. Crude oil prices (an average of Brent, WTI and Dubai) are forecast to weaken to US$58/bbl in 2020 from US$60/bbl in 2019 and US$59/bbl in 2021. Expectations for demand in 2019 and 2020 have been revised down, reflecting the weaker outlook for global growth. Growth in Russia is expected to firm in 2020, albeit be slightly weaker than previously envisaged, to 1.6 percent. The pick-up reflects policy support, as less restrictive monetary policy and planned public projects are anticipated to help foster growth. Additionally, the base effect for 2020 growth will be mechanically strong since 2019 was a particularly weak year on account of slowing global growth, subdued oil production and the slow start of national projects.

The global outlook remains fragile in the context of elevated economic and trade policy uncertainty, with growth projected to remain unchanged in 2020, at 2.5 percent (World Bank 2019[28]). Market expectations of GDP growth have deteriorated, with average forecasts for global and EMDE growth continuing to edge downward. Under current working assumptions, more than half of all economies — including several major advanced economies and EMDEs — are expected to slow in 2019. Collectively, they account for about two-thirds of global GDP. As a result, global growth in both 2019 and 2020 is now projected to be slightly slower than previously projected.

Table 4: Global growth is projected to remain unchanged at 2.5 percent in 2020
(GDP growth projections, percent)

	2016	2017	2018	2019f	2020f	2021f
World	2.6	3.2	3.0	2.5	2.5	2.6
Advanced economies	1.7	2.4	2.2	1.6	1.4	1.4
United States	1.6	2.4	2.9	2.3	1.6	1.5
Euro Area	1.9	2.5	1.9	1.1	1.1	1.2
Emerging and developing economies	4.1	4.5	4.3	3.7	4.2	4.4
China	6.7	6.8	6.6	6.1	5.9	5.8
Crude oil (Brent, WTI and Dubai average, US$/bbl)	43	53	68	60	58	59

Source: WDI, World Bank staff projections.

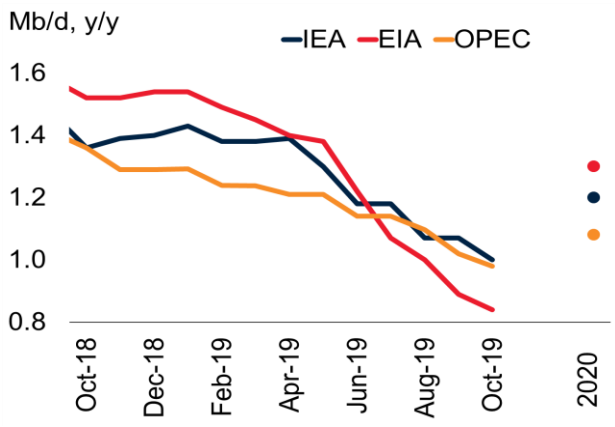
Price forecasts and risks

Crude oil prices (an average of Brent, WTI and Dubai) are forecast to weaken to US$58/bbl in 2020 from US$60/bbl in 2019, a substantial downward revision from US$65/bbl projected in April. Expectations for demand in 2019 and 2020 have been revised down, reflecting the weaker outlook for global growth (Figure 40A). For supply, while U.S. production increases have been modest in 2019 to date, they are expected to rise substantially by 2020, as new pipelines come into operation (Figure 40B). The forecast also assumes that production cuts by OPEC and its partners will be sustained into 2020.

[28] https://openknowledge.worldbank.org/handle/10986/32481

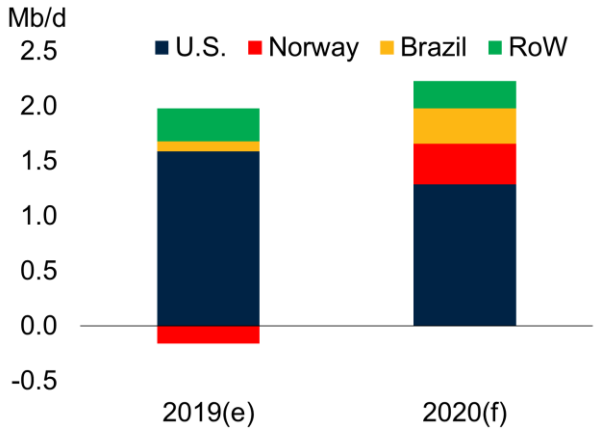
Figure 40: Crude oil prices are forecast to weaken in 2020

A. Expectations for demand in 2019 and 2020 have been revised down



Source: Energy Information Administration, International Energy Agency, Organization of Petroleum Exporting Countries.
Notes: circles indicate 2020 forecast.

B: Expectations for supply are expected to rise substantially by 2020



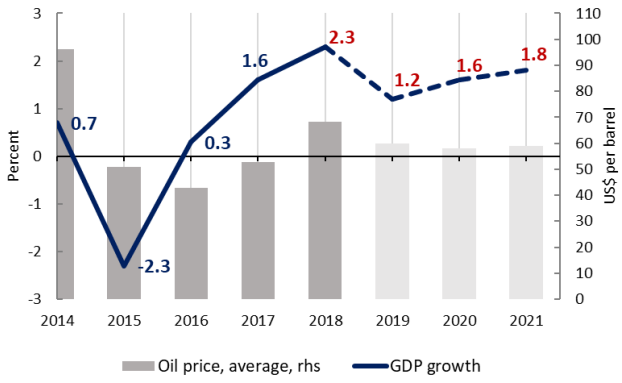
Source: Energy Information Administration, International Energy Agency, Organization of Petroleum Exporting Countries.

Risks to the oil price outlook are to the downside. The key risk is a further slowdown in growth, implying weaker demand for oil. The sectors of the economy which have seen the sharpest slowdown, notably trade and manufacturing, play an outsize role in the consumption of oil products. On the supply side, U.S. production has scope to surprise to the upside, given the additional pipeline capacity coming onstream in the coming months. Conversely, if producers continue to prioritize improved profitability, they may prove to be more cautious than currently expected. OPEC and its partners have indicated they may discuss further production cuts at their December meeting, which would help support prices. However, a push for larger production cuts, particularly if prices remain low, could put the agreement under increasing strain — Ecuador recently announced it will leave OPEC in January 2020, as it wants to increase production to boost fiscal revenue.

Non-energy prices are expected to stabilize in 2020 after a 5-percent decline in 2019. Metal prices are projected to have fallen 5 percent in 2019 and are forecast to fall further in 2020, as slowing global demand will weigh heavily on prices. Risks to this outlook are to the downside, and primarily include a greater-than-expected slowdown in global growth. A sharper-than-expected global downturn may further dampen industrial demand and depress metal prices, especially for copper and aluminum — metals with relatively higher income elasticities of consumption. Furthermore, recent fiscal stimulus measures announced in China may turn out to be less effective in lifting demand for metals (especially copper, aluminum, nickel, and zinc) than expected, since they prioritize tax cuts over government spending. Agricultural prices are expected to stabilize in 2020 following a projected fall in 2019, on reduced crop plantings. Risks to this outlook are broadly balanced.

Revived growth momentum is expected to spill to the fourth quarter of 2019, thus growth in Russia is expected to register 1.2 percent in 2019, and firm up in 2020, albeit slightly more weakly than previously envisaged, to 1.6 percent (Figure 41 and Table 5). The pick-up reflects policy support, as less restrictive monetary policy and planned public projects are anticipated to help foster growth. Additionally, the base effect for 2020 growth will be mechanically strong, since 2019 was a particularly weak year on account of slowing global growth, subdued oil production and the slow start of the National Projects. Going forward, Russia should benefit from relatively comfortable global oil prices (Table 4).

Figure 41: *The growth forecast for Russia suggests modest growth (real GDP growth, percent)*



Source: Rosstat, World Bank.

Private consumption is expected to improve in 2020, supported by looser monetary policy and continued credit growth to households. The dampening effect of the January 2019 VAT hike on consumption and its upward push on prices will also fade in 2020. A tight labor market will likely continue to support private consumption growth.

Investment is projected to accelerate over the next two years, assuming that private investment is revived by benign financing conditions in the near term. Increased spending for national projects is also expected to boost investment and growth over the medium to long term.

Against the backdrop of slowing global GDP and trade growth, export growth in Russia is also expected to be tepid. Oil exports will be tempered, however, by slowing global demand for oil. Imports are expected to improve after being contained in 2019, as National Projects are executed faster, and incomes grow as the effects of the VAT rate hike fade away.

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

	2017	**2018**	**2019**	***2020***	***2021***
GDP growth, percent	1.6	2.3	1.2	1.6	1.8
Private consumption growth, percent	3.3	2.3	1.8	1.9	2.0
Gross fixed capital formation growth, percent	5.2	2.9	0.5	2.0	3.7
General government balance, percent of GDP	-1.5	2.9	1.5	1.0	0.6
Current account (US$ billions)	33.3	114.9	73.81	68.8	65.4
Current account, percent of GDP	2.1	6.9	4.3	3.9	3.6
Exports (GNFS), bln US$	411.3	507.8	476.4	490.5	511.7
Imports (GNFS), bln US$	326.9	343.3	349.7	364.9	384.1
Trade balance (GNFS), bln US$	84.3	164.2	130.8	126.5	108.4

Trade balance (GNFS), percent of GDP	5.3	11.7	7.9	7.7	7.2
Net capital outflow (private sector), bln US$	24.3	63.0	35.0	33.8	29.9
Net capital outflow (private sector), percent of GDP	1.5	3.8	2.1	1.9	1.6
Change in reserves, bln US$	22.6	38.2	63.7	49.6	50.4
CPI inflation (average)	3.7	2.9	4.5	3.7	4

Source: Rosstat, CBR, WB staff calculations.

Supported by relatively comfortable oil prices, the general government budget is expected to remain in surplus in 2020-2021. After faster than expected inflation deceleration, the 12-month CPI index is projected to average 3.7 percent in 2020 and average at the central bank's target of 4 percent in 2021. The forecast of a narrower external surplus reflects lower oil prices and a pick-up in import spending. Net capital outflow is expected to decrease gradually with lower debt payments.

The moderate poverty rate is expected to continue to decline in 2019 and through 2021, although social vulnerability needs to be monitored. Continued growth of the economy, wage growth in the private sector, and the indexation of pensions to inflation will support disposable incomes and contribute to a gradual decline in the poverty rate (Table 6). However, many individuals lack formal employment and many households remain close to the poverty line, suggesting a level of social vulnerability that will continue to require close monitoring.

Table 6: Projected poverty rate in Russia, percent

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019 (proj)	2020 (proj)	2021 (proj)
Poverty rate	12.5	12.7	10.7	10.8	11.2	13.3	13.3	13.2	12.9	12.3	11.7	11.2

Source: Rosstat, WB staff calculations.
Note: Projections are done using HBS-2015 data and the private consumption growth rates and are based on the assumption of neutral income distribution and poverty line fixed in real terms.

Risks and challenges

Risks. Downside risks to the global growth forecast prevail in view of a weaker global economy, rising trade tensions, and domestic factors. Should an adverse shock materialize to the global economy, this could spill over into Russia through trade, financial, and commodity market channels. Russia also remains exposed to the possibility of additional economic sanctions, which would further dampen domestic and foreign private investment. Investment growth also relies on the successful and efficient implementation of government infrastructure investment initiatives.

The liquid part of the National Welfare Fund (NWF) will exceed 7 percent of GDP in 2020, creating a legal opportunity for the government to invest part of the NWF in domestic infrastructure projects. However, substantial domestic investments could render the economy more dependent on energy prices and heighten inflation risks. Demographic challenges, which weigh on Russia's growth potential, and the resulting tight labor market, pose medium-term risks and could generate upward pressure on inflation.

Fast-paced expansion in household credit amidst stagnating income may pose a risk to financial stability if the macroeconomic environment deteriorates, as low-income borrowers or borrowers with multiple loans seem

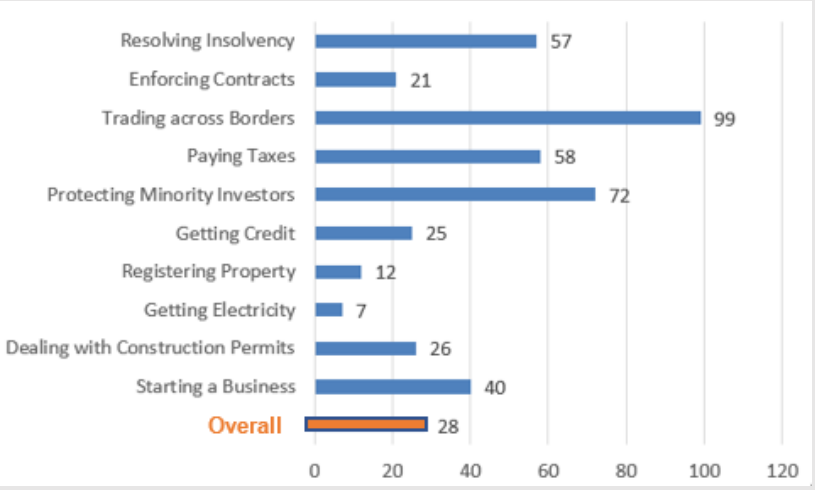
to be at risk of over-indebtedness. The effect of the CBR measures on unsecured consumer lending is yet to be seen. Additional macroprudential measures may be needed if lending growth does not moderate. To that extent, in September 2019, CBR published a consultation paper on the development of macroprudential measures aimed at managing consumer lending growth.[29]

Challenges. The government strives to achieve the National Goals (increase GDP growth rate to 3 percent, half poverty rate, increase life expectancy, etc). While National Projects implemented efficiently have the potential to increase GDP growth rate, they need to be complemented with efforts aimed at enhancing competition, leveling the playing field and reducing state footprint. Efforts to attract FDI and reduce barriers to external trade are important as well. Russia has undertaken important steps to improve its regulatory environment, advancing to the 28th position in the Doing Business Global rating (Box 7). Yet several areas including Trading Across Borders, Protecting Minority Investors, and Resolving Insolvency continue to lag.

Box 7: Russia continued its efforts to enhance the regulatory environment for small and medium enterprises.

The World Bank Group's Doing Business report provides an objective measure of business regulations and their enforcement for domestic small and medium enterprises in 190 economies around the world. In the Doing Business 2020 report, Russia advanced to 28th place in the global ease-of-doing-business ranking, an improvement of three positions from the 31st place last year. Performance on the individual components varies widely as seen in Figure B7- 1.

Figure B7- 1: Doing Business 2020: Indicator Ranks (out of 190)



Source: Doing Business 2020.

The greatest improvement among the Doing Business indicators this year was in **Dealing With Construction Permits**, which moved from a global rank of 48th in Doing Business 2019 to the 26th position this year. The change was driven by a reduction in the number of procedures required to obtain a construction permit as well as a reduction in the time required. Other changes recognized in Doing Business include:

[29] https://www.cbr.ru/Content/Document/File/79964/Consultation_Paper_190910.pdf

- **Getting electricity** has been made faster by setting new deadlines and establishing specialized departments for connection works within the utilities of Moscow and Saint Petersburg. The reforms helped advance Russia to the 7th position globally in the Getting Electricity indicator with just 2 procedures requiring 38 days in Moscow relative to the Europe and Central Asia average of 5.1 procedures requiring 99.6 days.

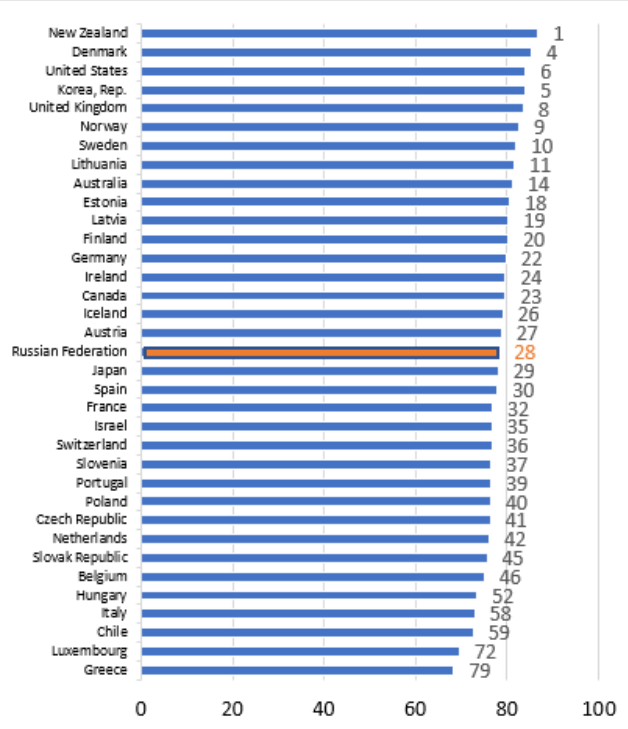
- **Minority investor protections** were strengthened by requiring greater corporate transparency, although even with this reform, the category remained among the lower scores for Russia.

- **Paying taxes** was made easier by reducing the tax authority review period of taxpayer applications for value added tax cash refunds and by further enhancing the 1C software used for tax and payroll preparation.

The Doing Business results also show room for further improvement in several areas, including **Trade Across Borders** and **Resolving Insolvency** where practices in Russia continue to lag regional averages. For example, the total time and cost to export are 92 hours and US$660 respectively compared to the Europe and Central Asia average of 41.2 hours and US$237.6.

Russia's Doing Business score currently stands at 78.2 (100 represents the theoretical best possible practice). This score positions Russia exactly in the middle of the OECD High Income Country Group, which has a collective average DB score of 78.4 (Figure B7- 2).

Figure B7- 2: Russia and OECD High Income: Doing Business 2020 Score (x-axis) and Country Rank (data label)



Source: Doing Business 2020.

Another initiative of the government aimed at improving regulatory environment is "Regulatory Guillotine" (see Box 8)

Box 8: The government strives to establish a modern and efficient control system with the "Regulatory Guillotine".

The goal of revising mandatory requirements that entrepreneurs must observe in their operations was announced in February 2019. This revision has since been labelled the "regulatory guillotine." Many of existing mandatory requirements have become obsolete and have not been reviewed for over 20 years. Over 20,000 legal acts of the USSR and the RSFSR have to be reviewed, and excessive and ineffective regulations are expected to be eliminated. The government declares they carefully analyze each legal act in order to avoid mistakes. The guillotine is to fall on January 1, 2021. New regulations shall contain modernized mandatory requirements based on risk and utilizing modern technology. All stakeholders, including regulators, business, think tank and experts, are expected to be involved in this process. Federal ministries and agencies which have control functions, business associations, Ministry of Economic Development, Ministry of Justice, the Expert Council by the RF Government, and the Analytical Center of the RF Government are responsible for implementation of the regulatory guillotine road map.

The inspection reform provides for the creation of a new regulatory platform based on two main federal laws on the state and municipal control and the mandatory requirements. These laws are expected to be submitted to the State Duma in December 2019.

The ultimate goal of the reform is a modern and efficient control system that provides increased protection to the life and health of Russian citizens, establishes a transparent environment for doing business and decreases corruption. The main focus of control shall move from punishment to prophylaxis.

For the regional and municipal control, the new legislation [Federal Law on Mandatory Requirements] is expected to include a standard matrix for control at the regional level (with exception of the federal cities). Regions will have an option to set up mandatory rules in accordance with the standard matrix.

PART 3. How Wealthy is Russia? Measuring Russia's comprehensive wealth from 2000-2017[30]

National income and well-being are underpinned by a country's assets or wealth – measured comprehensively to include produced capital, natural capital, human capital, and net foreign assets. Wealth, by its nature, concerns the future — the flow of income that each asset can generate over its lifetime. Russia experienced strong growth in wealth from 2000 to 2017. However, its total wealth per capita is less than a third of the OECD average and even lags behind the averages of other upper middle-income and high-income commodity exporters. Additionally, while Russia's wealth per capita grew steadily from 2000 to 2008, with a slight decline during the global financial crisis, it has since decreased or stagnated. This part of the report summarizes the most recent analysis on Russia's wealth trend in comparison to other countries, the distribution of the return on wealth, and concludes with the policy applications and directions to maximize it.

Russia is a country of global importance and great diversity. The world's largest transcontinental country spans eleven time zones and is the ninth most populous country in the world. Russia is the main trading partner for many of its more than a dozen neighbors. It is richly endowed with natural resources, which underscores its importance as a global commodity exporter. Owing to its rich resource base, Russia plays a crucial role in global energy and resource markets. The country holds the world's largest natural gas reserves, the second largest coal reserves, and the eighth largest oil reserves. Russia is one of the largest producers and exporters of natural gas, the third largest oil producer (after the United States and Saudi Arabia), and the second largest oil exporter after Saudi Arabia.

But how wealthy is Russia, really?

Understanding the difference between "wealth" and "income" is crucial. *Wealth* is measured comprehensively to include all assets – produced, human, and natural capital, as well as net foreign assets. *Income*, or GDP, is merely a return on this wealth. While GDP provides an important measure of economic progress, it is a flow measure that captures income and production in one year but does not account for any changes in the underlying wealth asset base. Hence, used alone, GDP is likely to provide misleading signals about the state of the economy, the efficiency of asset utilization, and the sustainability of development. GDP also does not reflect depreciation and depletion of assets; it does not indicate whether accumulation of wealth keeps pace with population growth, or whether the mix of different assets will support a country's development goals. Economic performance is thus best evaluated by monitoring both GDP growth and wealth.

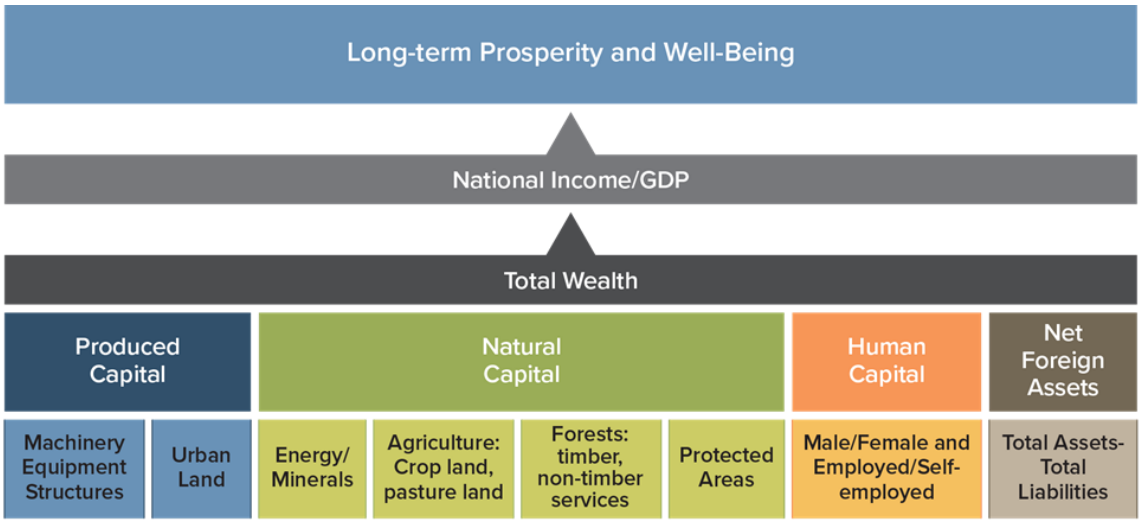
The analysis refines and tailors a methodology that, for the first time, comprehensively measures Russia's national wealth. In doing so, it attempts to address the following questions:

[30]This section is based on a new report **"How Wealthy is Russia? Measuring Russia's comprehensive wealth from 2000-2017"** by Esther Naikal, Olga Emelyanova, Vladislava Nemova, Glenn-Marie Lange and Apurva Sanghi (all World Bank). The interested reader is referred to this report for more in-depth discussion and technical analysis, including a list of references.

1. How wealthy is Russia as a nation? And is the typical Russian citizen wealthier or less wealthy today than in the past?
2. How does Russia's wealth compare to other countries, and what can Russia do to increase its wealth?
3. How are the returns on this wealth distributed amongst Russian citizens? Who has benefitted from Russia's wealth?

The assets and capital that drive wealth and development are summarized in Figure 42.

Figure 42: The assets and capital that drive wealth and development



Source: World Bank.

As shown in Figure 42 above, wealth accounts include the following asset categories, all measured in market prices and in constant US$:

- **Natural capital**:
  - Nonrenewable resources: 14 types of minerals and fossil fuels;
  - Renewable resources: Cropland, pastureland, forest timber, forest services (an estimate of nontimber forest products, watershed services, recreation values), protected areas (value estimated as the opportunity cost of converting to agriculture);
- **Produced capital** and urban land**:** Infrastructure, machinery, buildings, equipment, and urban land (For the sake of brevity, the abbreviated term 'produced capital' is used to include both);
- **Human capital**: Measured as the discounted value of earnings over a person's lifetime;
- **Net foreign assets**: The sum of a country's external assets and liabilities.

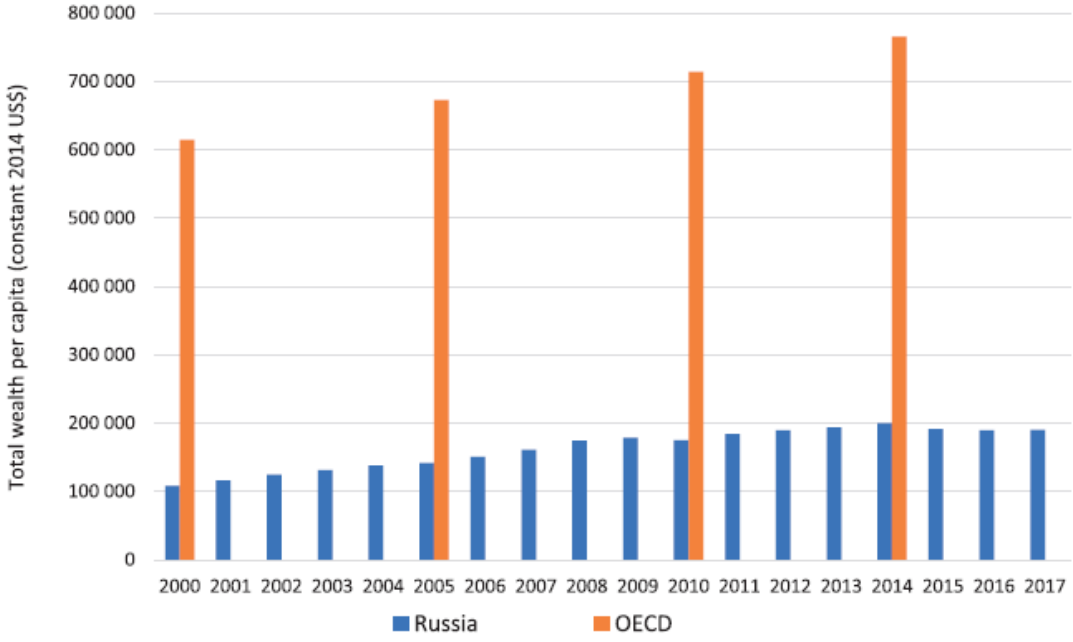
Building on the data and methods of the 2018 CWON report, which covered the period 1995 to 2014, this analysis extended the Russian wealth time series to 2017 and where possible, substituted country data for the report's global figures. The interested reader is referred to the "How Wealthy is Russia" report for a detailed review of each of the four components of Russia's wealth accounts and the underlying data, methodologies and assumptions.

Within this context, five key findings and policy directions are summarized below:

Finding #1: **A typical Russian citizen was 1.8 times wealthier in 2017 than in 2000. However, this is only about a quarter of wealth of a typical OECD resident.**

In 2017, the typical Russian citizen was 1.8 times wealthier than in 2000, with accumulated wealth of about 8.9 million rubles, or about US$ 152,451. Nevertheless, this is only about a quarter of wealth of a typical OECD resident (Figure 43).[31] From 2000–2017, Russia's per capita wealth grew multiple times faster than that of high-income countries, albeit from a much lower base. This remarkable performance in per capita wealth growth was uneven, however. The strong growth present in the early 2000s has weakened in recent years due to stagnant growth in human capital and the decline in oil and gas wealth.

Figure 43: Despite strong growth, Russia's per capita wealth is about a quarter of the OECD average *(Trend in Russia and OECD's total wealth per capita, 2000-2017)*



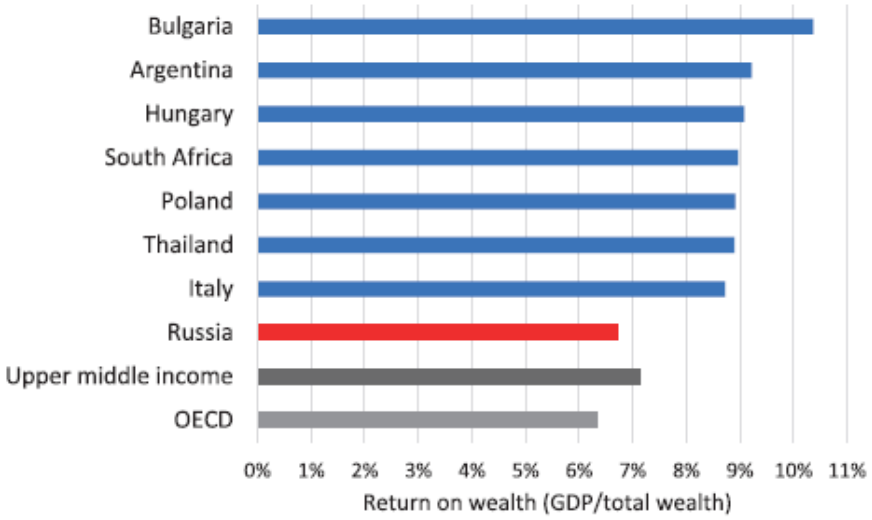
Source: Authors' calculations.

Finding #2: **Around 7 percent, Russia's return on wealth is similar to upper middle and high-income countries but lower than that of certain Eastern European countries. However, in recent years, this return to wealth has been less evenly distributed than in the past.**

On average, Russia's "return on wealth" (i.e., the ratio of GDP to wealth) has been around 7 percent for the 2000–2017 period, similar to the average of upper middle-income and high-income countries (Figure 44). However, it is lower than the 8-10 percent return in Eastern European countries such as Bulgaria, Hungary, and Poland, as well as the return in other countries such as Argentina, Italy, South Africa, and Thailand.

[31] Russia's values are in constant 2017 prices, however benchmarking / international comparisons are done in 2014 US$ for years 2000 – 2014, based on the CWON 2018 global database.

Figure 44: Russia's return on wealth averaged 7 percent between 2000 – 2017 (*Ratio of GDP to total wealth)*



Source: Authors' calculations.

An important question is: how well has this return to wealth been distributed? Measuring the evolution of two measures of shared prosperity (income growth of the bottom 40 percent of the population and growth in median income) reveals that, while sizeable during the boom years, Russia's shared prosperity premium has been shrinking in recent years. Incomes of the bottom 40 percent fell with the global financial crisis of 2008 – 2009 but recovered quickly and continued to grow, though at a slower pace. They stalled in 2012 with the weakening of the macroeconomic environment and falling oil prices, stagnating in 2012 and 2013, and then dropping faster than average incomes in 2014. Median income growth also decelerated. After growing annually at 9 percent in 2001-2008, median income grew by just 4.5 percent in 2009-2010, and by only 1.6 percent annually during 2010 - 2015.

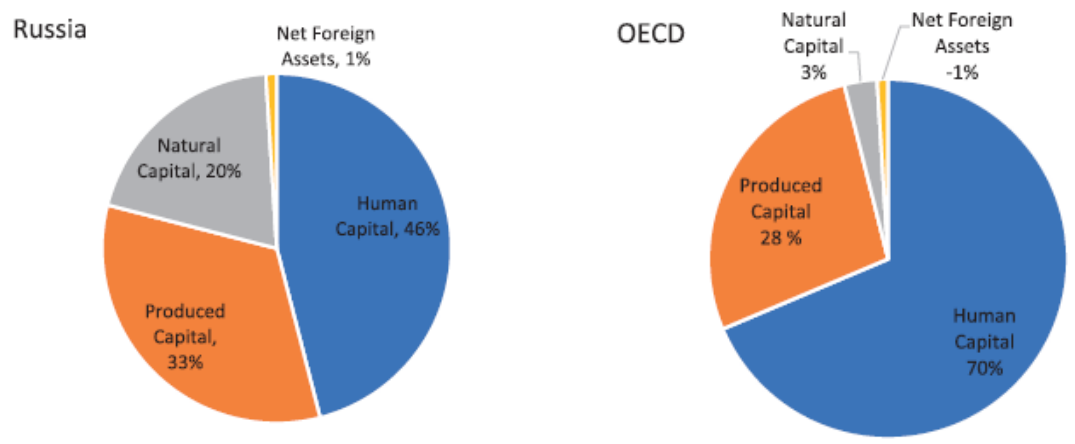
Finding #3: **Human capital, at 46 percent, comprises the largest share of wealth in Russia, however, much less than the OECD average of 70 percent. Russia's natural capital share stands at 20 percent. As a rough approximation, Russia's forests provide global carbon absorption benefits of over US$ 500 billion.**

Perhaps surprisingly, human capital comprises the largest share of wealth in Russia, at 46 percent (Figure 45). This is followed by produced capital at 33 percent, natural capital at 20 percent (of which renewables contribute 5 percent and non-renewables 15 percent), and net foreign assets (1 percent). In comparison, the wealth composition of OECD countries, on average, is 70 percent human capital, 28 percent produced capital, 3 percent natural capital, and minus 1 percent net foreign assets.

Russia's 15 percent share of non-renewables is well above the average for upper-middle and high-income countries (other than the Gulf countries), reflecting its abundant oil and gas resources. Russia's forests also hold vast amounts of carbon and, if the value of carbon sequestration is included, would increase its share of natural capital from 20 to 22 percent. Across Russia's varied forestland, the carbon absorption of its European forests is comparable to Finland, that of its Siberian forests to Canada, and the North Caucasus forests to the USA. As a rough approximation, Russia's forests (excluding reserve forests) provide absorption of more than

638 million tons of CO_2 equivalent or around 30,000 billion rubles (over US$ 500 billion)[32].

Figure 45: Human capital comprises the largest share of wealth in Russia, however, much less than in OECD average, meanwhile natural capital is well above the average



Source: Authors' calculations.

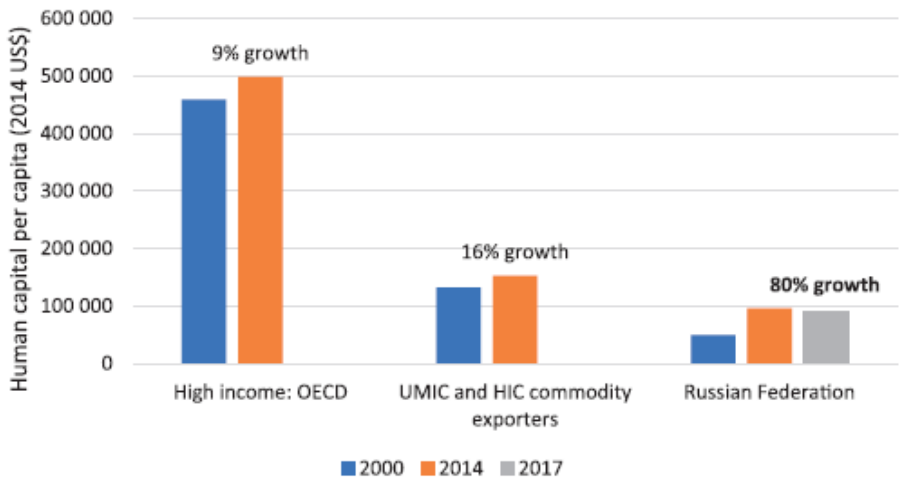
Note: Russia's figures are for year 2017. The OECD and upper middle-income group averages are for the latest available year, 2014.

Finding #4: **Despite its significant growth, Russia's human capital wealth per capita is one-fifth the OECD average (Figure 46). At current rates, Russia would only catch up after almost 100 years.**

During 2000–2017, Russia's human capital wealth per capita grew rapidly at 80 percent, compared to the overall wealth per capita growth of 76 percent. Russia's per capita growth in human capital dwarfed growth rates among OECD countries and commodity exporters. However, its average annual growth rate of per capita human capital wealth has slowed from 4.7 percent for the period covering 2000–2010 to 1.8 percent during 2010 to 2017. If Russia's human capital grew at its 2000–2017 average of 3.5 percent, it would take about 50 years to catch up with the OECD; and at the slower rate of 1.8 percent, Russia would only catch up after almost 100 years.

[32] This is the net present value of future annual sequestrations for the life of the forest, using a conservative social cost of carbon of US$ 33 per ton CO2 eq emitted in 2017 at 2017 prices. The estimation is sensitive to assumptions of the lifetime, discount rate, and future carbon sequestration levels and prices.

Figure 46: Despite significant growth in human capital, Russia's human capital wealth per capita is one-fifth the OECD average (Trend in human capital per capita, Russia and benchmark countries)

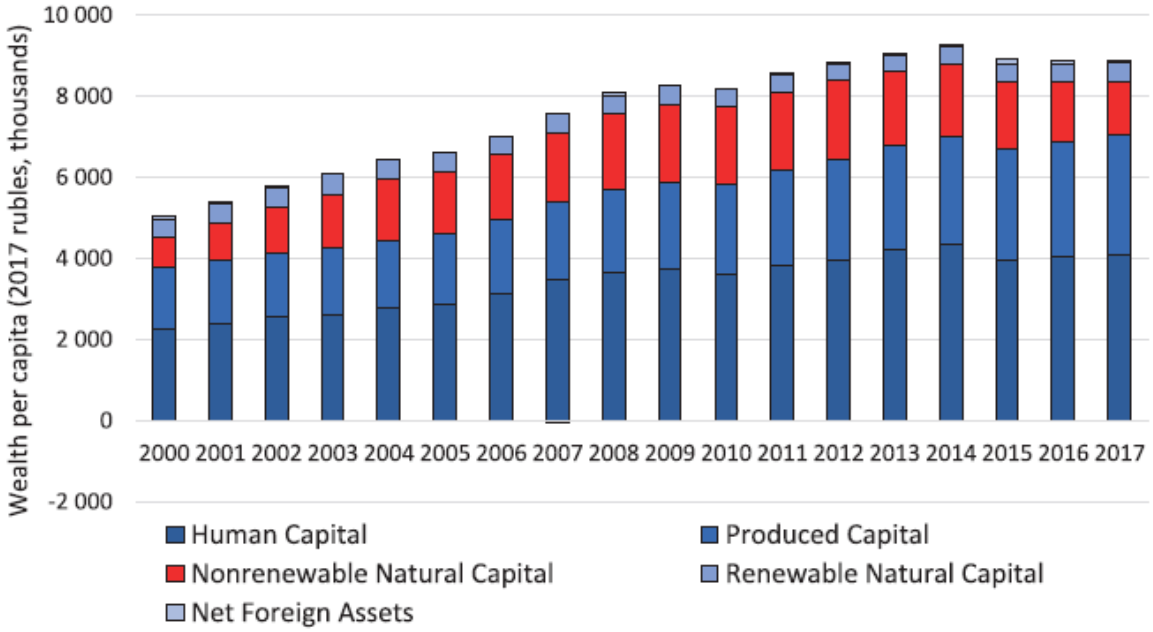


Source: Authors' calculations.

Finding #5: **Russia's large share of carbon-based wealth faces increased risk due to future price uncertainty and large-scale attempts at global decarbonization.**

To maximize the return on wealth, policies to rebalance Russia's wealth portfolio are needed. Russia's dependence on its non-renewable assets poses a specific development challenge, with its carbon-based wealth facing increased risk due to future price uncertainty and large-scale attempts at global decarbonization (Figure 47).

Figure 47: Oil and gas are a significant share of Russia's wealth (*Russia's trend in wealth per capita from 2000 to 2017, by components)*



Source: Authors' calculations.

Emerging Policy Directions

Policy Direction #1: Diversify the wealth portfolio

Rebalancing the portfolio and mitigating the risks of stranded assets will require Russia to diversify its wealth portfolio away from its fossil fuel sector and towards other productive capital. This will involve, in the short-term, maintaining the fiscal rule – a necessary though not sufficient condition for diversification.[33] The new fiscal rule has substantially curbed the economy from oil price volatility, and in order to further entrench its credibility, it will be important to refrain from investment of the National Welfare Fund in domestic assets.

However, Russia continues to depend on underground fossil fuel assets to generate a significant share of export revenues. In 2018, energy exports accounted for 65 percent of total exports (compared to 59 percent in the previous year). Other types of natural capital, such as minerals and timber products also play an important role. Furthermore, the structure of produced capital is skewed towards those are close to fossil fuels and require related skills, such as refining and heavy industry, including metals, chemicals and related equipment. This asset structure makes the Russian economy vulnerable to the structural impact of international, regional, and domestic efforts to address climate change, biodiversity, air and plastic pollution. The impact can manifest through technology and policies that reduce demand for fossil fuels and policies that can restrict market access to industrial products with high environmental footprint.

In the short term, the heavy and polluting industries that currently generate the bulk of revenue could lowering their environmental footprint through adopting modern environmental management systems. The payoffs are likely to be imminent. For example, Russian aluminum already enjoys a low carbon footprint by relying on hydro power, and this may give it a price and market access premium in the near future.

In the medium- to long- term, and with the necessary political backing, it would be important to increase fuel excise taxes and differentiate tax rates by the social and environmental cost of fuel use. Exploring the use of carbon taxes or other forms of carbon pricing harmonized within broader trade and technology agreements with prospective trading partners would also help. This could include, among other things, eliminating non-transparent subsidies to producers and consumers, which can be regressive and distort incentives for efficient consumption, and replacing them with more targeted cash transfers to the poor and vulnerable. Russia can also engage more proactively in international climate policies to access support (technology, finance, and access to market) for asset diversification, as well as leverage such cooperation to facilitate global market access for knowledge-intensive and environmentally sustainable goods and services made in Russia. The recent adoption of the Paris Agreement by Russia is a welcome step in this direction.

[33] According to the fiscal rule, the portion of the oil/gas revenue the federal government can spend in a given year is determined by a fixed oil price benchmark (US$40 per barrel in 2017 prices). If actual oil prices exceed the benchmark price, the difference will be saved in the National Welfare Fund (NWF). 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.

Policy Direction #2: Sustain policy focus on human capital

Specifically, given the significance of human capital in Russia's overall wealth, a sustained policy focuses on both increasing its share and increasing returns on the stock of human capital wealth will help. Some targeted measures to improve Russia's human capital performance (education and health) include:

a. Further developing Russia's university education potential: Although the situation is improving, Russia does not yet have a university among the top 100 in the world;
b. Improving the quality of Russia's vocational education system: Vocational education continues to attract a large stream of Russian students; for example, post-secondary vocational programs enrolled about 40 percent of graduates in 2018;
c. Improving collaborative problem-solving skills, communication, and creativity of Russian students: Russian students perform below the OECD average in these softer-skill areas;
d. Emphasizing primary care disease detection, prevention, and management rather than expensive ex-post, curative care.
e. Increasing health care efficiency and financing: This could be in the form of introducing evidence-based clinical protocols and quality assurance systems, rationalizing excessive hospital infrastructure, and better using information technology to digitize electronic health records.

One area that merits further examination is the reason why Russia's human capital proportion of its total wealth is significantly lower than the OECD norm. Prima facie, this is surprising since Russia's education performance appears to be on par -- and even better – than the OECD's in certain areas. For example, the proportion of the labor force with university degrees is higher in Russia than the OECD and the quality of education as measured by standardized tests such as PISA is on par with OECD. Women have long outranked men in accessing university education. A fertile area of policy enquiry thus lies in the interface of education and the labor market, through a thorough investigation of the private and social returns to education.

Policy Direction #3: Increase produced capital by improving investment climate

Russia's produced capital per capita is almost a fourth of the OECD average, and increasing produced capital would require improving the investment climate. This could be done through creating a level playing field for firms, by enhancing competition conditions and streamlining regulatory requirements. This includes:

a. Reversing a trend towards cartelization of the economy, especially in public procurement;[34]
b. Promoting competitive neutrality principles among state-owned enterprises (SOEs) and private sector actors;
c. Ensuring the transparency of state support and privileges to minimize competition distortions.

[34] Source: Federal Antimonopoly Service.

Policy Direction #4: Better manage natural capital and enhance Russia's role as an "ecological donor"

Although renewable resources make up a smaller share of Russia's natural capital (they are also underestimated), they can produce benefits in perpetuity if managed sustainably. An immediate priority is reducing forest fires, which are the main factor driving forest loss. Russia is home to 20 percent of the world's forest resources, and between 2015-2018, fires on both forest and non-forest lands increased 2.4 times. Scarce financing of forest management complicates efforts to fight or prevent forest fires, but if successfully implemented, the new national priority project, "Ecology" (2019-2024), could increase the values of timber and forest ecosystem services, including sequestration. This would also enhance Russia's role as an ecological donor to the planet.

Policy Direction #5: Pursue policies to distribute returns on wealth more equitably

The waxing and waning of two measures of shared prosperity (growth in incomes of the bottom 40 percent of the population and median income), coupled with the overall macro-economic conditions, underscores both the importance of increasing returns to Russia's wealth and pursuing policies that distribute these returns more equitably.