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The World Bank in Russia

Russian Economic Report*

After a 4 percent growth in 2010, Russia's real output is expected to grow 4.4 percent in 2011, increasingly driven by domestic demand. The country emerged from the global recession with lower-than-expected unemployment and poverty. Although in the short term, high oil prices will help Russia's export and fiscal revenues, there is no room for complacency. The challenge is to sustain reforms under the conditions of a new oil windfall. Economic policy should focus on the short-term objective of controlling inflation and making medium-term adjustment towards a long-term, sustainable level of non-oil fiscal deficit and a more productive, diversified economy. Improving the efficiency of public expenditure to create fiscal space for productive infrastructure and strengthening the investment climate for the private sector remain among key long-term challenges.

SUSTAINING REFORMS UNDER THE OIL WINDFALL

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RUSSIAN ECONOMIC REPORT No. 24

I. RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Summary. *Despite the recent slowdown, the underlying growth of the global economy remains solid. After a 4 percent growth in 2010, Russia's real output is expected to grow 4.4 percent in 2011, increasingly driven by domestic demand. Russia's households have absorbed the food price shock thanks to a combination of higher wages and pensions, and resort to private and public safety nets. The country emerged from the global recession with lower unemployment and poverty than feared. But global risks and uncertainties increased with the new oil shock. Although the short-term impact will be positive for Russia's export and fiscal revenues, there is no room for complacency. Macroeconomic policy should focus on the short-term objective of controlling inflation and medium-term fiscal adjustment towards long-term, sustainable level of non-oil fiscal deficit. Improving the efficiency of public expenditure to create fiscal space for productive infrastructure and strengthening the investment climate for the private sector remain among key long-term challenges. The ongoing rethinking of the government's long-term strategy and a period of high oil revenues provide an opportunity to focus on these long-term issues more forcefully than during the global crisis.*

GLOBAL TRENDS — return to more moderate growth

Following the bounceback in 2010, global industrial production and trade are now returning to more sustainable growth rates. This development partly reflects the ending of the trade and inventory cycle, as well as a gradual tightening of monetary and fiscal conditions against the backdrop of the financial sector and debt situation in developed countries. Industrial production has slowed worldwide (reaching 7.1 percent, annualized, in the last quarter of 2010, from 8.2 percent in the third), and growth in trade has also slowed (figures 1.1 and 1.2).

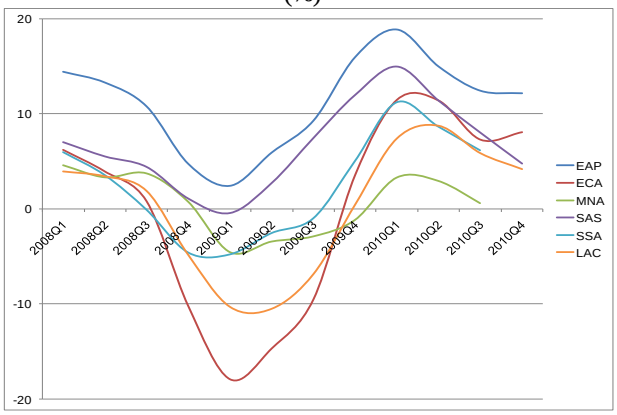
Despite some deceleration, growth in developing countries remains robust. China's growth eased somewhat from 11.1 percent in the first half of 2010 to a still impressive 9.8 percent in the fourth quarter (Q4) on a seasonally adjusted annualized basis; industrial production is also slowing, from 18 percent to 13 percent. Although most large middle-income countries experienced similar trajectories, one of the largest decelerations happened in Brazil, where Q4 growth was around 5 percent, compared with 9 percent in the first half of the year. Industrial production in developing countries as a group was up almost 9 percent year on year (y-o-y) by the last quarter of 2010.

Recent instability in Middle East and North Africa (MENA), however, may be affecting capital flows and risk perception of developing countries. Capital flows to developing countries started 2011 on a strong note, boosted by record bond flows. Total flows in January stood 69 percent and 8 percent higher than in the same period in 2009 and 2010, respectively. Bond issuance surged, with deals from 17 countries coming to market, bringing the total volume to US$29 billion, the highest monthly level on record. In contrast, bank lending fell to the lowest monthly volume since February 2009, reversing an uptrend in the second half of 2010, and equity issuance was down sharply from December, with East Asia accounting for much of the decline (table 1.1).

Although the unrest in MENA had limited contagion impact so far, risks to global growth have risen with the new oil shock and the aftereffects of the catastrophic earthquake in Japan. Shares in the most affected countries in the region experienced double-digit falls since the beginning of the year. After global equity indexes posted gains until mid-March, they too experienced increased volatility, but without signs of a major contagion, in part because MENA accounts for a very small portion of world stock market capitalization and global activity. Nevertheless, the crisis in MENA appears to be showing some limited signs of stock market contagion, weighing more heavily on emerging markets than on mature ones. With the escalation of risk aversion, risk premiums, and spreads in MENA, investors may be considering migrating from developing markets to developed economies (figure 1.3). The evolving impact of the earthquake in Japan adds a layer of uncertainty with the likely tightening of oil market conditions in Asia.

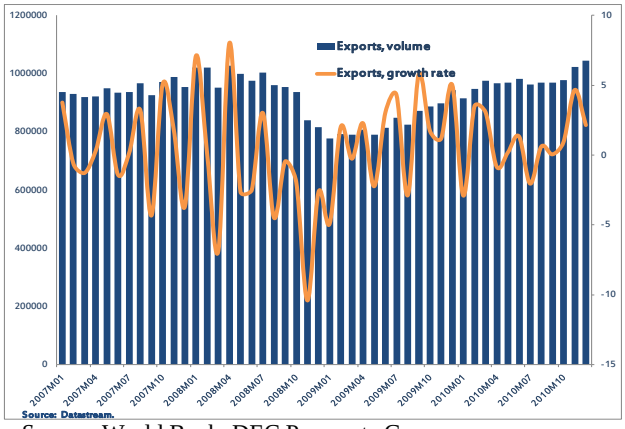
Figure 1.1: Global Industrial Production: Output Momentum Slowing

industrial production, seasonally adjusted annualized rate (%)



Source: World Bank, DEC Prospects Group.

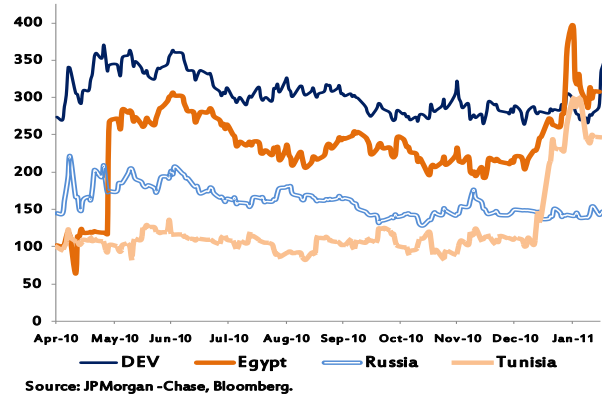
Figure 1.2: Global Trade Growth Stabilizing as Output Momentum Slows



Source: World Bank, DEC Prospects Group.

Figure 1.3: Selected Credit Default Swap Spreads Countries

Five-year sovereign credit default swaps, basis points



Source: Global Economic Prospects group, World Bank.

Table 1.1: Capital Flows to Developing

$ billion	2009				2010					2011
	Jan	H1	H2	Total	Jan	H1	H2	Dec	Total	Jan
Total	24	110	243	353	38	197	316	42	512	41
Bonds	9	36	80	115	22	86	98	4	184	29
Banks	9	43	86	129	9	54	87	15	141	2
Equity	6	32	77	109	7	57	131	23	188	10
Lat. America	10	37	100	137	9	66	98	10	164	17
Bonds	5	15	47	62	8	37	45	3	82	14
E. Europe*	4	22	50	72	13	53	70	4	123	10
Bonds	2	13	20	33	7	31	33	1	64	9
Asia	9	44	78	122	13	64	133	27	197	11
Bonds	2	6	10	16	7	13	15	1	28	4
Others	1	7	15	22	2	14	15	1	28	3

** Including Poland & Croatia*

Source: DECPG

Source: Global Economic Prospects group, World Bank.

RUSSIAN FEDERATION'S GROWTH — driven by inventory restocking and exports

Russia's economy grew 4.0 percent in 2010, driven largely by a sharp rebound in investment demand and inventory restocking, in particular. Gross capital formation contributed 4.5 percentage points to aggregate growth in 2010, most of it (3.7 percent) through inventory restocking rather than fixed capital formation and with exports contributing about 3.1 percentage points. The contribution of domestic consumption has been limited (only 1.6 percentage points) reflecting gradual improvements in labor and credit markets with domestic demand increasingly satisfied by imports. The negative contribution of imports to aggregate growth jumped to more than 5 percentage points, with a surge in consumer and intermediate imports.

Goods production was the main factor for gross domestic product (GDP) expansion in 2010, contributing about 60 percent to aggregate growth. Tradable industries (manufacturing in particular) led growth in 2010 (table 1.2). After a collapse during the crisis year, manufacturing grew 13.4 percent in 2010 y-o-y, contributing about 2 percentage points to GDP expansion, but not yet reaching the precrisis level; this growth helped the rebound of transport and communication. The contribution of major market services, however, has been uneven. Reflecting more gradual recovery of domestic demand, retail and wholesale trade grew 4.5 percent in 2010 y-o-y. On the negative side, agricultural output was hit by a severe drought, and fell 12.1. With limited access to long-term credit and the bankruptcies of many construction companies, the construction sector contracted 0.9 percent. Financial services (another major labor-intensive sector) also failed to expand last year, contracting by 3.0 percent despite rapid monetization and improved liquidity conditions.

Table 1.2: GDP Growth by Main Sectors (Value Added), 2006–10

	2007	2008	2009	2010
GDP growth	8.5	5.2	−7.8	4.0
Tradable sector	3.5	−0.1	−8.6	6.5
Agriculture, forestry	1.3	6.4	1.4	−12.1
Extraction industries	−2.2	1.0	−0.3	4.8
Manufacturing	7.5	−2.1	−15.6	13.4
Nontradable sector	12.8	9.1	−7.0	2.9
Electricity, gas, and water production and distribution	−3.4	0.7	−3.0	5.9
Construction	13.0	11.1	−14.6	-0.9
Wholesale and retail trade	11.7	9.9	−6.5	4.5
Transport and communication	4.8	5.2	−8.4	7.0
Financial services	29.1	13.5	2.2	−3.0

Sources: Rosstat; World Bank staff estimates.

The early 2011 data on sectoral gross output indexes convey a mixed picture. The growth momentum in industry has continued into 2011. Aggregate industrial production increased 6.3 percent in January-February 2011 (y-o-y), with the broad-based manufacturing sector leading the recovery (11.8 percent growth). But major service sectors experienced more sluggish growth, likely reflecting a 3.6 percent decline in real disposable incomes in January-February 2011. Retail trade grew by only 1.9 percent in January-February 2011 y-o-y, while construction sector contracted by 0.3 percent, failing to sustain the growth momentum of Q4 2010.

BALANCE OF PAYMENTS — stronger because of high oil prices

High oil prices helped the balance of payment (BoP) position in 2010 despite rapid growth of imports and sizable capital outflows (table 1.3). The overall *BoP position* improved, allowing the Central Bank of Russia (CBR) to accumulate US$37 billion in foreign currency reserves. At the end of 2010, international reserves stood at US$479 billion, equivalent to 33.8 percent of GDP, the third-largest amount in the world. The external *current account* balance improved to US$72.6 billion in 2010 from US$49.4 billion in 2009 because of higher-than-expected oil and resource prices (table 1.3). The *capital account* has also shown improvement from large total outflows of US$44.3 billion in 2009 to US$30.5 billion in 2010. This trend, however, has been mostly driven by a gradual recovery in the banks' rollover capacity.

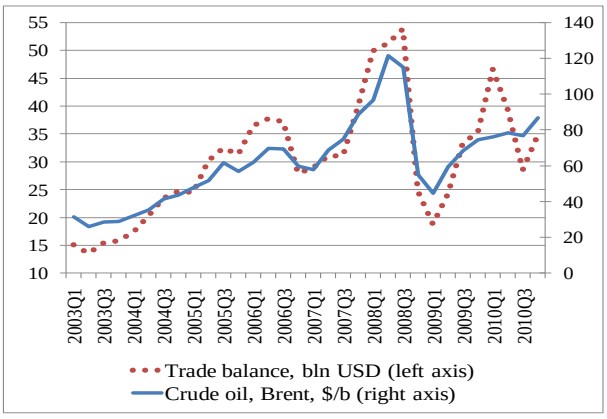
Table 1.3: Balance of Payments, 2006–10, US$ billions

	2007	2008	2009	2010[a]	Q3-2010[a]	Q4-2010[a]
Current account balance	77.0	103.7	49.4	72.6	6.1	14.3
Trade balance	130.9	155.4	111.6	149.2	29.1	34.3
Capital and financial account	84.8	−131.3	−44.3	−30.5	−6.0	−21.4
Errors and omissions	−12.9	−11.3	−1.7	−5.4	2.7	−1.5
Change in reserves (+ = increase)	148.9	−38.9	3.4	36.8	2.8	−8.6

Source: CBR. a. Preliminary estimates.

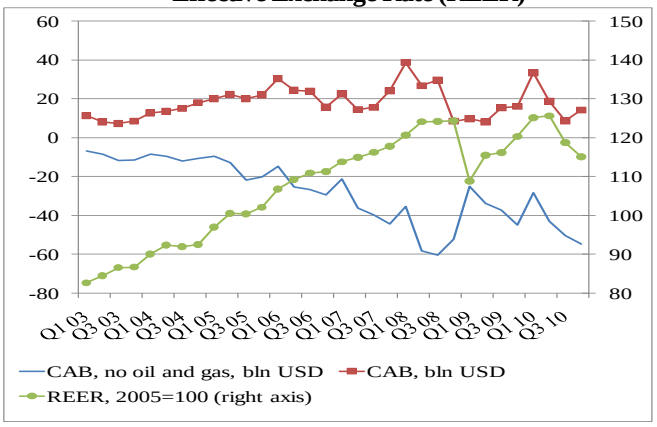
But the aggregate numbers may overstate the strength of Russia's external position. The external current account had been on a rapidly deteriorating trend up until August 2010, when imports more than doubled (compared to January 2010). As a result, the balance on the current account dropped to zero in August 2010 from a surplus of US$12.4 billion in January 2010, despite high oil prices. And capital flows remained volatile with net inflows into the banking sector (US$11.4 billion) but sizable outflows from nonbanking corporations (US$49.7 billion) (table 1.4). The CBR lost about US$9.0 billion in reserves in Q4 2010 as a result of large capital outflows (US$22.7 billion). These outflows were partially offset by a US$14.3 billion surplus on current account. But behind these numbers, the *non-oil current account balance* continued deteriorating during the second half of 2010, with the deficit reaching almost 4 percent of GDP in Q4 2010 (figures 1.4 and 1.5).

Figure 1.4: Oil Prices and the Trade Balance



Sources: CBR and World Bank staff estimates.

Figure 1.5: Current Account Balances (CABs) and the Real Effective Exchange Rate (REER)



Sources: World Bank staff calculations based on Rosstat and CBR data.

Table 1.4: Net Capital Flows, 2006–10
US$ billions

	2006	2007	2008	2009	2010	Q1 2010	Q2 2010	Q3 2010	Q4 2010
Total net capital inflows to the private sector	41.4	81.7	−133.9	−56.9	−38.3	−14.7	2.8	−3.7	−22.7
Net capital inflows to the banking sector	27.5	45.8	−56.9	−31.4	11.4	0.8	6.8	10.0	−6.2
Net capital inflows to the nonbanking sector	13.9	35.9	−77	−25.4	−49.7	−15.5	−4.0	−13.7	−16.5

Source: CBR.

LABOR MARKET AND POVERTY — gradually improving

Supported by continued output growth, labor market conditions improved noticeably in 2010. The effect of seasonal unemployment appears to have been limited in 2010, suggesting robustness in the underlying recovery of the labor market. Unemployment fell from 9.2 percent in January 2010 to 7.2 percent in December 2010 (International Labor Organization definition), with the lowest level of unemployment registered in September and November 2010 at 6.6 percent. With the decline in seasonal employment at the onset of Russian winter, however, unemployment started to pick up, reaching 7.6 percent in January 2011. But this figure is still significantly lower than the 9.1 percent rate registered in January 2010. This situation is reflected in the relatively stable number of vacancies.

But labor market conditions remain difficult in many of Russia's regions. According to Rosstat, the average level of unemployment in November 2010 to January 2011 varied from only 1.4 percent in Moscow to *47.5 percent* in the Republic of Ingushetia. Among the federal districts, the lowest unemployment for the period was registered in the Central Federal Okrug (4.6 percent), and the highest in North Caucasus (16.2 percent). But high unemployment seems to remain a persistent problem in many Russian regions, with about a *third* of all regions reporting an average unemployment rate above 9 percent between November 2010 and January 2011.

Table 1.5: Labor Productivity, Disposable Income, Wages, and Unemployment, 2007–10

	2007	2008	2009	2010
	Jan–Dec	Jan–Dec	Jan–Dec	Jan–Dec
GDP growth (%, y-o-y)	8.5	5.2	−7.8	4.0
Total employment (million people)	70.5	70.9	69.4	69.6
Employment growth (%, y-o-y)	2.4	0.5	−2.1	0.3
Labor productivity growth (%, y-o-y)	6.0	4.7	−5.9	3.7
Real disposable income growth (%, y-o-y)	12.1	1.9	1.9	4.1
Real wage growth (%, y-o-y)	17.2	11.5	−2.8	4.2
Average monthly wage (US$)	533.2	692.1	593.0	697.8
Unemployment[b] (%, end of period)	6.1	7.8	8.2	7.2

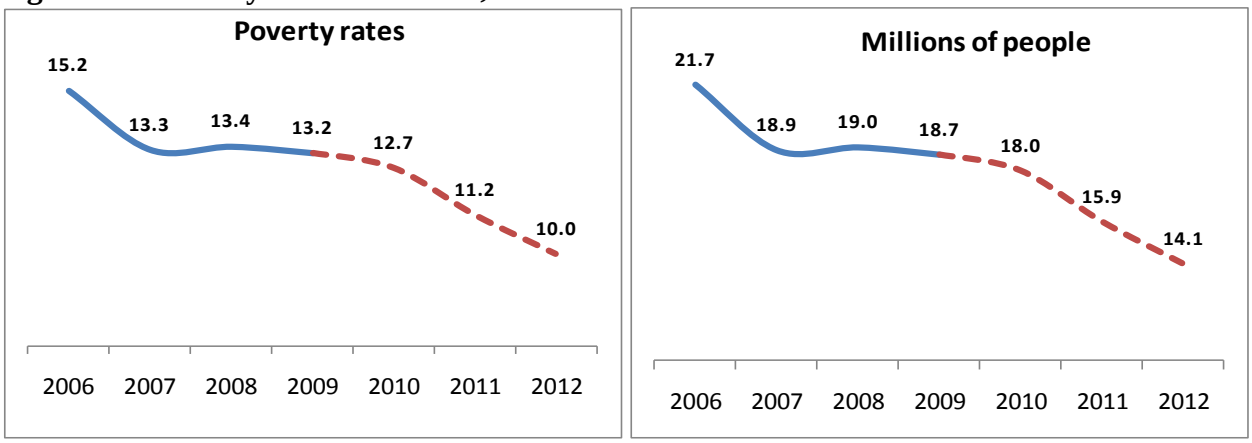
Source: Rosstat.
a. Data for the first half of 2010.
b. International Labour Organization definition.

Real wages and incomes in the economy as a whole grew broadly in line with productivity, while dollar wages hit a record high. According to Rosstat, real disposable incomes and wages grew 4.1 and 4.2 percent in 2010, respectively (y-o-y, table 1.5). Although growth in real income and wages has been in line with productivity adjustment, the relative labor costs have gone up

considerably compared with precrisis period, suggesting a loss in competitiveness. The average dollar wage in Russia increased to almost US$700 a month in 2010 (up 17 percent relative to 2009), the highest level on record since the beginning of the market transition.

Russia's national poverty rate has been broadly flat in 2009 and continued to fall in 2010, essentially because of a massive counter-cyclical stimulus, increases in pensions and wages, and unemployment that was much lower than expected. Both the unemployment and poverty rates increased sharply in early 2009; however, as the large increases in public sector wages and pensions and unemployment benefits kicked in, and as unemployment began to fall as firms shifted to labor hoarding, the national poverty rate fell from 13.4 percent in 2008 to 13.2 percent by the end of 2009. According to Rosstat, poverty has continued to decline in the first 3 quarters of 2010 in comparison to the similar period last year. Based on the 4 percent GDP growth in 2010, we estimate the poverty rate in 2010 at 12.7 percent, approximately 0.5 percentage point lower than in 2009 with about 0.7 million people moving out of poverty. Looking ahead, we project that poverty will decline in 2011 (11.2 percent) and 2012 (10.0 percent in 2012) (figure 1.6).

Figure 1.6: Poverty Rates in Russia, 2006-12



Source: Actual Rosstat data for 2006-2009. RER team calculations based on Household Budget Survey data and projections for 2010-12.

EXTERNAL DEBT — rising short-term borrowing

Official debt statistics suggest an improvement in access to external finance during the second half of 2010, but mostly for larger banks and nonfinancial corporations. According to CBR preliminary estimates, the outstanding external debt of the banking sector increased to US$145 billion by end-December 2010, from US$122 billion at end-June 2010 (table 1.6). Private nonfinancial corporations also increased their external liability by US$4.3 billion during that period. Earlier in the year, both sectors had a limited rollover capacity and thus had to deleverage their balance sheets. Access to external financing seems to have improved only in the second half of 2010. But it was probably concentrated in larger banks and enterprises, with many smaller ones without effective access.

Table 1.6: External Debt of the Private Sector, 2010

US$ billions

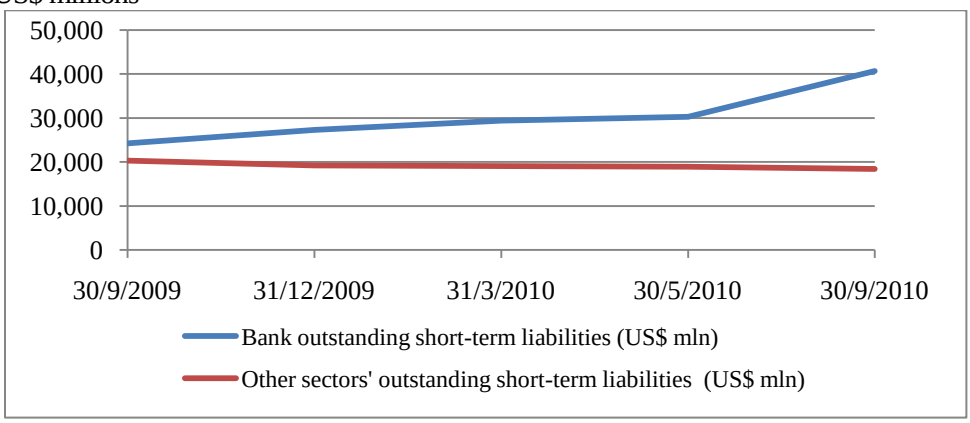
	January 1, 2010	April 1, 2010	July 1, 2010	October 1, 2010	January 1, 2011
Total debt	421.3	420.2	409.1	428.5	436.1
Banks	*127.2*	*129.0*	*122.1*	*140.0*	*144.8*
Nonfinancial corporations	*294.1*	*291.2*	*287.0*	*288.5*	*291.3*

Source: CBR.

With limited access to long-term external financing, banks returned to using short-term external borrowing to leverage their balance sheets. Although the banks' aggregate rollover capacity might have improved in 2010, the banks seem to have continued the 2009 pattern of using short-term borrowings, possibly to refinance their outstanding long-term loans and leverage their balance sheets. According to the CBR, the banks' outstanding short-term liabilities increased to US$40.1 billion by end-September 2010 (28 percent of total banks' external liabilities) from US$27 billion at the end of 2009 (figure 1.7). It is also likely that some of these short-term credits have been used in carry-trade operations, which involve borrowing at low rates in the low-interest rate currencies of developed countries (such as the U.S. dollar) while lending at high rates in rubles. Similar activity occurred before the 2008 crisis, when short-term liabilities of the banking sectors amounted to US$63 billion (32 percent of the banks' total external liabilities).

Figure 1.7: Bank and Nonbank External Short-Term Liabilities, Stock

US$ millions



Source: CBR.

MONETARY-EXCHANGE POLICY — inflation concerns

Inflationary pressures continued to mount in Q4 2010 and January 2011. Despite some tightening of the monetary conditions toward the year-end (M2 grew by about 28 percent in December 2010, compared to a 33 percent growth in August 2010 y-o-y), 12-month Consumer Price Index (CPI) inflation accelerated to 8.8 percent in December 2010 from only 5.5 percent in July 2010. In January 2011, however, inflation accelerated to 9.6 percent, fueled by seasonal hikes in food and adjustments in administered prices.

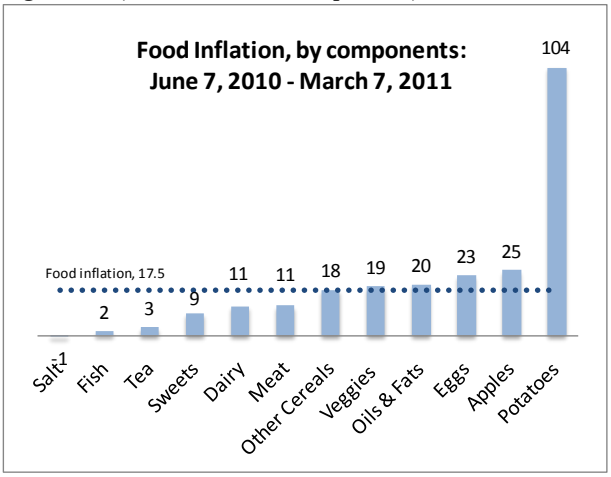
In response, the CBR began to gradually tighten the monetary conditions. On February 1, 2011, the CBR began monetary tightening by raising reserve requirements from 2.5 to 3.5 percent

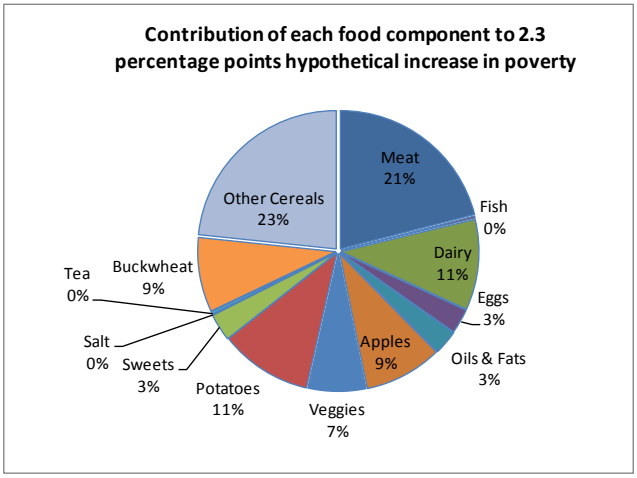
(on liabilities legal entities) and to 3.0 percent (on liabilities to individuals) while still keeping the main policy rates unchanged. At the end of the month, faced with the threat of return of double-digit inflation, the CBR became more aggressive by increasing its main policy rates (by 25 basis points) and further raising reserve requirements on liabilities to legal entities by 1.0 percent and to individuals by 0.5 percent. At the end of March 2011, CBR continued tightening monetary conditions by increasing reserve requirements to 5.5 percent for non-resident legal entities and to 4 percent for individuals.

Given the lags between money supply growth and inflation, there is a risk of higher inflation throughout 2011, depending in part on the timing and pace of CBR tightening. The rapid monetization of the economy during the first eight months of 2010 has proved to be excessive and has led to a buildup of inflationary pressures. As a result, managing these pressures and the resulting inflationary expectations will not be easy, given the escalation in world food prices, which add to price increases and negatively affect inflationary expectations (box 1).

Box 1: Food Prices and Their Impact on Poverty

Food prices have been soaring in Russia since summer 2010, increasing 17.5 percent between June 2010 and February 2011. With food accounting for about 38 percent of the consumer price index, most of inflation in this period is accounted for by increases in food prices. Initially, from mid-June to end-October 2010, food price increases were driven by the extensive drought in Russia. But later, prices continued to rise because of developments in the world food market as well as intermittent local shortfalls in production. As the accompanying figures show, buckwheat prices led the surge, rising 120 percent throughout the period and prices of other food commodities also jumped: potatoes (104 percent), oils and fats, eggs and apples (between 20 and 25), and dairy, meat, cereals and vegetables (between 11 and 20 percent).





It is estimated that the surge in the food prices had a non-marginal, first-order, short-term impact on the Russian population that was equivalent to an approximately 5 percent loss in total households consumption. The shock had a stronger impact on low-income households because of their higher food consumption and limited possibilities for substitution. All other factors constant, the increase in the food prices would lead to an increase in 2.3 percentage points in the poverty rate, reflecting these food items' share in household consumption and the increase in prices of these items. Most of the impact is attributable to increases in prices of grains and cereals (23 percent), meat (21 percent), potatoes (11 percent) and dairy (11 percent). However, with past increases in pensions, wages and further declines in unemployment, this initial impact was likely to be muted over time.

The exchange rate management could be complicated by a possible return of speculative capital inflows associated with high oil prices. In January and February 2011, the CBR kept from actively interfering in the exchange rate market, allowing the ruble to appreciate by more than 4 percent against the U.S. dollar–euro currency basket to below 34. If oil prices remain high, the CBR could again face a difficult trade-off between keeping the current flexible exchange rate regime (implying possible further widening of the corridor) and allowing nominal appreciation and more active interference in the exchange market to smooth excessive volatility but at the cost of domestic inflation. A more flexible exchange regime has served Russia well in recent years, and it should be maintained, especially given the potential of new speculative inflows associated with high oil prices and carry-trade activities.

BANK CREDITS — credit recovery under way

With improved liquidity, the long-awaited, gradual credit recovery got underway in 2010. After staying flat throughout 2009, in December 2010, the stock of credit to the private sector increased 14 percent in nominal terms (4.7 percent in real terms) year-on-year (figure 1.9). But this recovery in credit is limited compared to the precrisis credit growth. Furthermore, if adjusted for restructured loans, the net change in the stock of credits would be significantly lower than shown by aggregate statistics.

The spreads between the CBR refinancing rates and effective lending rates to enterprises narrowed considerably, but spreads on household loans remained very high in 2010 (figure 1.8). The banks considerably lowered the lending rates to enterprises in the second half of 2010, narrowing the average spread to the CBR refinancing rate to only 135 basis points in November 2010 from 515 basis points in January 2010. The lending rates to households, however, were kept at a high level, with an average spread to the refinancing rate at more than 1,680 basis points in 2010. Also, lending to small and medium-size enterprises (SMEs)—which suffered disproportionately during the crisis—is very slowly recovering. This slow recovery suggests that banks still perceive SMEs and households as high-risk borrowers, often imposing prohibitive terms on consumer loans, thereby limiting the growth of domestic consumption. As a result, there is scope for greater policy focus on lending to SMEs promotion and microfinance, and lending to households, especially given the comparatively low household debt burden.

Figure 1.8: Bank Lending Rates versus the Central Bank Policy Rate

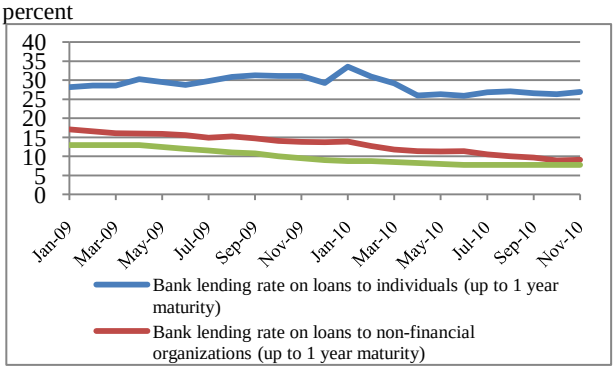
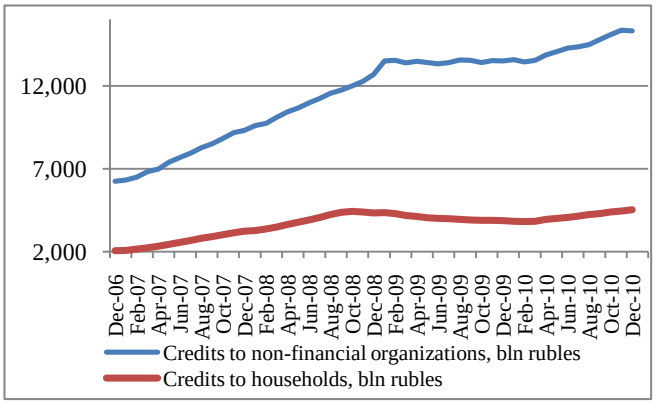


Figure 1.9: Stock of Credits to Companies and Households



Sources: CBR; World Bank staff estimates.

FISCAL POLICY — return of the "oil curse?"

The fiscal outcome for 2010 was better than expected, but there is no room for complacency: this outcome was mainly due to high oil prices. According to preliminary estimates from the Ministry of Finance, the federal budget was executed with a deficit of 4.1 percent of GDP, down from the actual 5.9 percent of GDP in 2009, and lower than the budgeted 2010 deficit of 5.3 percent. The lower deficit was mainly due higher revenues from oil: federal budget revenues amounted to 18.7 percent of GDP, compared to 17.4 percent stipulated in the 2010 Budget Law. The expenditures have been executed as planned in the Budget Law—at 22.7 percent of GDP, a 2 percent reduction in spending relative to 2009 level. But the *non-oil fiscal deficit* remained at a very high level of 12.7 percent (13.5 percent in 2009), indicating high vulnerability of the budget to a sudden drop in oil prices. This scenario is something that the Russian economy has experienced repeatedly in recent decades, and it should not be discounted in the current environment of high oil prices.

Going forward, the government is implementing a program of gradual fiscal adjustment, which aims to reduce the deficit from 4.1 percent of GDP in 2010 to less than 2 percent in 2011, according to recent policy statements. This revised target implies, however, that the oil price will remain above US$100 per barrel compared to US$75 per barrel, as stipulated in the 2010 Budget Law. There are two opposing short-term risks to this plan, each resulting in a higher-than-anticipated fiscal deficit and a danger of delay in fiscal adjustment. First, higher oil prices might encourage greater public spending in the preelection period at the end of 2011 and in 2012 (and could also fuel inflation). Relatedly, under that scenario, measures aimed at improving public expenditure effectiveness could be pushed off the priority agenda. Second, a fall in oil prices could threaten the revenues needed to attain fiscal targets.

But although the balance of risks of oil prices has shifted upwards, Russia's budget remains vulnerable to a sudden drop in prices and a rise in expenditures. If, for example, starting from the baseline 2011 budget, oil prices fall to US$60 per barrel (close to the long-term historical average) for a period of about a year, the deficit in 2011 could increase well above 5 percent of GDP, raising the issue of financing such a large deficit.

Table 1.7: The Government's Medium-Term Fiscal Framework

(In percent of GDP)

	2009	2010	2011	2012	2013
Revenues (consolidated)	***34,3%***	***35,3%***	***34,8***	***34,0***	***33,2***
Of which federal budget	18,8	18,7	17,6	17,0	16,8
Expenditures (consolidated)	***40.5***	***38,9***	***38,9***	***37,6***	***36,3***
Of which federal budget	24.6	22.7	21,1	20,1	19,7
Federal budget non-oil deficit	−13.5	−12.7	-11,6	-10,5	-9,8
Federal budget balance	−5.9	−4,1	-3,5	-3,1	-2,9
Consolidated budget balance	***−6.2***	***−3,6***	***-4,2***	***-3,6***	***-3,1***

Source: Ministry of Finance.

The balance of the government's reserve fund fell below 2 percent of GDP by end-February 2011. Aiming prudently to not draw down the fund, the government resorted to limited borrowing

to finance the deficit. The government is now planning to avoid using the reserve fund if oil prices stay at current levels. Any financing needs will be met in part by borrowing and in part from privatization revenues, though the latter are likely to be limited. There is a risk that fiscal adjustment on the expenditure side could become slower and the deficit could become higher during the election cycle, as well as in the period approaching the 2014 Olympic Games. Such a scenario would put further pressure on the domestic market, aggravating the interest rate and creating crowding-out effects. Irrespective of the *short-term* oil price movements, the government would be well advised to keep the focus of its fiscal policy on *long-term fiscal sustainability*, aiming at a more ambitious fiscal adjustment and long-term non-oil fiscal deficit of about 4.3 percent of GDP (see *Russian Economic Report* No. 23, November 2010).

Against this backdrop, the government's plan to privatize minority stakes in some strategic companies while selling nonstrategic assets elsewhere is one of the most important reform efforts of recent years. The declared goals of this wave of privatization are (a) reducing government ownership in SOEs, (b) streamlining property still held by the state into a more coherent structure, and (c) introducing new technologies and business methods in privatized enterprises. The estimated size of the sales ranges from US$32 billion to more than US$50 billion, about 2 to 3 percent of GDP.

ECONOMIC OUTLOOK FOR RUSSIA, 2011–2012

The World Bank's estimate for global GDP growth in 2010 was a robust 3.9 percent, but a slowdown is expected to 3.1 percent in 2011 and to a more robust 3.4 percent in 2012 (table 1.8). Following the bounceback of 2010, global growth is likely to be constrained by monetary and fiscal conditions, remaining debt and financial sector problems in some of the world's largest economies, higher commodity prices, and less robust capital flows. After the robust 7.0 percent growth in 2010, developing countries are expected to continue outperforming high-income countries by a large but declining margin, with their GDP growth averaging around 6.0 percent in 2011 and 6.1 percent in 2012 (table 1.8). The comparable figures for high-income countries are 2.4 percent and 2.7 percent, after 2.8 percent in 2010. In general, despite slower global growth in 2011, the short-term outlook remains relatively favorable for the global economy, which is still dealing with the after-effects of the Great Recession.

Table 1.8: GDP Growth: Summary of the Global Outlook

(percent)

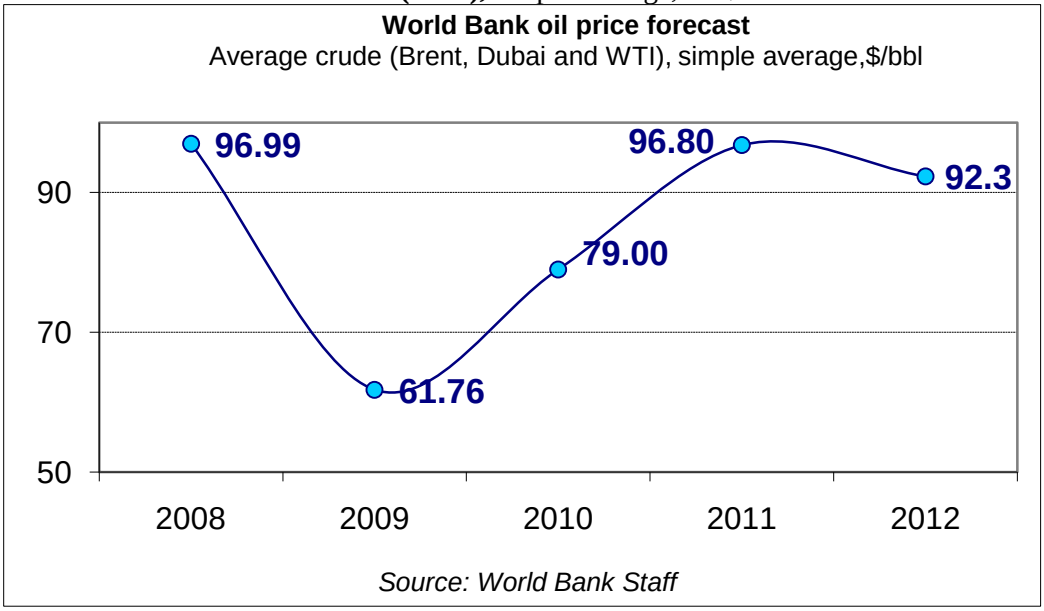
	2009 (actual)	*2010 (actual)*	*2011*	*2012*
World	−2.2	3.9	3.1	3.4
High-income countries	−3.4	2.8	2.4	2.7
Developing countries	2.0	7.0	6.0	6.1
Russian Federation	−7.9	4.0	4.4	4.0

Source: Global Economic Prospects Group for world and regional growth; Russian Economic Report for Russia, World Bank.

But tightening monetary policy in many countries and regional political instability may presage lower capital flows—even reversals—to developing countries. Against the signs of rising inflation and episodic overheating, many developing countries are embarking on tightening

their monetary policies. The BRIC countries (Brazil, Russia, India, and China) have now increased their interest rates, and there are indications that capital flows to developing countries may have stalled and even reversed in a few cases (some US$1.9 billion was withdrawn from emerging market equity funds in late February, with Brazil suffering one of the largest outflows since the beginning of 2011). This situation seems to have been caused in part by shrinking growth and interest rate differentials in favor of high-income countries, which are also beginning to signal the start of a monetary tightening cycle, and in part by the increased political risk, notably in MENA. The situation may put additional pressure on developing countries with weaker external positions. Nevertheless, among the developing countries, Russia may prove to be one of the exceptions to a scenario of more restricted capital flows, given the high oil prices, moderate growth and its new privatization program (as exemplified by the recent successful initial public offering of the VTB Bank). (box 2).

Figure 1.10: World Bank Oil Price Forecast for Average Crude: Brent, Dubai, and West Texas Intermediate (WTI), simple average, US$/barrel



Box 2: World Oil Market: The New Oil Shock and Its Impact on Oil Prices

Developments

The beginning of 2011 brought about a new global oil supply shock—and associated risks—for the global economy. Crude oil prices increased 5.6 percent in February 2011, up for a seventh consecutive month. The price of the international oil marker, Brent oil, rose above US$116 per barrel in early March 2011 because of escalating conflict and oil supply losses in Libya, as well as concerns about potential disruptions in other oil-producing and oil-exporting countries in MENA. Those concerns included an earlier fear of a possible of closing of the Suez canal and the Sumed pipeline in the Arab Republic of Egypt after mass protests and the eventual change of government. As of late March 2011, up to 1.0 million barrels per day of Libyan crude production has been closed—out of the typical output of 1.6 million barrels per day (equivalent to slightly more than 1 percent of world oil supply). The bulk of Libya's light sweet crude goes to Western Europe, and it will be difficult for refiners to fully replace this grade. Hence, there may be an attendant impact on prices in the short term. Saudi Arabia and other member countries of the Organization of Petroleum Exporting Countries (OPEC) are reportedly raising output to make up for the shortfall, but much of their spare capacity is in medium-sour crude, which is harder and costlier to refine. Reflecting that fact, the negative differential between the prices of the Urals blend (produced and exported by Russia) and the benchmark,

sweeter Brent reached almost US$6 by early March 2011, the highest for several years, and two and one-half times the differential observed in late 2010.

The International Energy Agency (IEA) forecast for global oil demand for 2010 and 2011 was revised upward. The reason is higher-than-expected demand in Asian countries that are not members of the Organisation for Economic Co-operation and Development (OECD) and improved economic prospects for the OECD itself, especially in the more energy-intensive U.S. economy. Global oil demand, estimated at 87.8 million barrels per day in 2010 (+3.3 percent or +2.8 million barrels per day y-o-y), is now projected by the IEA to increase to 89.3 million barrels per day in 2011 (+1.7 percent or +1.5 million barrels per day y-o-y). Global oil supply increased to 88.5 million barrels per day on higher OPEC crude and natural gas liquid production. Year-on-year, global output levels rose by 2.4 million barrels per day in January 2011. Non-OPEC oil supply in that month remained unchanged month on month at 53.0 million barrels per day: the estimated 2010 production remains at 52.8 million barrels per day, whereas the 2011 outlook has now been increased to 53.5 million barrels per day, because higher North American production is to offset a fall in the former Soviet republics. Russian oil production picked up again in January 2011, to 10.5 million barrels per day. In 2010, total oil production in Russia is estimated at 10.45 million barrels per day, rising to 10.51 million barrels per day in 2011, which represents a significant slowing of growth observed in 2009 and 2010. According to the IEA, total OECD stocks stood at 91 days of forward consumption by December 2010.

So far, the shortfall caused by a drop in production in Libya was made up by other major producers. In previous episodes of instability in the oil market, OPEC's spare capacity stood at around 6 million barrels per day, with about 5 million barrels per day of the surplus in the Gulf states and nearly two-thirds of the total in Saudi Arabia. Between one-third and one-half of this total is estimated to have already been used to cover the shortfall in Libyan production (which itself also reduced the availability of global spare capacity), implying considerably tighter global oil markets.

Prospects

Currently, nominal prices are projected to remain at an average of US$96.8 per barrel in 2011 before easing to US$92.3 per barrel in 2012; this compared with the World Bank's last projection of about US$80 and US$85, respectively before these shocks. Although the balance of risks has shifted towards higher prices, much will depend on further developments in MENA, global oil market balances, and most recently, developments in Japan. The changing scenarios in those countries may further affect not only available spare capacity, but also production. If there are new, persistent supply shocks, they may result in significant spillover effects into the broader global economy from continuously higher oil prices, ultimately dampening global demand (Figure 1.10).

With strengthened growth in its largest trading partner, Western Europe, and oil prices on the rise, Russia is expected to grow by 4.4 percent in 2011, followed by 4.0 percent growth in 2012 (table 1.9). Investment demand is expected to be the main factor of growth during the first half of 2011, whereas private consumption will be the main factor during the second half of the year in line with further decline in unemployment (figures 1.11-1.12). However, the pace of economic growth in 2011 and 2012 could be constrained, and growth will depend on sustained gains in consumption and the rate of recovery with respect to longer-term credit to the private sector. The downside risks associated with highly volatile oil prices and global demand will remain.

Table 1.9: Outlook for Russia, 2011–12

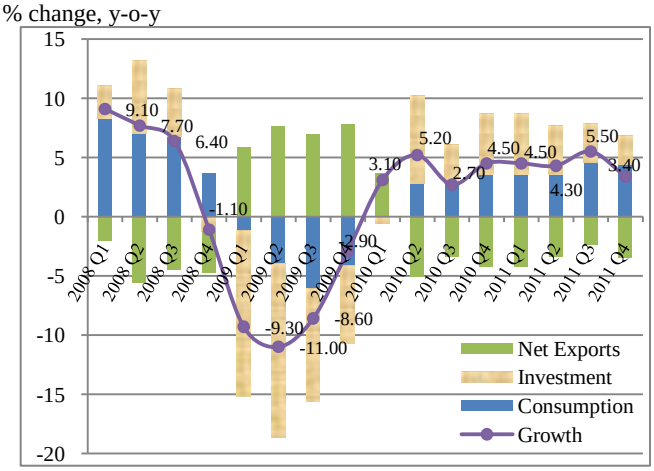
	2011	2012
GDP growth (%)	4.4	4.0
Consolidated government balance (%)	−0.9	−0.8
Current account (US$ billions)	67	28
Capital account (US$ billions)	13	19

Source: World Bank staff projections.

Given the rapid growth in import volumes and export constraints, the current account can be expected to deteriorate in 2011 and 2012; the capital account, by contrast, is expected to improve through 2011 and 2012, whereas capital flows are likely to remain volatile. If oil prices remain at their forecast levels, the surplus on the external current account would amount to about US$67 billion in 2011 (about 4 percent of GDP) and would deteriorate to US$28 billion in 2012. Given the improved rollover capacity of the private sector, the capital account is projected to have a surplus of about US$13 billion and US$20 billion in 2012, reflecting an increase in nondebt capital inflows, lower debt repayments, and improved borrowing capacity of banks and nonfinancial corporations. There are downside risks, however, associated with a terms-of-trade shock attributable to a sharp fall in oil prices, as well as with potential capital outflows resulting from rising political risks with an onset of the 2011–12 election cycle. As the current account deteriorates in 2011 and 2012, the exchange rate will be increasingly driven by net capital flows, if oil prices remain within the projected range.

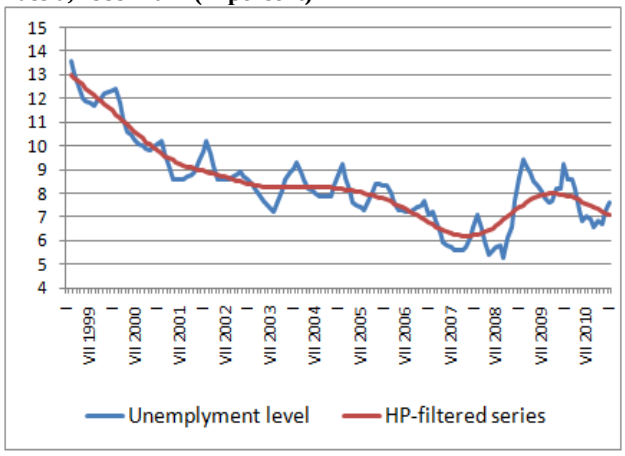
An increase in fiscal revenues because of higher oil prices is likely to be partly offset by new pressures from additional social spending, as well as spending on infrastructure and modernization of the army. Given the global oil price projections, the consolidated fiscal deficit can be estimated at 0.9 percent of GDP in 2011 and 0.8 percent in 2012. With the reserve fund down to less than 2 percent of GDP (on March 1, 2011) and the policy of replenishing the fund in the environment of high oil prices, the expected budget deficit in 2011 and 2012 will likely be financed by domestic and external borrowing, supplemented by privatization proceeds. The downside risks associated with highly volatile oil prices will remain.

Figure 1.11: Demand Sources of Russia's Real Growth, by Quarter, 2008–11



Sources: Rosstat; World Bank staff estimates.

Figure 1.12: Monthly Unemployment Rate Dynamics in Russia, 1999–2011 (in percent)



Sources: Rosstat; World Bank staff estimates.

Given the current trends, inflationary pressures are likely to remain in the first half of 2011. Although monetary tightening could help to contain inflation later in 2011, it is unlikely that the CBR will be able to meet the initial inflation target of 6 to 7 percent. CPI inflation in 2011 is projected in the range of 8 to 9 percent, reflecting the timing of the explicit tightening as well as a negative effect of rising world food prices. The upside risks for inflation, associated with additional fiscal spending during the election cycle, will remain in 2011 and 2012. CPI inflation is not expected to decline below 8 percent in 2011 or below 7 percent in 2012, unless the fiscal stance is tightened.

Beyond the short-term, Russia's government could use the next few years to advance difficult reforms to build the basis for dynamic long-term growth. The agenda is well known and includes infrastructure, public sector and energy efficiency, skills, institutions, SMEs, and investment climate. The government is pursuing important initiatives, including renewed efforts towards membership in WTO, privatization, and reforms of public administration and improvements in the effectiveness of public expenditures. But it is the implementation that will influence outcomes with respect to productivity growth and competitiveness and, therefore, Russia's long-term economic future. In the next two chapters, we turn to two such areas of importance for Russia's public and private sector efficiency, competitiveness, and growth: public expenditures on transport infrastructure and investment climate.

II. ADJUSTING AND IMPROVING THE EFFICIENCY OF PUBLIC EXPENDITURES

Compared with the 7 percent average annual growth in the precrisis period, Russia is likely to grow at a much more moderate pace in the postcrisis years. Under these circumstances, Russia faces a balancing act of controlling public finances at all levels and supporting the recovery under more difficult conditions. Two major public expenditure policy questions arise. First, how can expenditure efficiency be increased to provide public services with reduced fiscal resources? And second, how can the fiscal space for key infrastructure investments be increased to ensure an enabling environment for long-term growth and economic diversification? To address those policy issues, the government should focus on three broad areas. First, fiscal adjustment in 2011–13 needs to be ambitious in reducing the non-oil deficit level to sustainable levels given the uncertain international environment. Second, cutting unproductive spending will free up resources needed to upgrade Russia's deteriorating infrastructure to meet economic diversification and modernization goals; this would also require additional resources from user fees and a strengthened institutional framework, including procurement practices. Third, to increase the quality and access of public service delivery, the government will have to improve the public sector's wage structure, reassess priorities within the public sector, and right-size the staffing levels. This note, based on a recent World Bank analysis of public expenditures highlights three issues of particular importance: (i) the scale of fiscal adjustment, and the need to (ii) upgrade road infrastructure, and (ii) rationalize public sector wage bill and employment.

The countercyclical fiscal policy during the crisis helped Russia contain the impact, but the government now faces a balancing act of implementing fiscal adjustment while improving the efficiency of public expenditures and supporting recovery. Remaining fiscal reserves allow a margin of maneuver to balance these risks; however, in a likely scenario of a more moderate growth after the initial bounceback, Russia will face three interrelated challenges: (a) reducing the non-oil deficit to sustainable levels and creating fiscal space for priority infrastructure expenditures, (b) strengthening capital budgeting practices, and (c) providing public services with fewer recourses. This section elaborates the implications of these challenges that threaten Russia's medium-term growth recovery and ambitious diversification agenda.

Issue 1: Persistent budget deficits could become a drag on economic performance in the uncertain world.

More ambitious measures to reduce nonpriority expenditures and broaden the nontax revenue are required.

The government's postcrisis medium-term plans indicate an ambitious economic modernization and diversification agenda, but this will require additional resources and reforms. According to the federal budget for 2011 to 2013, these additional expenditures amount to almost 1 percent of gross domestic product (GDP) (table 2.1). But they are unlikely to be sufficient to address the infrastructure constraints and support Russia's vast modernization agenda. In particular, the budget is likely to require (a) a permanent increase of budget expenditures equivalent to another half percentage point of GDP by 2013, including quasi-fiscal activities of state-owned enterprises (SOEs) to support economic

modernization initiatives such as energy efficiency; (b) 1.1 percent of GDP to close the road maintenance gap; and (c) 1.0 percent of GDP for capital expenditures to address the maintenance backlog and basic road network expansion. These expenditure pressures are daunting and can be accommodated only by sustained and significant fiscal adjustment, which means cutting other, non-priority and unproductive spending and broadening the non-oil tax revenues.

Moreover, on the revenue side, both oil and non-oil revenues face significant downside risks. For example, the draft federal budget is based on a favorable oil forecast. Even if oil prices remain high over the medium term—which is not a given—oil and gas revenues are expected to decrease by more than 1 percent of GDP because of relatively stable oil and gas extraction and export volumes that are not offset by high prices of minerals or movements in the exchange rate. This reflects the vulnerability of Russia's budget to a new, sudden drop in oil prices from the current lofty levels.

Table 2.1: Preliminary Estimates of Additional Funding Needs in 2011–13: Changes Relative to the Previous Year

(percentage points of GDP)

Funding need	Draft federal budget law				Total needs (2013 relative to 2010)
	2011	2012	2013	Total (2013 relative to 2010)	
1. Additional expenditure pressures	**0.5**	**0.0**	**0.4**	**0.9**	**3.3**
Modernization of road infrastructure	0.1	0.1	0.1	0.3	2.2
Modernization of military	0.2	- 0.1	0.4	0.6	0.6
Support of economic modernization and innovations	0.2	- 0.1	- 0.2	0.0	0.5
2. Gradual decrease in oil and gas revenues	**0.5**	**0.3**	**0.3**	**1.1**	**2.5**[a]
3. Decrease in nontax revenues	**1.2**	**0.3**	**0.1**	**1.6**	**1.6**
4. Debt financing	**0.2**	**0.1**	**0.0**	**0.3**	**0.3**
Total (1 + 2 + 3 + 4)	**2.4**	**0.7**	**0.8**	**3.9**	**7.7**

Source: World Bank staff estimates based on budget projections from Minfin.

[a] oil price falls to 60 USD/barrel relative to the baseline assumption of the budget

To deal with these pressures, the government's federal budget for 2011 to 2013 aims to gradually broaden the non-oil revenue base and reduce expenditures (Table 2.2). The government expects in the medium term to gradually reduce the fiscal deficit from about the actual 4.1 percent of GDP in 2010 to 2.9 percent in 2013. But the gradual approach to fiscal adjustment reflected in the current budget plan carries nonmarginal risks. First, excessive reliance on domestic borrowing implies a risk of increasing interest rates. Second, the adjustment could be slower than envisaged because of the expenditure pressures of the 2011–12 election cycle. Third, a negative oil price shock could widen the deficit significantly, as had happened before. And fourth, under all realistic medium-term scenarios, Russia will not likely have the cushion of fiscal reserves that it enjoyed before the crisis, thus making its budget and the economy more vulnerable to new shocks. Under these circumstances, fiscal adjustment in 2011 to 2013 might need to be more ambitious given the highly uncertain international environment and prospects for oil prices and, more importantly, the needs of long-term fiscal sustainability.

Table 2.2: The Russian Government's Plan (Scenario A): Creating Fiscal Space for Expenditure Priorities in 2011–13, Changes Relative to the Previous Year

(percentage points of GDP)

	2011	2012	2013	Total (2013 relative to 2010)
1. Net revenue measures (nonoil revenues)	**0.7**	**0.0**	**0.2**	**0.9**
Excise tax on tobacco (1,000 cigarettes with filters: Rub 284 in 2011, Rub 360 in 2012, Rub 460 in 2013; 1,000 cigarettes without filters: Rub 360; 1,000 papyrus cigarettes: Rub 460)	0.04	0.03	0.02	0.1
Excise tax on gasoline (increase by Rub 1 per liter in 2011 and by an additional Rub 1 in 2013)	0.16	0.01	0.08	0.3
Additional dividends from SOEs (federal-level ownership) and unitary enterprises	0.1	0.0	0.0	0.1
vement of value added tax administration	0.5	0.0	0.1	0.5
2. Net expenditure measures	**2.2**	**1.2**	**0.8**	**4.2**
Wage bill savings	0.2	0.3	0.4	0.9
Streamlining of transfers (regional level)	0.1	0.3	0.1	0.6
Optimization of social expenditures	1.5	0.1	0.1	1.8
Other expenditure cuts	0.3	0.4	0.2	1.0
3. Total revenue and expenditure measures (1 + 2)	**2.9**	**1.2**	**1.0**	**5.1**
4. Net fiscal adjustment taking into account new cost pressures and shortfall in non-oil and nontax revenues	**0.5**	**0.5**	**0.2**	**1.2**

Source: World Bank staff estimates based on the draft federal budget.

Therefore, it is argued that Russia will need to introduce more ambitious measures (scenario B) to more aggressively reduce nonpriority and unproductive expenditures and broaden the nontax revenue base in order to regain fiscal strength in the uncertain environment. Additional increases in excise taxes on tobacco, alcohol, and gasoline to bring them to the average levels of Group of 20 countries could further broaden the non-oil tax base (adding non-oil revenues of 0.7 percentage points of GDP over three years). There is also scope to increase value added tax (VAT) revenues by improving tax administration and minimizing VAT exemptions (adding non-oil revenues of 1 percentage point of GDP over three years). Specific proposed measures on the expenditure side could include the following:

- Strengthening results monitoring systems to monitor target indicators of public programs—specifically public investment programs
- Improving capital budgeting practices by introducing performance-based contracting in road maintenance and increasing competition in road maintenance contracts (estimated fiscal savings of 0.5 percentage point of GDP over three years)
- Reducing crisis-related subsidies supporting select sectors of the economy (estimated fiscal savings of about 0.9 percentage point of GDP over three years)
- Increasing the targeting of social assistance programs (estimated fiscal savings of about 1 percentage point of GDP over three years)
- Taking steps to ensure the long-term sustainability of the pension system
- Supporting structural reforms in the education and health sectors

These revenue measures, together with strengthened public expenditure management and better expenditure allocations, could be expected to yield further savings of about 4 percentage points of GDP over a three-year period.

Implementation of this more ambitious consolidation plan would not only create fiscal space for additional spending needs to support critical infrastructure rehabilitation and more efficient public services and, hence, diversification and modernization, but also ensure a fiscally sustainable nonoil deficit level earlier—by 2015.

Figure 2.1: Medium-Term Funding Needs and Source under Two Adjustment Scenarios, End of 2013 Relative t 2010

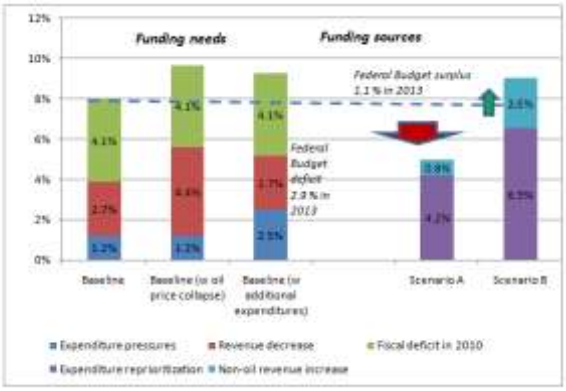
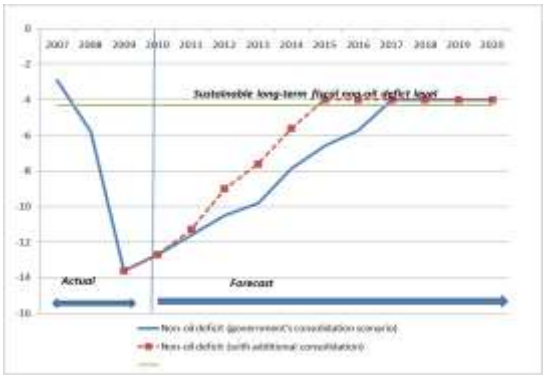


Figure 2.2: Russia's Nonoil Fiscal Deficit under Two Adjustment Scenarios, 2007–20



Source: World Bank staff estimates.

Issue 2: Russia's deteriorating infrastructure is increasingly viewed as a key constraint to Russia's competitiveness and business.

Upgrading Russia's deteriorating infrastructure would require not only significant fiscal resources, but also strengthening of the institutional framework in the road sector.

Russia's transport infrastructure is generally poor and has been declining because of underinvestment in maintenance and rehabilitation. Given a limited scope for the cost recovery in the transport sector, much of the transport infrastructure (capital expenditures)[1] is directly financed by capital transfers from the budget. Whereas operating costs of service provision in railways, seaports, and airports are largely financed by user charges, roads depend almost exclusively on public financing. As a percentage of GDP, public expenditures on roads have declined from 2.8 percent of GDP in 2000 to only 1.5 percent in 2009. In comparison, China has spent about 3.5 percent of GDP annually since the 1990s and has significantly improved the quality and expanded the size of its network, thereby supporting its subsequent economic boom.

Although the quality of transport infrastructure in Russia varies significantly across different modes of transport, the *road* infrastructure is estimated to have deteriorated the most. Out of the 50,000 kilometers of federal roads, less than one-third of those roads meets the standard requirements and can be considered in good or fair condition. The remaining roads are in poor condition. Over 50

[1] The rail sector, which is organized as a large state-owned company (Russian Railways), had been successful at accessing domestic and external capital markets in raising funds required for capital expenditures.

percent of the federal network fails to meet the smoothness and strength requirements. A number of factors have played a role:

- **Inadequate planning and management of regular maintenance.** Failure to maintain a paved road has also been estimated to increase user costs by a factor of three in terms of additional time, fuel, and vehicular wear and tear, with a direct impact on the price of goods and the expenses that individuals pay for goods and services.
- **High traffic intensity in some routes because of structural deficiencies.** The radial structure of the road network makes it highly dependent on the Moscow hub, with regions deprived of more direct transportation links.
- **Operation of roads above designed loading capacity.** Russia's present design standards are still based on a maximum axle load of 6 tons, whereas the European designs of many trucks operating in Russia support axle loads of 11 to 16 tons on double axles. Many of these roads now sustain traffic from a high number of much larger trucks with European dimensions.
- **Rampant overloading.** Overloading is a key factor shortening the life span of the pavement surface. Pavement damage from loading is proportional to the axle load raised to the fourth power. Hence, heavier vehicles cause greatly increased rates of pavement damage.

The federal budget suggests a considerable increase in financing to the road sector during 2011 to 2013, but the increase will still be below levels required to ensure adequate road maintenance and rehabilitation of the existing road network. According to estimates, the proposed funding levels for the road sector by 2013 will narrow—but not eliminate—the funding gap for maintenance of the federal highway system. Calculations suggest a sizable financing gap for maintenance and rehabilitation for federal and regional roads of about 1.1 percent of GDP, with the largest gap in the regional road network. If one adds the estimated financing for capital expenditures to address the maintenance backlog and basic road network expansion, the aggregate financing gap exceeds 2 percent of GDP.

It is argued that additional financing for the road sector could come from user fees and improving the performance and outcomes in the road sector. On the revenue side, additional financing in the road sector could include the following:

- **Fuel taxes—the primary transport pricing policy instrument worldwide—remain relatively low in Russia, with important scope for increases, resulting, among other things, in higher revenues and a progressive distributional impact on households**. A well-designed fuel surcharge could generate revenue sufficient to finance the maintenance of the network but not its expansion, which would have to be funded from other sources.
- **Vehicle license fees are generally low but could raise substantial additional financing for the road sector.** In 2008, Rub 53.1 billion (US$1.7 billion) was collected from a vehicle fleet of 38 million. The total funds collected are quite small, reflecting generally low vehicle registration rates.
- **International financial institutions (IFIs) remain an important potential source of funding for road projects.** IFIs could provide not only finance with long maturity, but also international and best-practice experience as well as expertise in project preparation, monitoring, and supervision.
- **Innovative local credit enhancement entities and techniques (credit guarantees) can be used to help mobilize domestic commercial debt resources for subsovereign**

infrastructure finance. Credit enhancements are meant to mitigate risks in debt transactions that creditors cannot or are not willing to take.

- **The Russian Federation has almost no toll roads, but the potential for their development is considerable.** Unlike many developed countries (as well as many developing countries), where networks of toll roads and high-speed motor roads have long been successfully operated and have generated substantial revenues, *Russia has only one toll section in its entire federal road network—a 20-kilometer detour in the Lipetsk region*.
- **Infrastructure bonds are another mechanism for tapping into long-term domestic financing of road projects.** These bonds are meant to be issued by a special-purpose project entity to raise funds to finance infrastructure construction or reconstruction.

But to improve the performance and outcomes in the road sector, it will be important not only to raise expenditures, but also to adopt measures to ensure that funds are spent efficiently. The official unit costs per kilometer of maintenance (regular and major repairs) in Russia ranges between US$27,000 and US$55,000, depending on the category of road. This figure appears very high. In the case of Finland, which has a climate similar to Russia's, the comparable cost was €6,512 per road kilometer (US$9,442 per road kilometer) in 2007. The lack of competition in the road industry, as well as leakages and corruption, is likely to be among the factors behind high road maintenance costs. A number of reforms could be introduced to strengthen performance and outcomes in the road sector:

- **Russia could use the fuel tax and vehicle license fees to ensure a fully funded road maintenance program.** Several countries use a second-generation road fund to ensure the affordability of a fully funded road management program. These funds aim to link revenues, such as the fuel tax and vehicle license fees, and expenditures with charges paid into a road fund that is typically managed by boards representing the interests of road users. On January 1, 2011, a Federal Motorway Fund was established for financing road construction, rehabilitation, and maintenance projects. However, this fund appears to be a traditional road fund and not a second-generation road fund. Instead, the recently established Avtodor could potentially assume the functions of a second-generation road fund.
- **A road classification exercise would need to be undertaken with a view to the governments' financial capacity and users' willingness to pay for existing and planned roads.** Functional classification is an indispensable tool for rational assessment and assignment of responsibilities in the road sector. A road network that is very large and poorly maintained and that has technical standards that are too high will deteriorate. Indeed, this scenario is occurring in Russia.
- **There is an urgent need to reconsider current procurement rules, which require procurement of civil works through reverse auction, a practice unique to the Russian Federation.** A *reverse auction* is a type of auction in which sellers compete to obtain business on the basis of the lowest price quoted. Instead of reliance on the market, an initial price or ceiling is introduced to determine the contract price, but in many instances the starting price of the procured works is based on the available funds rather than on an accurate estimation of costs. As a result, the final contract cost is in most cases far from the realistic market price that would result from open and fair competition.
- **Increasing competition for the procurement of road works is imperative.** Few contractors have the capability to deliver large roads projects, particularly at the

regional level.[2] Possible remedies might include requiring procurement competitions to include bidders from as many regions as possible and outlawing subcontracting between bidders once the contract has been awarded.

- **Introducing performance-based maintenance contracts could lead to significant cost savings.** The traditional way of contracting out road maintenance defines specific works to be done, and payments are based on the completed work. By contrast, performance-based contracts define *minimum* conditions of road, bridge, and other traffic assets that have to be met by the contractor, as well as other services.
- **The Transport Strategy sets out a series of ambitious targets for regional road network expansion, but a valid question remains regarding whether such an expansion in peripheral regions is necessary or feasible.** The econometric analysis and international experience suggest that the productivity-enhancing effect of improved infrastructure would be the strongest in Russia's capital region. Thus, infrastructure investment by itself is unlikely to help growth in lagging regions.
- **Introducing an improved asset management system for the road network should assist in making spending decisions.** Asset management should lead to improvements in financial efficiency through (a) improved decision making based on costs and benefits of alternatives, (b) justification of work programs and funding requirements, (c) recognition of costs of operating road assets over the life cycle of the assets, and (d) increased cost-effectiveness of maintenance through proper planning of works.

Issue 3: There is a need to rationalize wage bill and public employment

To contain the wage bill pressures, the government will need to reassess priorities within the public sector and right-size the staffing levels.

At present, the government's wage bill—comprising more than one-fourth of all government expenditure—faces conflicting pressures. In the current environment, one of the most important challenges is to ensure the medium-term fiscal sustainability of overall expenditures, including the aggregate wage bill. But as long as public wages—especially in education and health—remain low compared to those in the private sector, pressures on the aggregate public wage bill will persist. At the same time, improving remuneration is fundamental to improving the performance of public administration and quality of service delivery.

It is also clear that without structural changes in the education and health sectors, closing the large wage gaps will come at a significant fiscal cost. The largest gaps are in municipal education and health. For example, wages in preschool, primary, and secondary education institutions at the municipal level are, on average, more than 50 percent below the average wage level. The estimated cost of closing these gaps without reducing employment in education is estimated at about 0.82 percent of GDP per year and in the health sector at about 0.53 percent of GDP per year. The largest burden would fall on the budgets of subnational entities, whose wage bills would increase by almost a third. Already in past years, measures to close the wage gap resulted in a sharp increase in the wage bill. Between 2006 and 2009, the subnational wage bill increased by more than 20 percent per year in real terms.

[2] This lack of contractor capability reflects, in part, the large and expensive equipment required to undertake road construction projects, but it also results from the Soviet legacy of organizing the industry around large regional monopolies.

To contain the wage bill, the government will need to reassess priorities within the public sector and to right-size the staffing levels. This effort is a medium-term challenge. In the education and health sectors, the government's effort to transform public budget organizations into autonomous agencies will greatly enhance managers' incentive to right-size employment. The existing education system, in particular, has significant scope for optimizing inputs without jeopardizing education outcomes.

In the medium term, the government plans boldly to right-size the civil service by reducing federal-level civil service positions by 20 percent over the next three years. By 2013, according to the Budget Law, a combination of short-term and medium-term measures is expected to result in a decrease in the aggregate federal-level wage bill by 0.9 percentage points of GDP. In the short term, a reduction of 5 percent in federal-level civil service employment could be achieved by a combination of measures that include elimination of vacant positions and voluntary retirement. In the medium to long term, these and additional reductions in employment will require the consolidation of administrative functions through automation and modernization. But the biggest challenge will be to implement similar measures at the subnational level.

It is clear that improving remuneration is instrumental to improving the performance of delivery of public services; however, experiences in other countries indicate that adjusting the average public sector salaries may not be as important as improving the structure of public sector salaries. In the wage structure, nonperformance-related benefits and allowances (including ones linked to seniority) remain high. Poor incentives for performance, especially for excellence, are likely to further jeopardize both the quality of and the access to public services. Although Russia made much progress in introducing various elements of performance management, reform of individual performance has been slow.

Although the Russian civil service law defines personal performance evaluation tools, most are highly formal and disconnected from institutional performance management. A lack of methodological guidance on developing individual performance contracts, as well as individual performance indicators, prompted ministries and agencies to choose the traditional remuneration practice, consisting of a base salary and additional payments (mainly compensations related to rank and position).

Despite weak performance appraisal systems, implementation of a performance-related pay (PRP) system in public budget organizations (non–civil servants) is advancing rapidly. The new system has multiple objectives, including (a) differentiating remuneration on the basis of performance and outcome, (b) increasing attractiveness to hire qualified staff, (c) increasing productivity and optimizing the employment size in public budget organizations, (d) increasing transparency of the pay system, (e) introducing incentive measures that result in the use of more applied knowledge, (f) increasing the overall wage levels, and (g) increasing the independence of managers of public budget organizations.

There is a temptation (and danger) to develop PRP to boost public sector performance or potentially reduce base salaries. Lessons from member countries of the Organisation for Economic Co-operation and Development indicate that the success of implementing PRP depends more on the quality of the performance appraisal process than on pay and that monitoring and measuring performance in the public sector remain a challenge. Unlike the private sector, where the results are easily measured in financial terms, the public sector deals with policies, regulation, and public services, which are difficult to turn into quantifiable performance indicators within individual control.

III. How does Russia compare on indicators of competitiveness and ease of doing business in global ratings?

Summary. *Innovation, sophistication, and dynamism among firms are key to a country's competiveness and development. In most leading economies small- and medium-size enterprises (SMEs) are vital to employment, innovation and growth. However, for SMEs to thrive they must have access to user-friendly government services, available capital, good infrastructure and skilled labor. Russia has paid increasing attention to improving the domestic investment climate and the ease of doing business—both at the federal and the regional levels—and has embarked on important regulatory simplification initiatives. This note examines how Russia ranks vis-à-vis other economies on business environment and economic competitiveness indexes such as the Global Competitiveness Report (GCR) and the Global Doing Business (DB) rankings, and highlights Russia's key strengths and weaknesses. Russia's performance varies across the regions, but most indicators suggest that its firms still find it difficult to operate in the business environment; that competition levels are insufficient to produce greater firm innovation and efficiency; and that businesses often operate at a low level of technology and knowledge. While this note is meant to be informational, the World Bank is also analyzing the binding constraints to diversification in Russia. The findings of this work – which focuses on competition, innovation and export promotion – will be disseminated in a later report.*

The Global Competitiveness Report

The GCR provides a broad picture of the competitiveness of the 139 economies in its survey. By looking at a wide range of economic factors affecting an economy's competitiveness the GCR seeks to identify priorities for reforms that will unlock the incremental productivity gains required for an economy to move to the next level of development and sustain long term growth.

The report uses three broad categories, each covering a range of elements important to a country's competitiveness. They are "basic requirements" (institutions, infrastructure, the macroeconomic environment, health, and primary education); "efficiency enhancers" (higher education and training, market efficiency of goods, labor market efficiency, financial market development, technological readiness, and market size); and "innovation and sophistication factors" (business sophistication and innovation). The broad categories and their elements are scored on a scale of 1 (the worst) to 7 (the best) and assigned a ranking in the Global Competitiveness Index (GCI). The data are drawn from national and international statistics sources and from a survey of business executives in each country.

Russia's overall position

Russia ranks 63rd in the latest GCI (2010–11) with a competitiveness score of 4.2. This is the same rank and score as the previous year but down on its 2008–09 rank of 51 and score of of 4.3. In absolute terms, Russia currently performs best on basic requirements (score of 4.5), followed by efficiency enhancers (4.2). Its lowest score is on innovation and sophistication factors (3.4). But

according to its relative *ranking*, Russia is actually best on efficiency enhancers (rank of 53) and weakest on innovation and sophistication factors (80), with basic requirements in the middle (65).

Russia competes against a wide range of countries for business. This section looks at Russia's relative performance vis-à-vis five different country groupings: (a) some of the world's richest nations, through the OECD; (b) leading industrial nations plus some fast-developing ones, through the Group of 20 (G-20); (c) economies at a similar level of development as defined by the GCR (Group 2) and the World Bank's group of upper-middle-income countries (UMI); (d) the BRICs (Brazil, Russia, India, and China); and (e) countries in Eastern Europe and Central Asia (Russia's neighbors). Table 3.1 shows how Russia compares to the average of each of these groups on its overall score and its scores on the three subindexes. It also shows what these scores mean for its ratings within each country group. Each of the scores are on a scale of 1 to 7, so negative numbers show how many points Russia is behind on the given factor, whereas positive numbers show how many points it is ahead.

Table 3.1: Russia Compared on the GCR Subindexes to the Rest of the Countries in Various International Groups

Group	No. of countries	Overall 2010-2011		Basic requirements		Efficiency enhancers		Innovation and sophistication factors	
		Rank	Score	Rank	Score	Rank	Score	Rank	Score
OECD[a]	35	33rd	-0.7	32nd	-0.8	32nd	-0.6	35th	-1.2
G20	20	18th	-0.6	14th	-0.6	17th	-0.5	20th	-1.0
Group 2[b]	29	12th	0.1	11th	0.0	7th	0.2	17th	-0.1
UMI	34	13th	0.1	14th	0.0	7th	0.2	19th	0.0
BRICs	4	4th	-0.3	2nd	-0.1	4th	-0.3	4th	-0.6
ECA	22	7th	0.2	8th	0.1	4th	0.3	8th	0.1

a. The 34 members of the OECD plus Russia.
b. Countries surveyed by the GCR are divided into groups according to their level of GDP per capita and share of exports accounted for by mineral goods. The GCR considers the countries in Group 2 to be at the middle stage of development, also referred to as the *efficiency-driven stage*.

Russia compared to the OECD

Russia is at the bottom of the OECD on nearly every ranking. Both overall—where its score is significantly behind other scores such as those of Sweden (5.6), Germany (5.4), and Canada (5.3) — and on each of the subindexes, it is a long way from the average of the group. It is most competitive on efficiency enhancers and least competitive on innovation and sophistication factors.

Russia compared to the G-20

Russia's competitiveness is nearly at the bottom of the G-20. It scores best on the basic requirements subindex (score 4.5) where it actually exceeds or matches the scores of the countries immediately above it in the overall table, such as Brazil, South Africa, and Turkey. However, countries such as France, which scores 5.7, are way ahead. Russia performs closest to the average of the group on efficiency enhancers and furthest from the group on innovation and sophistication factors.

Russia compared to the Group 2 level of development in the GCR and to the UMI countries

In both groups, Russia is average on basic requirements, a bit better on efficiency enhancers, and average or a little bit worse than average on innovation and sophistication factors. Russia does not compare badly to the other economies at its level of development, but judging by the fact that it is not pulling ahead on innovation and sophistication factors—which the GCR sees as important signs of progress toward a higher level of development—it cannot be said to be excelling against many of its development peers.

Russia compared to the BRICs

Overall, Russia is the least competitive of this group, but it has the second-best rank and score on basic requirements. On the other two subindexes it has the lowest rank, and it particularly lags on innovation and sophistication factors. The fact that Russia has a higher income per capita suggests, on the one hand, that it is further ahead than the other countries in the group. On the other hand, these relative scores would suggest that the other countries are more likely to sustain their current level of advancement and develop the competitiveness that will keep them growing toward the highest, technologically driven stage of development.

Russia compared to other ECA countries

In terms of both its scores compared to the average of the group and its positions relative to the other countries, of all the international comparisons made in this analysis Russia does best in the ECA group. Its highest relative and absolute positions are on efficiency enhancers, where it ranks fourth and is 0.3 points above the average. Even though it ranks eighth on innovation and sophistication factors with a score of 0.1 points above the average, the combination of its performances across the subindexes suggest that, according to the GCR methodology, it can strongly compete in the ECA region.

What is generating Russia's strengths and causing its weaknesses on these measures?

Looking at Russia's performance in both absolute and relative terms gives some interesting insights into its competitiveness. It scores best on basic requirements, less well but still at a reasonable level on efficiency enhancers, and poorly on the innovation and sophistication factors that will determine its jump to the next level of growth. But by looking at its ranks on these subindexes one can see that it actually ranks more highly on efficiency enhancers. Hence, it is more competitive on this particular subindex because there are fewer countries with superior scores on the elements that comprise this category.

On the basic requirements subindex, Russia scores best in absolute terms on health and primary education (score of 5.9, rank of 53). On primary education it does particularly well because of its 99.8 percent enrollment rate, which is equaled only by Spain and bested only by Costa Rica and Japan. In relative terms, it does comparatively best on infrastructure (rank of 47, score of 4.5), but even here, its rank is far below what would be expected, given the large infrastructure stock inherited from period of socialism. And while Russia ranks eighth in the world on the number of mobile phone subscriptions per head (163.6), more detailed analyses of infrastructure quality and performance—as shown by the chapter II of this report—indicate major weaknesses in the quantity, quality and institutions in large infrastructure sectors such as transport.

However, Russia's poorest performance on the basic requirements subindex is on institutions (rank of 118, score of 3.2). On the strength of property rights it ranks 128th with a score of 2.9; on the diversion of public funds for corruption it ranks 109th with a score of 2.6; on judicial independence it ranks 115th with a score of 2.7; and on the strength of auditing and reporting standards it ranks 116th with a score of 3.8.

The links between poor institutions, corruption, and business performance can also be seen in Transparency International's bribery and graft monitor, *Transparency in Reporting on Anti-corruption*, which looks at the anticorruption measures in place at 500 of the world's biggest companies. Each of these firms is assessed for the overall strategy, policies, and management systems it has in place to monitor and prevent the giving or receiving of bribes. Out of 17 countries, Russia's companies were the worst, with an average of only 2 points out of a possible 50 for good practice.[3]

The strongest and weakest parts of Russia's performance on efficiency enhancers are similarly clear. Its biggest strength is on the combined access its firms have to nearby markets plus the size of their domestic market, giving it a "market size" rank of eighth and a score of 5.7. However, the potential on this measure is let down by a poor result on "goods market efficiency" (rank of 123, score of 3.6), or the amount of competition, buyer sophistication, and lightness of government regulations that prevail in the goods market. But the lowest absolute and relative result in this subindex is actually on "financial sector development," where Russia ranks 125th with a score of 3.2. This result is caused by some low ranks in a number of areas such as the "soundness of banks" (rank of 129), "ease of access to loans" (107), and "financing through local equity market" (107). An impressive number of critical legal and regulatory acts laying the foundation of a modern capital market in Russia have been adopted in recent years. However, the above indicators underscore the need for the government to pursue its current reform agenda in the area of financial sector development and further strengthen its banking sector, enhance access to finance, and deepen and diversify its financial market.

Under the innovation and sophistication factors subindex, some of the consequences of Russia's weaknesses on competition become apparent. There are only two elements in this subindex, "business sophistication" and "innovation." On innovation, Russia has a low score (3.2), but this result does not actually penalize it a great deal in comparison to other countries because it ranks 57th overall. However, on business sophistication (rank of 101, score of 3.5), Russia's weak institutional environment, lack of competition, and high regulatory barriers to establishing and running businesses clearly contribute to a lack of dynamism among firms, hence inducing the low level of sophistication reflected in this measure. There were, however, some good signs in the 2008 BEEPS (Business Environment and Enterprise Performance Survey), which found that the percentage of firms that had developed new products in the three years prior to being asked had increased by 24 percentage points between 2005 and 2008.[4] It will be interesting to see if the new upcoming round of BEEPS planned for 2011 confirms this trend.

Overall, Russia clearly has some strengths in the *basic* requirements for a well-functioning market economy, but it is let down by weak scores on its *institutional framework*. If it were to

[3] Transparency International, *Transparency in Reporting on Anti*-corruption (Berlin: Transparency International, 2010), 13.
[4] World Bank, "BEEPS at-a-Glance 2008: Russia" (report, World Bank, Washington, DC, 2010): 17.

improve in this area, it could expect to compete a lot stronger on the most basic elements needed to support growth and attract foreign firms, such as strong property rights, judicial independence, and better auditing and reporting standards.

Doing Business

The Doing Business index (DB) concentrates on a complementary but narrower set of issues: the regulatory environment that businesses operate in. DB analyzes the regulatory environment by studying nine indicators, which measure the ease of starting, operating, and closing a business. Importantly, it looks at the ease of doing business for the small and medium-size enterprises that operate in a country's largest business center, often the capital city. The choice of business size means that it is possible to use the data to judge the environment in which the next generation of companies will be operating. If that environment is hard to navigate, it is less likely that new companies will blossom and force advances in sophistication and product development. The DB data can thus be useful in showing policy makers how they can make practical changes that will directly improve the business environment if properly implemented.

However, it is also important to pay attention to the geographic aspect of the data. DB concentrates on the biggest business centers of the countries that it looks at because those centers often contain the leading businesses in an economy. What happens in these places is emblematic of the business environment—especially in Russia, where much of the country's economic activities are concentrated in the Moscow area. To obtain a more nuanced picture of Russia's regional comparative performance, the Russian government and World Bank conducted a first subnational Doing Business assessment in 2009 in nine additional Russian regions covering the cities of Irkutsk, Kazan, Perm, Petrozavodsk, Rostov-on-Don, Saint Petersburg, Tomsk, Tver, and Voronezh. Interestingly, Moscow was ranked lowest overall while Kazan was ranked highest with considerable regional variations.[5]

The assessment's findings suggest that regional policy makers can make a real difference to the ease of doing business in their regions. Thus, local policies, as well as local interpretations of federal rules, can be significant in determining the burdens on enterprises. The Russian government is planning to launch a new round of the subnational Doing Business assessment this year in partnership with the World Bank to compare 30 Russian regions on four indicators (starting a business, dealing with construction permits, registering property, and getting electricity) with a view to better capturing regional variations and facilitating cross-regional comparisons and peer learning.

Russia's overall position

Table 2.2 summarizes Russia's overall position in the various groups studied according to DB measures. There were 183 countries assessed in the global Doing Business 2011 report. In DB 2011, Russia fell overall from 116th place to 123rd. On measures such as starting a business, it is

[5] World Bank, *Doing Business in Russia 2009* (Washington, DC: World Bank, 2009).

down to 108th from 104th. Its best ranking, on enforcing contracts, has not changed, and neither have its worst two, on trading across borders and dealing with construction permits.[6]

Table 2.2: Russia Compared on the DB Measures to the Rest of the Countries in Various International Groups[7]

Country Groupings	OECD	G20	Group 2	UMI	BRICs	ECA
Number of countries in each group	35	20	29	46[8]	4	25[9]
Overall ranking 2011	35th	20th	25th	38th	2nd	22nd
Starting a business	29th	14th	17th	32nd	1st	21st
Dealing with construction permits	33rd	20th	28th	46th	4th	25th
Registering property	21st	7th	5th	11th	2nd	11th
Getting credit	Equal 7th	Equal 8th	Equal 9th	Equal 9th	Equal 3rd	Equal 7th
Protecting investors	Equal 10th	Equal 7th	Equal 11th	Equal 11th	Equal 3rd	Equal 8th
Paying taxes	27th	11th	16th	26th	1st	13th
Trading across borders	35th	19th	29th	43rd	4th	21st
Enforcing contracts	11th	7th	2nd	4th	2nd	4th
Closing a business	34th	15th	20th	29th	2nd	18th

The DB data suggest that although it is difficult to start a company in Russia, it is especially challenging to keep a company running because on so many measures operating a business is burdensome. The problem with business operation is clear from the fact that Russia ranks low on getting credit (89th), protecting investors (93rd), paying taxes (105th), and dealing with construction permits (182nd). Trading across borders is also more difficult in Russia than in other countries (Russia ranks 162nd). Finally, the process of closing a business down also continues to be problematic: Russia ranks 103rd overall on this measure.

Russia compared to the OECD

Russia's business environment compares poorly to the business environments in many OECD countries. Consider one factor, closing a business, as a measure of comparison. It takes nearly two years more than the OECD average to close a business, and creditors can only expect to recover 25 cents in the dollar rather than the OECD average of 65 cents in the dollar. However, Russia is competitive on what it costs as a percentage of the debtor's estate to close a business: 9% rather than the OECD average of nearly 10%.

[6] In the World Bank's BEEPS data of 2008, 59 percent of the firms in the survey said that customs regulations were not a problem. In addition, in 2008 only 1 percent of total sales for Russian enterprises came from direct exports. Trading abroad may therefore not be the most important challenge Russian companies face. For details, see World Bank, "BEEPS At-a-Glance 2008: Russia" (report, World Bank, Washington, 2010).

[7] It should be noted that in the DB data some countries have the same rankings as other countries on certain sub-indexes. Where this has occurred the countries have been given the same rank, thus meaning that five countries might be ranked as fifth on a particular measure. When this happens Russia's rankings will often rise up the table.

[8] Because DB studies more countries than the GCR this group contains 12 more countries (i.e. a total of 46) than the same group in the GCR data.

[9] Because DB studies more countries than the GCR this group contains three more countries (i.e. a total of 25) than the same group in the GCR data.

Russia compared to the G-20

Compared to the rest of the G-20, Russia fares poorly, with difficulty in operating a business being a clear disadvantage when put against the world's leading industrial nations. It is also clear that in very few of the nations in the group is it as hard as in Russia for firms to buy goods from, or sell goods to, companies abroad. However, Russia's framework for enforcing contracts clearly puts it ahead of many other countries on this score, including Canada. Indeed, even though Russia might have a few more procedures than other countries, much less time is required for the process of enforcing contracts. Costs can also be much lower than in other countries. Russia also does not do badly on registering property, where it beats countries such as France, Germany, and Japan.

Russia compared to the Group 2 level of development in the GCR and to the UMI countries

What is particularly striking about some of the top countries in the Group 2 and UMI group comparisons is the extent to which they have managed to achieve a good position across all of the factors. Mauritius is the best-performing country in the UMI group, with a best score of 12 and a worst score of 89. In Group 2, Thailand outperforms all of the other countries and also manages to achieve some high rankings while not at the same time having its lowest rankings at the bottom of the table. Russia, however, has only a few competitive rankings, which are offset by some uncompetitive ones. Thus even among its similarly developed peers in terms of gross national income per capita it does not perform strongly.

Russia compared to the BRICs

Even though the GCR places Russia as the least competitive of the four BRIC countries, its business infrastructure gives it some advantages. Its rank on starting a business is low overall (108), but that ranking is actually better than Brazil's, China's, or India's. Some of its lowest scores—on dealing with construction permits and paying taxes—look a little better because the other three countries also score low in those areas. However, the hurdles that Russian firms face when trading with other countries still stick out.

Russia compared to other ECA countries

Russia has some competitive advantages in its business environment over its ECA neighbors. These advantages include the lower cost of starting a business and the fewer tax payments that Russian firms need to make. However, Russia's weaknesses on other factors that contribute to the burden of doing business look stark even when compared to the other countries in the ECA region. For example, it still takes nearly a year longer to deal with a construction permit and several hundred U.S. dollars more to export a container in Russia than in other countries in the region.

What is generating Russia's strengths and causing its weaknesses on these measures?

As one would expect, Russia's problems in dealing with construction permits and trading across borders mean that on every measure in those subcategories it is harder to do business. Getting construction permits in Russia (Moscow) is simply a long and expensive process. Apart

from their higher cost (US$4,141.00 versus US$215.20 across the rest of the G-20), it also takes a year longer to complete the process.[10]

It is the same story for companies that want to import and export. Compared to the average wait of 13 days in the G-20, Russian companies have to wait 36 days to export a container of goods and 36 rather than 14.7 days to import a container of goods. Moreover, they must deal with eight documents rather than five to get their products to a foreign market. To get a container of goods in or out of the country, they pay between US$700 and US$800 more than the average in the OECD.[11]

On Russia's strengths, enforcing contracts appears to be a lot easier than in some other countries. Although Russia has slightly more procedures, the whole process is nearly 270 days shorter and much cheaper than the G-20 average. However, compared to the rest of the G-20, it is harder to get a business in Russia through the initial stages of setting it up, finding credit, and doing simple things such as registering property. Interestingly, Moscow ranks eighth on the list of Russian cities surveyed in the 2009 subnational DB assessement for opening a business. In Rostov-on-Don, the best place for doing so, there are four more procedures, but the cost of the process as a percentage of income per capita is 1.1 percentage points lower than in Moscow.

Russia has advantages in that firms are required to pay less money to establish themselves, but in doing so they must go through longer procedures than companies in many G-20 countries (an additional 1.5 procedures and 8.5 days more than the G-20 average). The legal regime for borrowing capital receives a weak score (3.0 points rather than 6.1 for the G-20), and investors are offered only mediocre protection for their investments (5.0 points rather than 6.2 for the G20).[12] Moreover, they face clear difficulties when trying to obtain construction permits (540 days rather than 176, and 53 procedures rather than 18).

The Doing Business Group has developed a simulator tool that allows countries to project how their scores might hypothetically change—everything else being constant—if they simplified the number of procedures and decreased the time and cost of doing business under various indicators. If, for example, Russia's below-average scores were adjusted to match the averages that prevail on the respective DB measures in the G-20 grouping, its ranking might rise to the 44th best country for doing business.[13] However, this achievement would, of course, depend on the unlikely scenario of other countries not making any changes.

Improving investment climate conditions in Russia is a top priority for the Government. The authorities at the federal, regional and municipal levels have been working to address the above

[10] Two of the reasons for Russia's low rating in this area stand out. First, a high number of procedures must be completed for a location permit in Moscow, which requires a number of permits above and beyond those required by the federal urban development code. See World Bank, *Doing Business in Russia 2009* (Washington, DC: World Bank, 2009): 10. Second, the cost of electricity hookups in Moscow is high.

[11] However, the 2008 BEEPS did find that between 2005 and 2008 the percentage of firms stating that bribes were frequently requested or expected when dealing with customs declined from 11 percent to 6 percent. This decline is in part due to the government's ongoing program to reform the Federal Customs Service, which concentrates on (a) promoting internationally acceptable practices for processing of international trade flows by customs and (b) increasing taxpayer compliance with the Customs Code and the uniformity of its application. See World Bank, *Trends in Corruption and Regulatory Burden in Eastern Europe and Central Asia* (Washington, DC: World Bank, 2011): 15.

[12] In the 2008 BEEPS, only 25 percent of firms said that getting access to credit was not a problem; given the persistent problems with the availability of credit after the financial crisis, this issue is unlikely to have improved. See World Bank, "BEEPS at-a-Glance 2008: Russia" (report, World Bank, Washington, DC, 2010): 13.

[13] It could do so by, for example, cutting the number of documents required to export goods from eight to around five or by reducing the number of procedures required to obtain a construction permit from 53 to 18.

weaknesses and simplify the regulatory environment. New legislation and amendments to existing legislation have already been adopted or developed, including in the areas of construction and customs. The World Bank is working with the Ministry of Economic Development on a broad range of investment climate issues with a view to improving business conditions for firms and investors operating across Russia. In addition to improving the stock of existing legislation, the Ministry has been working to improve the quality of new regulatory activity through implementation of Regulatory Impact Assessment (RIA) methodology designed to assess the costs and benefits of new legislation.

Main Macroecnomic Indicators

	2007	2008	2009	2010													2011	
Output Indicators	**Jan-Dec**	**Jan-Dec**	**Jan-Dec**	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**	**2010**	**Jan**	**Feb**
GDP, % change, y-o-y 1/	**8.5**	**5.2**	**-7.8**	-	-	3.1	-	-	4.2	-	-	3.7	-	-	4.0	**4.0**	-	-
Industrial production, % change, y-o-y	**6.8**	**0.6**	**-9.3**	10.2	8.4	9.8	10.4	12.6	9.7	5.9	7.0	6.2	6.6	6.7	6.3	**8.2**	6.7	5.8
Manufacturing, % change, y-o-y	**10.5**	**0.5**	**-15.2**	13.3	10.0	13.1	16.5	18.7	14.0	8.0	11.0	9.4	9.9	10.1	9.7	**11.8**	13.5	10.2
Extraction of mineral resources, % change, y-o-y	**3.3**	**0.4**	**-0.6**	6.9	6.7	6.7	4.6	5.4	14.0	2.7	0.6	0.5	1.4	2.0	2.5	**3.6**	3.5	3.2
Fixed capital investment, % change, y-o-y	**21.1**	**9.8**	**-16.2**	-8.3	-7.5	0.4	1.7	5.6	8.3	-0.5	8.1	7.8	10.6	8.0	13.3	**6.0**	-4.7	-0.4
Fiscal and Monetary Indicators																		
Federal government balance, % GDP 1/	**5.4**	**4.1**	**-5.9**	2.4	-8.6	-3.2	-3.4	-3.3	-1.9	-2.2	-2.3	-2.2	-2.1	-2.2	-4.1	**-4.1**	3.6	0.7
Consolidated budget balance, % GDP 1/ 2/	**6.1**	**4.8**	**-6.2**	13.4	7.4	2.5	2.3	1.7	1.3	1.2	0.9	0.3	0.1	-0.2	-3.6	**-3.6**		
M2, % change, p-o-p 3/	**51.3**	**27.2**	**-3.5**	-2.3	1.5	2.8	2.7	2.3	2.2	0.8	1.9	1.4	1.1	2.4	8.9	**30.7**	**-4.3**	**1.2**
Inflation (CPI), % change, p-o-p	**11.9**	**13.3**	**8.8**	1.6	0.9	0.6	0.3	0.5	0.4	0.4	0.6	0.8	0.5	0.8	1.1	**8.8**	2.4	0.8
GDP deflator 1/	**13.9**	**18.8**	**2.7**	-	-	13.97	-	-	12.5	-	-	10.8	-	-	10.3	**10.3**	-	-
Producer price index (PPI), % change, p-o-p	**25.1**	**-7.0**	**13.9**	-1.1	2.0	1.8	3.2	2.7	-3.1	0.7	3.3	-1.3	2.2	4.4	1.0	**16.7**	2.1	3.3
Nominal exchange rate, average, Rb/USD	**25.6**	**24.8**	**31.7**	29.9	30.2	29.6	29.2	30.4	31.2	30.7	30.3	30.8	30.3	31.0	30.9	**30.4**	30.1	29.3
Reserves (including gold) billion $, end-o-p	**477.9**	**427.1**	**439.0**	436.3	436.8	447.4	461.2	456.4	461.2	475.3	476.3	490.1	497.1	483.1	479.4	**479.4**	484.2	493.8
Balance of Payment Indicators																		
Trade Balance, billion $ (monthly)	**130.9**	**179.7**	**112.1**	16.3	15.0	15.2	14.3	12.5	12.4	10.4	7.9	10.8	10.5	10.9	15.4	**149.2**	17.3	
Share of energy resources in export of goods, %	**61.5**	**65.9**	**62.8**	-	-	67.1	-	-	63.3	-	-	61.2	-	-	62.5	**63.3**	-	
Current Account, billion $	**76.6**	**102.4**	**48.9**	12.4	10.8	10.1	9.5	6.7	2.9	3.1	0.0	3.0	-	-	14.3	**72.6**	-	-
Export of goods, billion $	**354.4**	**471.6**	**304.0**	27.7	30.6	34.0	33.5	31.8	32.1	31.5	31.8	34.3	35.0	35.3	42.3	**398.0**	33.3	
Import of goods, billion $	**223.5**	**291.9**	**191.9**	11.4	15.5	18.8	19.2	19.4	19.6	21.1	23.9	23.6	24.5	24.5	26.9	**248.8**	16.0	
Gross FDI, mln USD 1/	**27,797**	**27,027**	**15,906**	-	-	2,623	-	-	5,423	-	-	8,196	-	-	13,810	**13,810**	-	-
Average export price of Russia's oil, $/bbl	**64.4**	**91.2**	**56.2**	71.6	69.6	71.7	75.2	74.5	71.8	72.8	73.5	73.6	77.0	80.3	83.8	**74.6**	89.8	
Financial Market Indicators																		
Average weighted lending rate for enterprises, % 4/	**10.8**	**15.5**	**13.7**	13.9	12.7	11.8	11.4	11.3	11.4	10.5	10.0	9.7	8.9	9.1	9.1	**9.1**		
CBR refinancing rate, %, end-o-p	**10.0**	**13.0**	**8.8**	8.8	8.5	8.3	8.0	7.8	7.8	7.8	7.8	7.8	7.8	7.8	7.8	**7.8**	7.8	8.0
Real average rate for Ruble loans, % (deflated by PPI)	**-3.4**	**-6.8**	**-0.1**	-2.3	-0.4	-0.1	-1.2	-3.3	2.0	2.3	0.0	2.2	-1.6	-6.0	-6.5	**-6.5**		
Stock market index (RTS, ruble term, eop)	**2,291**	**632**	**1,445**	1,474	1,411	1,572	1,573	1,385	1,339	1,480	1,421	1,508	1,600	1,634	1,770	**1,770**	1,910	1,963
Income, Poverty and Labor Market																		
Real disposable income, (1999 = 100%)	**245.6**	**252.2**	**257.0**	201.1	245.9	253.0	275.0	256.3	268.9	269.7	254.9	254.4	267.1	266.0	370.5	**267.5**	189.0	241.3
Average dollar wage, US $	**532.0**	**696.9**	**588.3**	622.3	635.0	701.3	695.0	665.0	698.6	706.4	676.9	690.8	681.3	686.2	874.1	**697.8**	696.6	728.5
Unemployment (%, ILO definition)	**6.1**	**7.8**	**8.2**	9.2	8.6	8.6	8.2	7.3	6.8	7.0	6.9	6.6	6.8	6.7	7.2	**7.2**	7.6	7.6

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

1/ Cumulative from the year beginning.

2/ Starting 2006 incl. extrabudgetary funds.

3/ Annual change is calculated for average annual M2.

4/ All terms up to 1 year.

5/ Data for the third quarter of 2010.