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RUSSIA'S ECONOMY LOSES MOMENTUM AMIDST COVID-19 RESURGENCE; AWAITS RELIEF FROM VACCINE

44 RUSSIA ECONOMIC REPORT
DECEMBER 2020



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SPECIAL FOCUS: RUSSIA INTEGRATES: DEEPENING THE COUNTRY'S INTEGRATION IN THE GLOBAL ECONOMY

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The cutoff date for the analysis and data used in this report was December 8, 2020 for parts 1 and 2.

This report is produced twice a year by World Bank economists in the Macroeconomics, Trade and Investment (MTI) Global Practice. The team that prepared this edition was led by Apurva Sanghi (Lead Economist for the Russian Federation) and Olga Emelyanova (Economist, MTI), and consisted of Irina Rostovtseva (Research Analyst, MTI), Lucie Wuester (Consultant, MTI), Katerina Levitanskaya (Senior Financial Sector Specialist, FCI), Peter Stephen Oliver Nagle (Senior Economist, EPGDR), Collette Mari Wheeler (Economist, EPGDR), Damien Matthias Valentin Boucher (Consultant, EPGDR), Samuel Freije-Rodriguez (Lead Economist, POV), Mikhail Matytsin (Data Scientist, EPVGE), Anya Vodopyanov (Public Sector Specialist/ Economist, EECG2), and Alberto Leyton (Lead Public Sector Specialist, EECG2).

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ABBREVIATIONS AND ACRONYMS

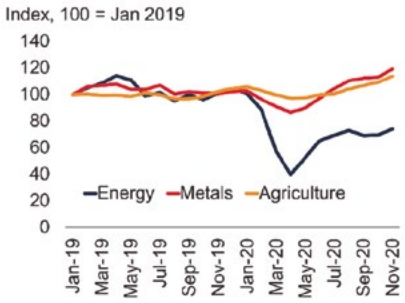
AEs	Advanced economies
APEC	Asia-Pacific Economic Cooperation
AVE	Ad valorem equivalents
CBDC	Central Bank Digital Currency
CBR	Central Bank of the Russian Federation
CEPII	Centre d'Etudes Prospectives et d'Informations Internationales
CIS	Commonwealth of Independent States
CMASF	Center for Macroeconomic Analysis and Short-term Forecasting
COVID-19	Corona Virus Disease 2019
CPB	Netherlands Bureau for Economic Policy Analysis
CSEE	The Center for Systems Science and Engineering
DC	District of Columbia
DTRI	Digital Trade Restrictiveness Index
EAEU	Eurasian Economic Union
EAP	East Asia and Pacific
ECA	Europe and Central Asia
ECI	The Economic Complexity Index
EEG	Economic Expert Group
EIA	Energy Information Administration
EMDEs	Emerging Markets and Developing Economies
EU	European Union
EUROMOD	Tax-Benefit Microsimulation Model for The European Union
FDI	Foreign Direct Investment
FIL	Foreign Investment Law
FX	Foreign Exchange
GDP	Gross Domestic Product
GNFS	General Number Field Sieve
GVC	Global Value Chains
HH	Household
ICRG	International Country Risk Guide
ICSID	International Centre for Settlement of Investment Disputes
ICT	Information and communications technology
IMF	International Monetary Fund
IP	Intellectual property
ISIC	The International Standard Industrial Classification of All Economic Activities
ISO	International Organization for Standardization
LAC	Latin America and the Caribbean
MICEX	Moscow Interbank Currency Exchange
MNA	Middle East and North Africa
MOF	Ministry of Finance
MXEF	MXEF Index
MXWO	MXWO Index
NAFTA	The North American Free Trade Agreement
NIL	New Investment Law
NWF	National Welfare Fund
OECD	Organization for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PIT	Personal income tax
PMI	Purchasing Managers' Index
PPP	Purchasing power parity
RCA	Revealed comparative advantage
REER	Real Effective Exchange Rate
RER	Russia Economic Report
RF	Russian Federation
ROA	Return on assets
ROE	Return on equity
ROSSTAT	Russian Federal State Statistics Service
RTS	The Russian Trading System
RUSMOD	Tax-Benefit Micro Simulation Model for Russia

RZD	Russian Railways
SAR	South Asia
SIC	Social Insurance Contributions
SIL	Strategic Investment Law
SML	Subsistence Minimum Level
SOE	State-owned enterprises
SSA	Sub-Saharan Africa
STRI	Services Trade Restrictiveness Index
UAE	The United Arab Emirates
UK	United Kingdom
UN COMTRADE	United Nations International Trade Statistics Database
UNCTAD	The United Nations Conference on Trade and Development
US	United States
USA	United States of America
UV	Unit value
VAT	Value-added tax
WB	The World Bank
WDI	World Development Indicators
WDR	The World Development Report
WG	Worldwide Governance Indicators
WTO	World Trade Organization

OVERVIEW

A. COVID-19's resurgence threatens to interrupt the incipient global recovery.

Figure O-1: Almost all global commodity prices rose in H2 2020, although with some divergence between commodities



Source: International Energy Agency; OPEC; World Bank.

The COVID-19 pandemic has plunged the global economy into its deepest recession since World War II. Despite substantial policy support, global GDP in 2020 is projected to contract by 5.2 percent, followed by a recovery of 4.2 percent in 2021. The pandemic has deeply disrupted livelihoods, with the fall in working hours estimated to be equivalent to the loss of nearly 500 million full-time jobs in 2Q 2020 alone. It is expected to push 110 to 150 million people into extreme poverty by 2021. The resurgence of COVID-19 is casting a shadow over the global recovery as countries are forced to re-tighten social-distancing measures, but confidence has been boosted by news that several COVID-19 vaccines have shown high efficacy rates in clinical trials. COVID-19 cases have risen sharply in the euro area – Russia's largest trading partner – in the fourth quarter and have imperiled the nascent economic recovery as authorities in several countries maintain, reintroduce, or tighten pandemic-control measures. Activity in China, Russia's second-largest trading partner, is showing signs of picking up, with output expanding in 3Q 2020 by 4.9 percent, y/y. The pandemic is expected to have longer-term scarring effects on productivity and potential growth, as investment weakens further and as human capital accumulation slows due to extended school closures and prolonged unemployment.

While global financing conditions eased considerably due to unprecedented monetary and fiscal policy responses in major economies, they remain prone to bouts of volatility. Financing conditions in Emerging Market and Developing Economies (EMDEs) have deteriorated amid acceleration in COVID-19 cases. EMDEs with large debt burdens or financing needs are particularly vulnerable to sharp increases in borrowing costs and to limitations in their access to financing.[1] Foreign Direct Investment (FDI) flows to EMDEs are projected to fall by nearly 32 percent in 2020 amid stalling investment and lower corporate profits. Additionally, remittances are projected to fall by 14 percent by 2021 relative to pre-pandemic levels in 2019, with Europe and Central Asia anticipated to face the steepest decline, as the region grapples with job losses in host economies, such as in the euro area, and as the slide in oil prices dents outflows from Russia.

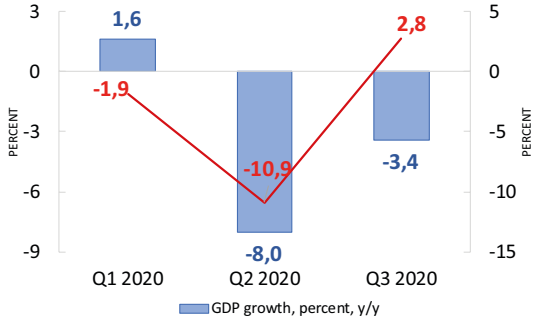
Almost all global commodity prices rose in H2 2020 following steep declines earlier in the year due to the COVID-19 pandemic, although with some divergence between commodities (Figure O-1). Energy prices, particularly crude oil, remain well below their pre-pandemic levels, with oil consumption still affected by reduced travel due to the pandemic. In contrast, most non-energy prices have risen above their pre-pandemic levels as global growth started to recover, particularly in China. Energy exports are particularly important for Russia and accounted for over 60 percent of total exports by value in 2019.

B. Russia's GDP contracted in Q2 and Q3, with negative momentum expected to continue in Q4 amidst rising cases and the reinstatement of restrictions.

2Q GDP contracted by 8 percent, y/y, on the back of massive pandemic-induced supply-and-demand shocks, but it performed slightly above expectations because of the stronger-than-expected export dynamics. The Q3 GDP growth estimate posted -3.4 percent, y/y, given some resumption of economic activity as COVID-19 cases

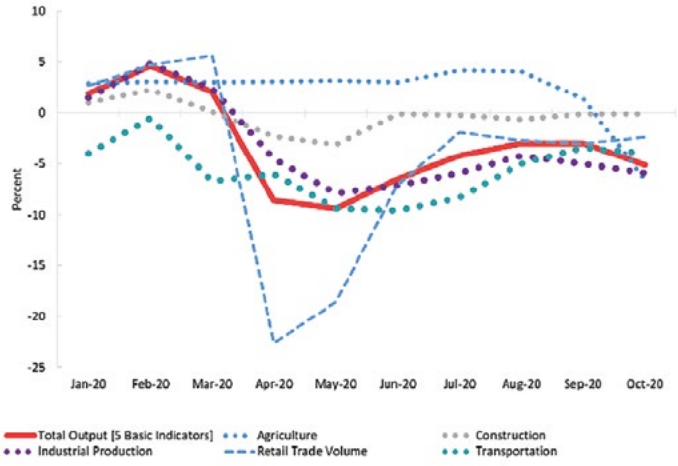
[1] Between 2007 and 2019, government debt in EMDEs increased by about 11 percentage points of GDP, on average, to 55 percent of GDP. Fiscal surpluses of more than 2 percent of GDP in 2007 had turned into deficits of 1 percent of GDP by 2019.

Figure O-2: Russia's GDP contracted in both Q2 and Q3



Source: Rosstat.

Figure O-3: Negative momentum is expected in Q4

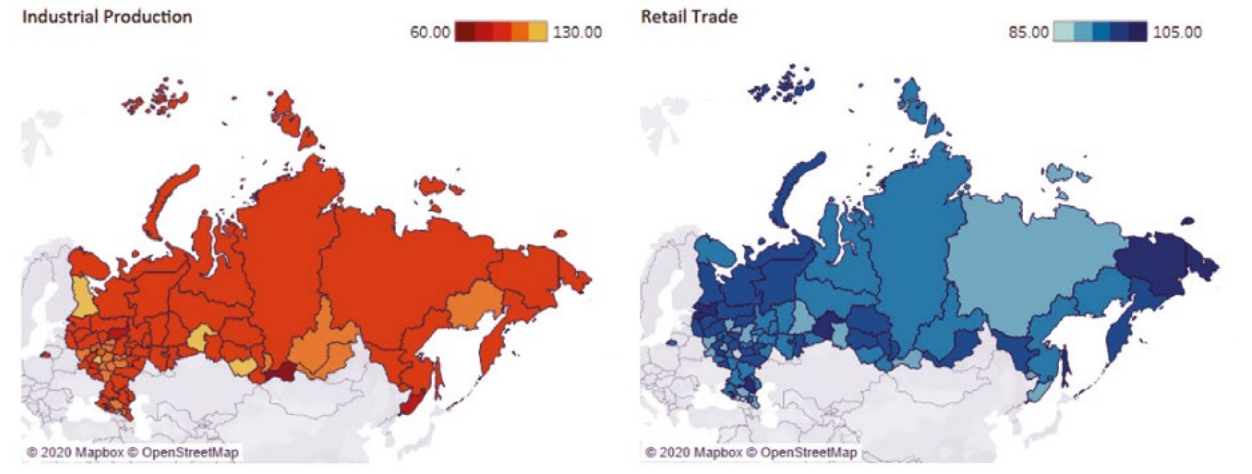


Source: Rosstat.

started declining and restrictions were eased (Figure O-2). With fiscal stimulus (in the order of 4 percent of GDP; see previous RER #43 for a detailed discussion on Russia's fiscal response) being channeled into the economy along with an accommodative monetary policy, domestic demand became the driver of the resumption of economic activity. Negative momentum is expected to continue in Q4 amidst a growing number of new COVID-19 cases and the reinstatement of restrictions. In October, output in five basic sectors registered -5.1 percent, y/y, compared to -3 percent, y/y, in September. IP production dropped by 5.9 percent, y/y, and remained flat m/m, with a weaker performance in manufacturing (Figure O-3).

The Covid-19 crisis has affected the Russian regions' economic indicators to varying extents, based on their exposure to the pandemic, pre-existing conditions, and the type of activity (Figure O-4). Overall, investments decreased by 4.1 percent in real terms in Russia in the first 9 months of the year, with wide regional variations. Investments declined most sharply in the Volga District (-6.6 percent, y/y) and in the Far East (-6.5 percent, y/y), but rose in oil and gas-producing regions, notably the Tyumen region (+8.1 percent), and in federal cities (Moscow +11.5 percent, St. Petersburg +5.5 percent). Regional variations in industrial production was also significant, with the crisis affecting regions that produce minerals the most. In the first three quarters of 2020, only 34 regions (versus 72 in the same period of 2019) saw

Figure O-4: Industrial production & retail sales in regions indicate varying performances (January – September, 2020)

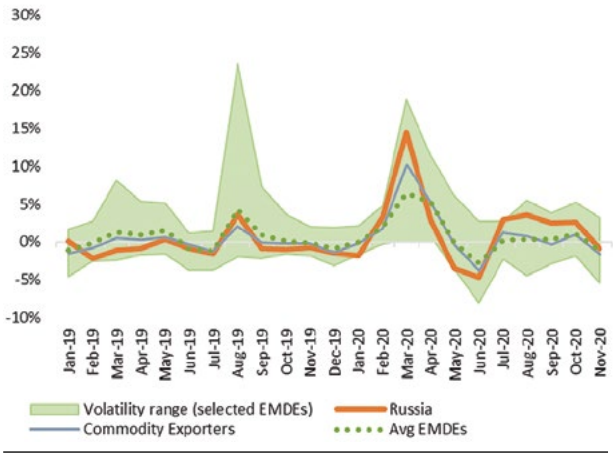


Source: Rosstat.

growth in industrial production. The largest declines in industrial production were in the Republic of Tyva (-48.5 percent), accounted for largely by the mining sector, and in the Kostroma region (-15.1 percent), in part due to lower electricity production. Almost all North Caucasian regions showed positive dynamics of production, mainly due to the important role of the food sector, which was less affected by quarantine restrictions.

Pressures from lower energy-export receipts, financial-markets volatility and increased geopolitical risks resulted in capital outflow and ruble depreciation (Figure O-5). Russia's reliance on foreign currencies through external trade channels somewhat decreased with the ruble's share in Russia's external-trade settlements increasing, notably in trade with China and India. However, the ruble depreciation increased balance-sheet vulnerabilities for firms with external debt in foreign currency. Their debt reached 22 percent of GDP (as of July 1, 2020).

Figure O-5: Pressures from lower energy export receipts, financial markets volatility and increased geopolitical risks resulted in a ruble depreciation (Exchange rate change, m/m)



Source: Haver Analytics.

The CBR's monetary policy remained consistent with the inflation-targeting framework. On the back of increased short-term pro-inflationary factors, the bank paused its accommodative policy actions, keeping the key policy rate at a record low of 4.25 percent. In November, the annual headline consumer price index (CPI) inflation rate reached 4.4 percent, above the CBR target of 4 percent. Monetary policy maintained short-term interest rates close to the key rate. Disinflationary risks, which pertain to the slower recovery of domestic demand compared to the summer months, and the complications arising from the pandemic, prevail, although the effects of short-term pro-inflationary factors have increased. Pro-inflationary factors pertain to the weakening of the ruble on the back of increased volatility in global markets, as well as to higher geopolitical risks, negative oil-price dynamics and capital outflows due to the COVID-19 outbreak. The impact of the weakening ruble on inflation will continue in the coming months.

Countercyclical fiscal policy and sizeable buffers have helped contain the impact of the crisis. The fiscal policy response was mostly concentrated on expenditure measures (3 percent of GDP); revenue measures (0.4 percent of GDP); and loans, equities and guarantees (0.6 percent of GDP). Please see the previous RER #43 for a detailed discussion. Consequently, the federal budget registered a deficit of Rub1,800 billion in January-October 2020. While contained overall, regional debt increased substantially in some regions. The general government deficit is expected to reach about 4.6 percent of GDP in 2020, compared to its surplus of 1.9 percent of GDP in 2019. Economic support measures under the framework of the plan of action aimed at restoring economic growth and growth of disposable incomes will be rolled over to 2021. After a stronger fiscal impulse in 2020, Russia's fiscal consolidation in 2021-2022 will be deeper than in other EMDEs and become a drag on growth. Given its relatively low public debt, sizeable macro-fiscal buffers,[2] and expected persisting negative output gap, Russia has some fiscal space for a more gradual consolidation and to further increase spending on social support and support to regions. Regional transfers are set to drop more than 10 percent in real terms in 2022, compared to the 2017-2019 pre-pandemic average.

The Russian banking sector is weathering the pandemic, but the worst may lie ahead. The COVID-19 pandemic and related deterioration of economic conditions in 2020 have undermined balance sheets in all sectors in the economy, affecting firms' ability to service and repay debt. In the first nine months of 2020, profits of large and medium enterprises halved compared to the same period last year, with several sectors recording losses (notably hotels, catering, railways and air passenger transportation). SMEs, which account for a fifth of the GDP, were affected even more severely. The deterioration in their operating environment has greatly affected the profitability of banks and

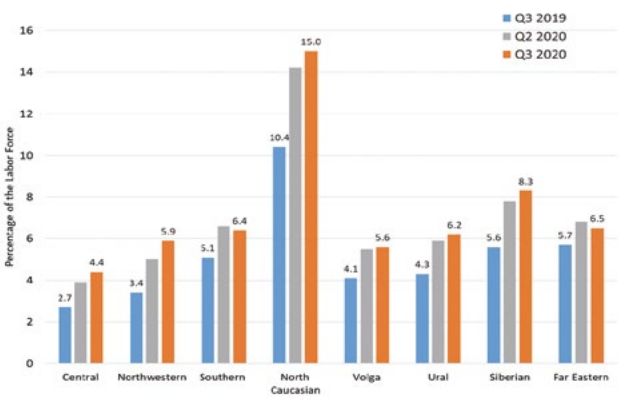
[2] As of December 1, 2020, Russia's sovereign wealth fund – the NWF – reached a robust US$177 billion (13.1 percent of GDP), while its liquid part reached 9 percent of GDP. International reserves stood at a comfortable US$583 billion (23 months of imports). Russia's external debt, at 33 percent of GDP, favorably compares to the 60 percent EMDE average. And public debt is at about 14 percent of GDP compared to 62 percent EMDE average.

the quality of their assets. Policy response measures introduced by the government and the central bank helped to relieve immediate pressure, with system-wide capital adequacy remaining largely stable. However, the real extent of problem loans on bank balance sheets will start emerging in mid-2021, when the remaining regulatory forbearance measures are supposed to be lifted. Pre-existing vulnerabilities such as a high share of non-performing loans (16.3 percent[3]), combined with uncertainty about the length of the second wave of the pandemic and related economic costs, suggests that the worst may still lie ahead.

The crisis increased unemployment in all regions, but most job losses were concentrated in only a few economic activities. The unemployment rate increased from 4.6 percent in October 2019 to 6.3 percent in October 2020 – the highest in eight years. All regions experienced a rapid rise in unemployment in the second and third quarters of 2020 except for the Far Eastern Federal District. Given the larger population of the Central and North Western federal districts (and the high incidence of COVID cases in their capitals of Moscow and Saint Petersburg), these regions count for the largest share of total unemployed as of September 2020 (29 percent) and the largest share of newly unemployed over the past year (38 percent) (Figure O-6). Job losses were concentrated in only a few economic activities (Figure O-7). Total employment – formal and informal – declined by 1.5 million jobs between the 2nd quarters of 2019 and 2020. Approximately half a million jobs have been lost in each of three large sectors: manufacturing, construction, and retail and hospitality services. These losses are explained by the lock-down measures and the difficulty of tele-working in these sectors. Labor market conditions are still loose with job postings from employers in employment agencies still well below the total number of unemployed. Real wages mirrored these changes – increasing in agriculture, communications, education and health services, but with large declines in hospitality services (-11.0 percent), construction (-5.8 percent), retail (-4.1 percent) and manufacturing (-2.9 percent). The combination of job losses and lower wages led to an important decline in real disposable income: 8.4 percent for 2Q and 4.8 percent for 3Q 2020.

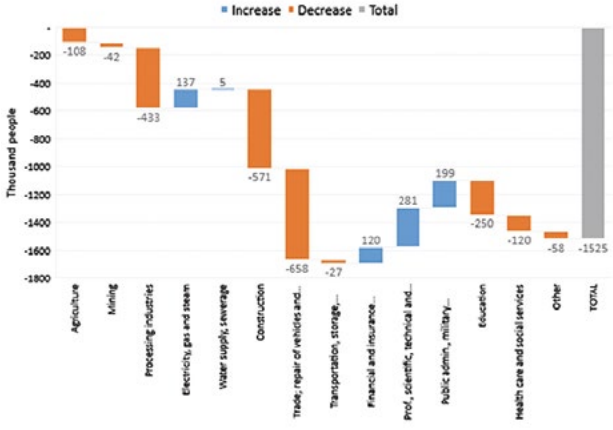
Informal and migrant workers are bearing the brunt of the crisis. Informal employment fell by 1.9 million jobs between June 2019 and June 2020, reducing the rate of informal employment from 21.5 to 19.4 percent in the period. Comparing this figure to the figure of total job losses suggests that it is informal workers who have borne the brunt of the crisis. Lacking proper labor contracts and concentrated in activities that cannot telework, informal workers have been most affected by the lockdown, underlining their vulnerability. Migrant workers, who tend to concentrate on activities adversely affected by the pandemic (i.e., construction, retail/hospitality services) and who work under informal contracts, are particularly affected. Russian authorities introduced a series of welcome measures to delay or suspend visa/work permit requirements for migrants, allowing at least some workers to keep working in their sectors or work in other sectors.

Figure O-6: The unemployment rate increased in all federal districts



Source: Rosstat.

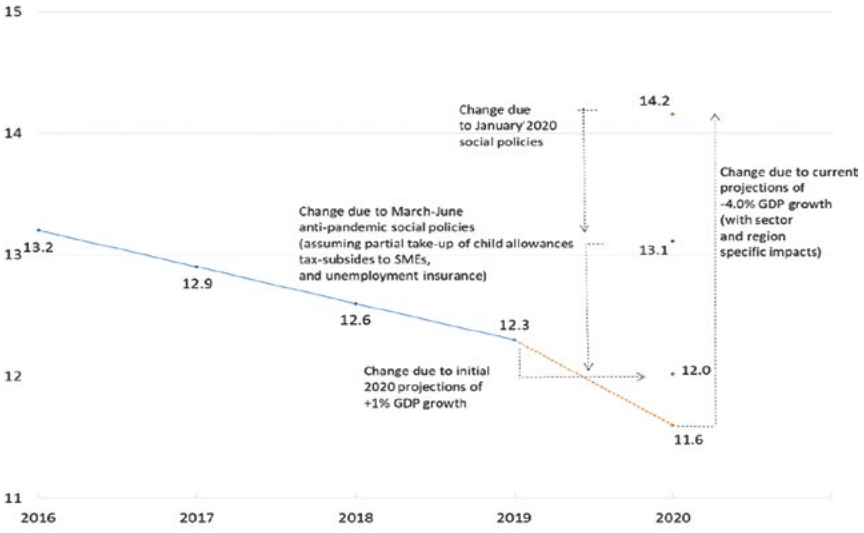
Figure O-7: Job losses were concentrated in three economic activities: manufacturing, construction and retail/hospitality services (changes in employment by economic activity, 2Q 2020 vs 2Q 2019)



Source: Rosstat.

[3] Includes "doubtful loan category" in addition to CBR-reported system wide NPLs of 9.3 percent.

Figure O-8: Social policies are compensating for the increase in poverty rate



Source: World Bank staff calculations.

Social policies put in place in light of the pandemic seem to have blunted the impact on poverty. The national poverty rate increased from 12.3 percent at the end of 2019 to 12.6 percent and 13.2 percent in Q1 and Q2 of 2020. However, the increase in Q1 was much smaller than in the same quarter in previous years. The Q2 poverty rate was still lower than in the same quarter of the previous two years. This suggests that social policies adopted earlier in the year to attenuate the impact of the COVID-19 pandemic are blunting the severe impact of the crisis on employment and disposable incomes (Figure O-8). Key policies included an increase in the maximum level of unemployment benefits from Rub 8,000 (US$103) to Rub 12,130 (US$157) per month and a series of family allowances and pension benefits (see the previous RER #43 for detailed analysis).

C. Outlook: the vaccination spread in 2021 is expected to put the economy on a path to sustained recovery and to a decline in poverty, but risks are tilted to the downside.

The pandemic is anticipated to have a prolonged impact on global oil consumption, which is expected to remain 5 percent below its pre-pandemic trend by the end of 2021. Oil prices[4] are forecast to increase to US$44/bbl in 2021 and US$50/bbl in 2022 from a projected US$41/bbl in 2020. The better-than-anticipated economic rebound in the third quarter of 2020 led to an upgrade in Russia's economic outlook for 2020 to minus 4.0 percent (from the previous projection of minus 5 percent in September). Consumer and business confidence are expected to improve assuming a vaccine deemed safe and effective is rolled out; this would pave the way for a gradual rebound at 2.6 and 3.0 percent in 2021 and 2022, respectively. The poverty rate, under the upper middle-income poverty line of US$ 5.5 per day, is expected to decline in 2021 to below 2019 levels as the economy rebounds. An uptick in poverty in 2020 is possible, however, if social policies have incomplete up-take and face implementation hurdles, or the economy contracts more than expected towards the end of this year. A downside scenario assumes a sharper surge in new cases that lasts into the second half of 2021, with GDP projected to grow by 0.6 and 2.8 percent in 2021 and 2022.

Risks are firmly tilted to the downside. A sharp increase in new infections could lead to a reintroduction of strict lockdowns negatively affecting domestic demand. Lower-than-expected safety, effectiveness, or acceptance of the vaccine could also delay the economic recovery. New sanctions could worsen Russia's outlook. Banks could face a significant deterioration in asset quality, profitability and capitalization, including from an overheated mortgage market. The CBR has recently prolonged the forbearance on impairment recognition until end June 2021. While

[4] Defined as an average of Brent, West Texas Intermediate, and Dubai.

these measures should ease regulatory pressure and allow banks to accumulate more profits to cover increases in problem loans, they will also delay recognition of unavoidable and costly losses. The pandemic has also amplified contingent liabilities risk.

While near-term recovery will be contingent on the stemming of the pandemic, longer-term economic prospects will depend on boosting potential growth. Potential growth in Russia has been on a declining trend even prior to the current crisis.[5] Increasing competition is essential in boosting potential growth: product market regulation in Russia is restrictive to competition mainly through direct state control in the economy. The government can foster competition by leveling the playing field and strengthening state-owned enterprises (SOE) governance to make existing SOEs more efficient and competitive by: removing barriers for firms to contest markets where SOEs are present and by limiting the procedural discretion with which public-sector entities — SOEs in particular — procure goods and services. With about 15 percent of labor force[6] employed by SOEs, they could have served as buffers for employment losses during the current crisis and somewhat cushioned the impact of the crisis on disposable incomes. However, SOE reform remains important to address structural constraints to lifting potential growth. The COVID-19 crisis brings opportunities for such reform in the shape of new fiscal and demand-side pressures. The fiscal crunch, combined with low commodity prices, is forcing the government to search for efficiency-improving measures. The SOE sector presents a clear opportunity, given its heavy demands on the national treasury. Historically, many countries began their most ambitious SOE reforms after large fiscal shocks, and Russia may be no exception. Digitalization is another area the crisis has unveiled as an opportunity that can speed up Russia's recovery. Russia has made good progress in digital transformation. It has about 96 million people online; E-government infrastructure now reaches more than 103 million users; and Russian digital platforms have established leading positions in many markets. Yandex is among the top-5 largest web search platforms in the world; Vkontakte is among the top-5 largest global social media platforms; and HeadHunter is the 3rd most popular internet recruitment platform globally. Yet Russia is the 6th worst out of the 46 economies included in the OECD STRI database in digital services such as computing, motion pictures, and sound recording. In computer services, there are relatively high restrictions on foreign entry as well as cumbersome regulations for the hiring of foreign professionals, including intra-corporate transferees, and independent and contractual service suppliers. Removing such barriers would help Russia in improving its quality and quantity of digital services exports and in upgrading its more complex global-value chains that rely on imported services (see special focus).

[5] Okawa, Yoki; Sanghi, Apurva. 2018. Potential Growth: Outlook and Options for the Russian Federation. Policy Research Working Paper; No. 8663. World Bank, Washington, DC.

[6] IMF 2019. "Reassessing the role of SOEs in Central, Eastern, and South-Eastern Europe", data for 2016.

PART I

RECENT ECONOMIC DEVELOPMENTS

1.1 Global activity: COVID-19 resurgence threatens to interrupt the incipient recovery

The COVID-19 pandemic has plunged the global economy into its deepest recession since World War II. Despite substantial policy support, global GDP in 2020 is projected to contract by 5.2 percent, followed by a recovery of 4.2 percent in 2021.[7] The pandemic has also deeply disrupted livelihoods, with the fall in working hours estimated to be equivalent to the loss of nearly 500 million full-time jobs in 2Q 2020 alone.[8] After more than two decades of annual poverty reduction, the pandemic is expected to push 110 to 150 million people into extreme poverty by 2021.[9] The resurgence of COVID-19 is casting a shadow over the global recovery as countries are forced to re-tighten social-distancing measures, but confidence has been boosted by news that several COVID-19 vaccines have showed high efficacy rates in clinical trials. The pandemic is expected to have longer-term scarring effects on productivity and potential growth, as investment weakens further and as human capital accumulation slows due to extended school closures and prolonged unemployment.[10,11]

Almost all global commodity prices rose in H2 2020 following steep declines earlier in the year due to the COVID-19 pandemic, although with some divergence between commodities (Figure 1)[12]. Energy prices, particularly crude oil, remain below their pre-pandemic levels, with oil consumption still affected by reduced travel due to the pandemic. In contrast most non-energy prices have risen above their pre-pandemic levels as global growth has started to recover, particularly in China. Energy exports are particularly important for Russia and accounted for over 60 percent of total exports by value in 2019.

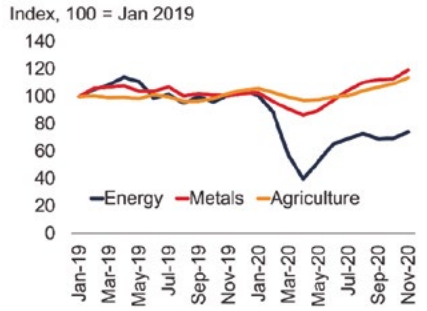
Crude oil prices stabilized in Q3 2020 after rebounding from their April lows, with the price of Brent crude oil averaging US$43/bbl over the quarter. However, prices weakened in October and early November amid renewed concern about oil consumption as countries began to reinstate lockdown measures in response to rising COVID-19 infection rates. While oil consumption has seen a partial recovery after plummeting 16 percent in Q2 2020 (y/y), it remains 6 percent lower than its pre-pandemic level. The successful trial of a vaccine in mid-November is positive news for oil consumption and caused prices to rise toward the end of 2020, however, its impact on demand won't be material until the vaccine is widely distributed.

Global oil production also fell significantly in Q2 2020 in response to the decline in demand. The drop was driven by production cuts among OPEC and its partners who agreed to a historically large cut of 9.7mb/d from May (Figure 2). In Russia, crude oil production declined from an average of 11.3mb/d in Q1 2020 to 9.4mb/d in May-July. The group increased production by 2mb/d from August – December 2020 and agreed to increase production by a further 0.5mb/d in January 2020. Compliance with the cuts among OPEC+ so far has been high. One exception is Libya, which had seen production fall close to zero in mid-2020 as a result of internal geopolitical conflict, from an average of 1.1mb/d in 2019 (Libya is a member of OPEC but is not subject to the OPEC+ agreement). However, a nationwide ceasefire was announced in October and has led to a robust recovery in oil production, which is estimated to have averaged almost 1mb/d in November[13]. Production outside of OPEC+ also fell, notably in the United States where it declined by around 20 percent between April and May, although it has since seen a partial recovery, with a modest increase in the rig count in November.

Natural gas prices fell sharply in the first half of 2020, with European prices reaching a record low in May as global demand fell as a result of the pandemic. However, prices have since recovered robustly as global economic activity has picked up, with prices in Europe boosted by rising demand due to colder weather. Russia is the world's second largest producer and consumer of natural gas, and its exports have grown rapidly in recent years, rising by more than one-quarter between 2014 and 2019. Exports of liquefied natural gas have seen a particularly sharp increase, growing nearly 60 percent in 2019 alone, fueled by rising demand from Asia.

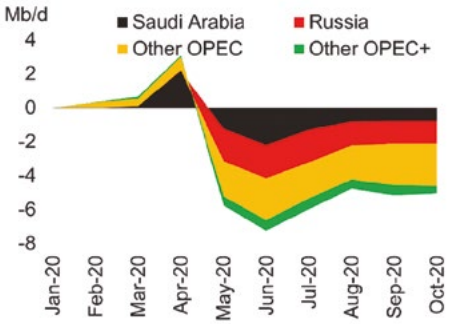
[7] World Bank. 2020. *Global Economic Prospects*, June 2020. Washington, DC: World Bank.
[8] International Labour Organization. 2020. *ILO Monitor: COVID-19 and the world of work*. Sixth edition. Geneva: ILO.
[9] World Bank. 2020. *Poverty and Shared Prosperity: Reversals of Fortune*, October 2020. Washington, DC: World Bank.
[10] Dieppe. 2020. *Global Productivity: Trends, Drivers, and Policies*. Washington, DC: World Bank.
[11] World Bank. 2020. *Human Capital Project:* Year 2 Progress Report, October 2020. Washington, DC: World Bank.
[12] World Bank. 2020. *Commodity Markets Outlook*, October 2020. Washington, DC: World Bank.
[13] International Energy Agency. 2020. "*Oil Market Report,* November 2020." Paris, International Energy Agency.

Figure 1: Almost all global commodity prices rose in Q3 2020, although with some divergence between commodities



Source: International Energy Agency; OPEC; World Bank.
Note: "Other OPEC" includes all current OPEC countries except Saudi Arabia, and Iran, Libya, and Venezuela which are exempt from production cuts. Other OPEC+ includes Azerbaijan, Bahrain, Brunei, Kazakhstan, Malaysia, Oman, South Sudan, and Sudan.

Figure 2: In May, OPEC+ have implemented a historic production cut (change in OPEC+ crude oil production since January 2020)

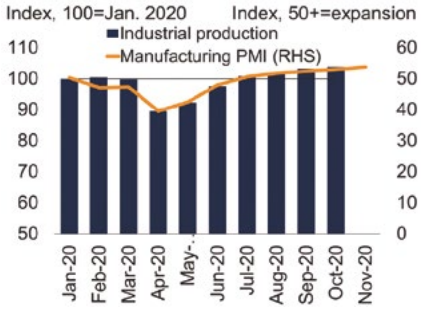


Source: International Energy Agency; OPEC; World Bank.
Note: "Other OPEC" includes all current OPEC countries except Saudi Arabia, and Iran, Libya, and Venezuela which are exempt from production cuts. Other OPEC+ includes Azerbaijan, Bahrain, Brunei, Kazakhstan, Malaysia, Oman, South Sudan, and Sudan.

Almost all non-energy prices rose in Q3 2020, with many returning to or exceeding their pre-pandemic levels. Metal prices rose 20 percent on the quarter, with sizeable increases for all metals, particularly copper and iron ore. The robust recovery in China has led to a surge in the country's imports of metals, which has been further augmented by stockpiling. China accounts for more than half of global consumption of metals and is Russia's second largest trading partner. Some metal prices, notably copper, were also boosted by COVID-related supply disruptions. Precious metal prices also rose sharply, led by silver which rose 50 percent (q/q), while gold reached an all-time high in early August. Precious metals have been boosted by the fall in interest rates as major central banks aggressively eased monetary policy, as well as heightened uncertainty and safe-haven flows. *Agricultural commodity* prices rose by 6 percent in Q3 2020, albeit with notable divergence between broadly stable grain prices and rising prices of other commodities. Among food commodities, prices of oils and meals, gained the most in the quarter due to supply shortfalls in some oils and strong import demand by China in the case of soybeans.

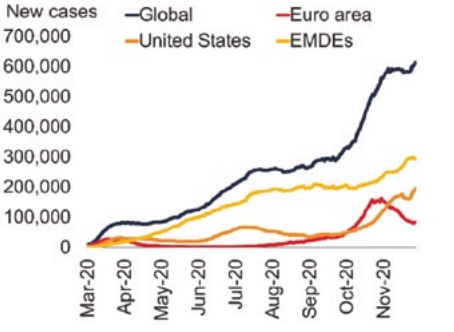
The resurgence of COVID-19 has interrupted the global recovery. The onset of COVID-19, combined with pandemic restrictions, halted global activity in the second quarter of 2020, with GDP shrinking nearly 28 percent (q/q/ saar). By the third quarter of 2020, the phasing out of restrictions paved the way for a robust rebound in activity, particularly manufacturing, with the euro area and United States registering record-high GDP growth rates in the Q3 2020 (Figure 3). Services activity, however, remained exceptionally weak as consumers and businesses continued to shy away from face-to-face interactions. Despite an initial rebound, output in Q3 2020 in over 90 percent of countries with

Figure 3: Global industrial production and manufacturing PMI experienced an initial rebound



Source: Haver Analytics; World Bank.
Note: PMI readings above 50 indicate expansion in economic activity; readings below 50 indicate contraction. Last observation is October 2020 for industrial production and November 2020 for PMI.

Figure 4: After stabilization of new daily COVID-19 cases, a resurgence of the virus began in Q4 2020

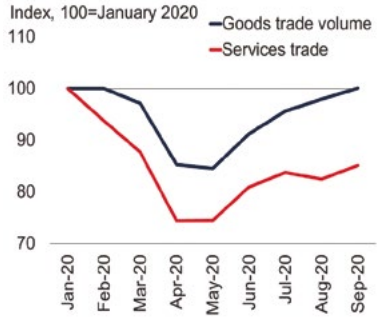


Source: Johns Hopkins University; World Bank.
Note: EMDEs = Emerging market and developing economies. Figure shows 7-day moving average of the daily new COVID-19 cases. Last observation is December 6, 2020. Sample consists of 212 economies, including 145 EMDEs.

available data remained below Q4 2019 levels. The resurgence of COVID-19 has interrupted the nascent recovery, with the number of confirmed cases soaring to more than 65 million globally and the daily pace accelerating at a rate of nearly 600,000 new cases (Figure 4). Rising infection rates have led to the reintroduction of restrictions, including nationwide lockdowns in several euro area economies.

Global goods trade continues to recover, while trade in services lags. Following a steep decline in global trade amid the collapse in demand, goods trade volumes firmed throughout the third quarter of 2020 (Figure 5). Rising new export orders, as measured by the Purchasing Managers' Index (PMI), expanded in September for the first time since 2018. Global shipping also experienced a rebound, with volumes exceeding pre-pandemic levels, as China's exports and imports picked up sharply. The pace of improvement, however, could weaken as earlier pent up demand is exhausted and business inventories are replenished.[14] Trade in services, on the other hand, remains anemic, weighed down by a continuing depression in international travel. In the third quarter, tourist arrivals were 90 percent below seasonal averages in many countries. The resurgence of the virus and associated mobility restrictions could lead to additional sharp falls in services trade going forward.

Figure 5: Global goods trade volumes improved but services trade remained depressed



Source: CPB Netherlands Bureau for Economic Policy Analysis; World Bank; World Trade Organization.
Note: Goods trade measured as the average of export and import volumes; services trade measured as the average of export and import values. Last observation is September 2020.

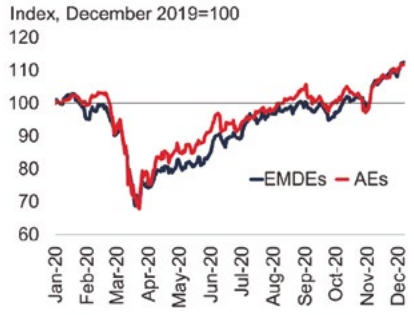
Global financing conditions improve on the back of vaccine optimism. Financial conditions eased considerably in the second quarter on the back of unprecedented monetary and fiscal policy responses in major economies. Global equities continued to recover following news of the effectiveness of several COVID-19 vaccine candidates in preliminary trials (Figure 6). Corporate and sovereign credit spreads remain at historically low levels, but credit standards have tightened significantly. Still, exceptionally low borrowing costs pushed the volume of negative-yielding debt to a record high in late November. While the pace of U.S. corporate debt issuance slowed in the fourth quarter of 2020, year-to-date issuance exceeds that of 2019 by almost 50 percent. The ability of firms to raise new debt, alongside government support and loan forbearance, is helping to keep the pace of credit defaults and downgrades below that of the global financial crisis.

EMDE financing conditions deteriorate amid acceleration in COVID-19 cases. After improvement throughout the third quarter of 2020, portfolio flows to EMDEs decelerated starting in late September, with risk appetite for EMDE debt and equities remaining fragile. Positive news regarding the COVID-19 vaccine, however, helped to erase some of the earlier losses. Nonetheless, portfolio flows remain below pre-pandemic levels for many economies. Similarly, EMDE bond spreads also widened, reflecting concerns over the resurgence of COVID-19 as well as rising financial pressures and geopolitical risks in some large EMDEs. EMDEs with large debt burdens or financing needs are particularly vulnerable to a sharp increase in borrowing cost or more limited access to financing.[15] Foreign direct investment flows to EMDEs are projected to fall by nearly 32 percent in 2020 amid stalling investment and lower corporate profits, which likely reduced reinvested earnings.[16] Additionally, remittance are projected to fall by 14 percent by 2021 relative to pre-pandemic levels in 2019, with Europe and Central Asia anticipated to face the steepest decline as the region grapples with job losses in host economies, such as in the euro area, and as the slide in oil prices dents outflows from Russia (Figure 7).[17]

Activity in the euro area, Russia's largest trading partner, is set to stall amid resurgence of COVID-19. The euro area experienced an initial rebound in economic activity in the third quarter of 2020, following a period of limited COVID-19 spread and helped by unprecedented policy support after policymakers agreed to a landmark European Union–wide recovery fund. COVID-19 cases, however, have risen sharply across the region in the fourth quarter. In

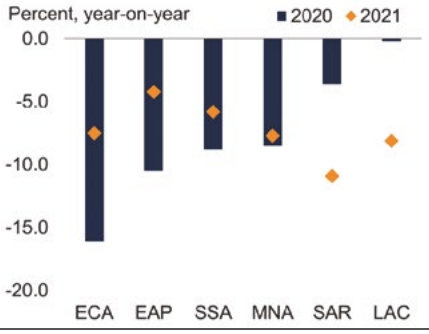
[14] World Trade Organization. 2020. *Trade Statistics and Outlook,* October 2020. Geneva: World Trade Organization.
[15] Between 2007 and 2019, government debt in EMDEs increased by about 11 percentage points of GDP, on average, to 55 percent of GDP. Fiscal surpluses of more than 2 percent of GDP in 2007 had turned into deficits of 1 percent of GDP by 2019.
[16] World Bank. 2020. *Migration and Development* Brief 33, October 2020. Washington, DC: World Bank.
[17] World Bank. 2020. *Migration and Development* Brief 33, October 2020. Washington, DC: World Bank.

Figure 6: Equity markets gradually recovered from earlier lows but experienced bouts of volatility



Source: Bloomberg; World Bank.
Note: EMDEs = Emerging markets and developing economies, AEs = Advanced economies. Figure shows daily last price of MXEF Index for EMDEs and daily last price of MXWO Index for AEs. Last observation is December 7, 2020.

Figure 7: Remittances inflows to EMDE regions are projected to face steep declines, particularly in Europe and Central Asia

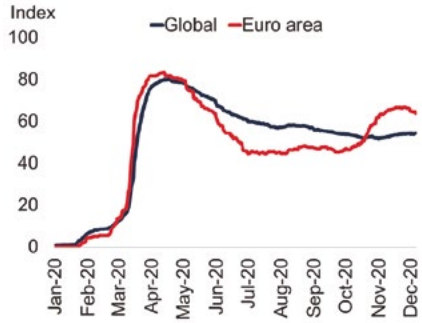


Source: World Bank.
Note: EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, SAR = South Asia, SSA = Sub-Saharan Africa. Figure shows projected year-on-year change of remittance flows to low-income and middle-income regions for 2020 and 2021.

addition to the health consequences, this is imperiling the nascent economic recovery and forcing authorities in several countries to maintain, reintroduce, or tighten pandemic control measures (Figure 8). Signs that the recovery has begun to stall are growing, with the rebound in industrial production decelerating sharply and the services PMI in falling back into contraction amid growing restrictions to mobility. Goods trade volumes were unable to recover to pre-pandemic levels prior to the resurgence of COVID-19, remaining more than 3 percent below January 2020 volumes. The acceleration in new COVID-19 cases and subsequent restrictions will likely erode sentiment in the euro area, particularly in member countries that rely heavily on tourist arrivals.

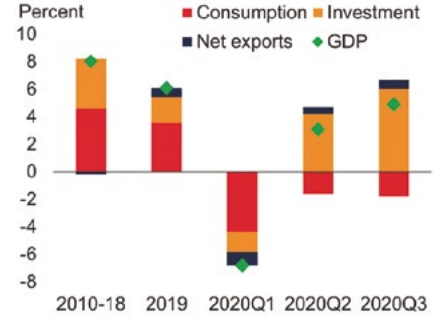
China, Russia's second-largest trading partner, is showing signs of a pick-up in economic activity. Output in China continued to expand in the third quarter of 2020, by 4.9 percent (y/y), with growth led by investment (Figure 9). Industrial production and retail sales also continued to experience a robust improvement amid a continued relaxation of lockdown measures and policy support. High-frequency indicators also point to a strengthening recovery for the service sector, with the official non-manufacturing PMI reaching its highest reading in November since June 2012. Trade flows also ticked up, with exports remaining robust and the recovery in domestic demand aiding the improvement in imports.

Figure 8: After relaxing stringency measures, the euro area was forced to re-introduce restrictions due to a surge in new COVID-19 cases



Source: Oxford University; World Bank.
Note: Figure shows the simple average stringency index for 185 economies. The stringency index refers to the average sub-indexes of nine mitigation measures: School closings, workplace closings, cancelation of public events and public transport, restriction on gatherings, stay-home requirements and restrictions to international and domestic travel and public information campaigns. The stringency index range is between 0 and 100, with 100 being the most stringent. Last observation is December 6, 2020.

Figure 9: The recovery in China has been robust, particularly investment



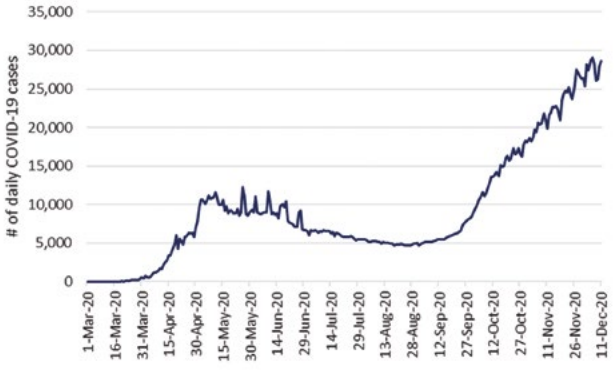
Source: World Bank.
Note: Consumption, investment, and net exports refer respectively to contribution to China real GDP change of final consumption expenditure, gross capital formation and net exports of goods and services.

1.2 Russia: Russia's GDP contracted in Q2 and Q3, with negative momentum expected to continue in Q4 amidst rising cases and re-installment of restrictions

In Q2, Russia's GDP contracted sharply, faced with domestic supply and demand, and terms of trade shocks. Yet supported by exports, GDP growth performed slightly above expectations. In the third quarter, as COVID-19 cases declined, restrictions eased and on the back of fiscal, monetary, and regulatory measures[18] economic activity showed signs of picking up, as reflected by some resumption in industrial production sectors and services. However, negative momentum is expected to continue in Q4 amidst rising COVID-19 infection rates and re-installment of some mobility restrictions. The COVID-19 pandemic weakened corporate balance sheets, especially in services sectors such as hotels, tourist agencies, railway and air passenger transportation.

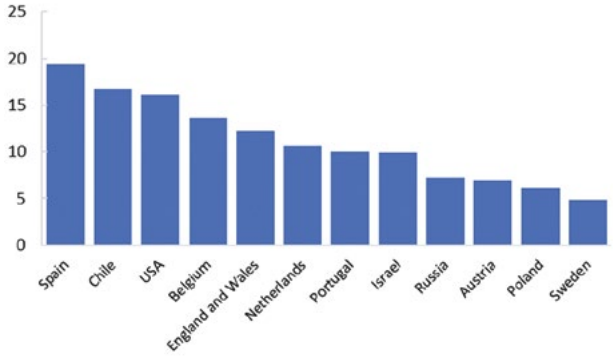
After the first wave of Covid-19 flattened in Russia in June – July, cases began to rise again in September, reaching even higher levels. Strict mobility restrictions, which were introduced in the last week of March, have been gradually removed – at a varying pace – in all the regions until July. By the beginning of September, stage 2 of re-opening had been reached in 43 regions and stage 3 in 29 regions of Russia.[19,20] Since the beginning of September, the number of new COVID-19 cases began to grow sharply, exceeding peak numbers of the first wave by the beginning of October (Figure 10). As of December 11, Russia had registered more than 2.5 million cases (45,893 deaths). In terms of the number of cases, Russia ranks fourth in the world (after the USA, India and Brazil). Different regions started to introduce their own restrictions, depending on the epidemiological situation, restricting movement of elderly people and people with chronic conditions, and promoting remote work regimes. However, strict lockdown measures were not re-introduced. Russia has registered 2 anti-COVID19 vaccines, Sputnik V and Vector ("EpiVacCorona"). Mass vaccinations (Sputnik V) started on December 7, 2020. Doctors, teachers and social workers are among the first to receive the vaccine. While excess mortality has been relatively low in Russia, compared to other countries (Figure 11), it started to increase in the second wave of the epidemic.

Figure 10: The second wave of Covid-19 hit Russia in September



Source: stopcoronavirusrf.

Figure 11: Excess mortality has been relatively low in Russia, compared to other countries



Source: Rosstat, OurWorldInData.

Supported by stronger-than-expected export dynamics, GDP growth performed slightly above expectations in the second quarter (-8 vs -9.6 percent, y/y, Figure 12). The slump in domestic demand weighed down on GDP growth in the second quarter of 2020. Russian household consumption dropped by 22.2 percent, y/y, as the economy was hit by both supply and demand shocks, and real incomes declined by 8 percent, y/y (Figure 12). This was an unprecedented contraction, not registered in any previous crisis. While this reading is lower than the contraction of

[18] Please see "Recession and Growth under the Shadow of a Pandemic", Russian Economic Report #43, World Bank, 2020, for details.

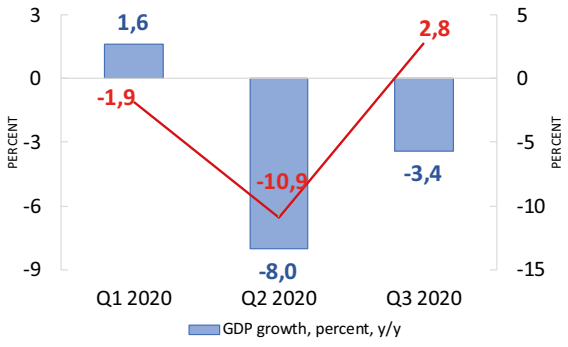
[19] Residents are allowed to move freely, schools, large shops (up to 800 m2) and service-sector businesses can open as well as some education facilities.

[20] In the third stage, parks, hotels, restaurants, and all shops are to reopen. The reopening is conditional on safety guidelines for all three stages, including social distancing and disinfection.

average household consumption in the EU (-15.2 percent, y/y), it is at par with some EU countries which introduced strict lockdown measures such as Spain (-24 percent, y/y) and Italy (- 17.4 percent, y/y). Russia's gross fixed capital formation dropped to a lesser extent (-11.7 percent, y/y), supported by fewer restrictions on construction works during the lockdown as compared to other sectors of the economy. In the EU, gross fixed capital formation dropped by 19 percent, y/y, with the hardest hit countries registering up to a 70 percent decline (Ireland). Russia's export dynamics were unexpectedly strong (+0.3 percent, y/y), which could be attributed to higher demand for oil and oil products from China, which has seen a relatively early pick-up in economic activity, and base effect (the Druzhba pipeline contamination resulted in an oil export decline in Q2 2019). Strong food production exports volume growth supported exports as well (Figure 13). Net exports contributed a solid 4.8 pp to GDP growth in Q2 2020, as imports shrank in line with negative GDP dynamics, REER depreciation, and obstacles to trade.

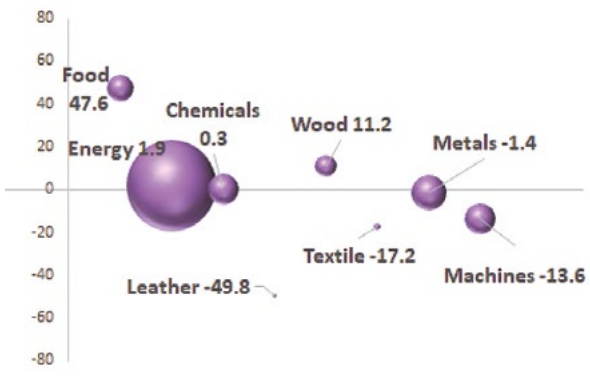
From the supply side, GDP growth was supported by positive contributions from the financial sector, state management and agriculture (Figure 14). In Q2 2020, Russia performed better than many countries (AEs and EMDEs) which registered 2-digit contraction: Germany, Portugal, Italy, Austria, Belgium, France, UK, Spain, Hungary and Mexico.

Figure 12: In Q2, faced with domestic supply and demand, and terms of trade shocks, Russia's GDP dropped by 8 percent, y/y.



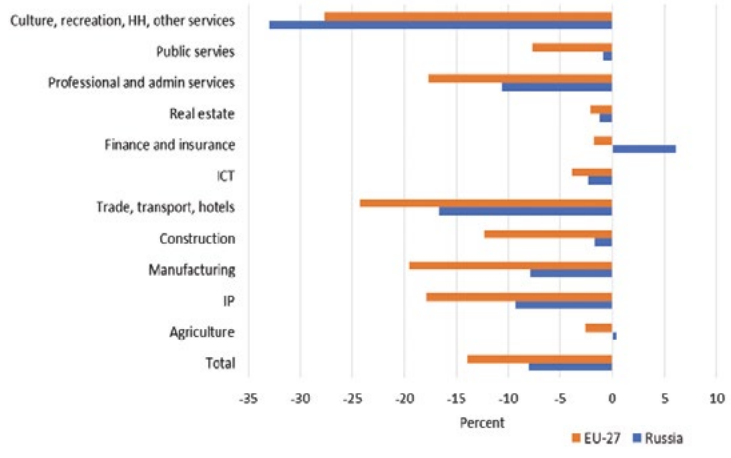
Source: Rosstat, CMASF.

Figure 13: Energy exports registered growth partly due to rebound in China and base effect, Export volume growth by category, y/y, percent.



Source: Russian Customs.

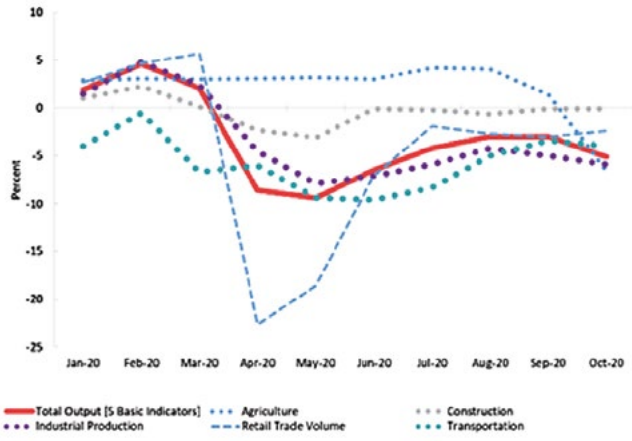
Figure 14: Compared to the EU-27, both industrial sectors and services sectors in Russia were more resilient to the shocks induced by the COVID-19 pandemic



Source: Rosstat, EU statistics.

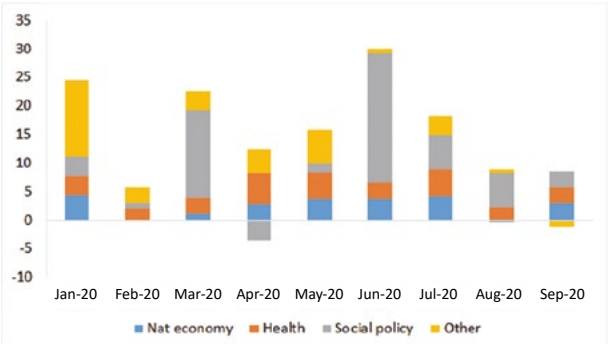
In the third quarter of 2020, economic activity somewhat resumed as COVID-19 cases declined, restrictions eased, and government support measures (fiscal, monetary, and regulatory) positively affected incomes and firms' solvency (Figure 16). The resumption of economic activity in industrial production was rather gradual, with OPEC+ agreement weighing on the oil sector dynamics. (Figure 15). Economic activity in services saw a more robust pick-up after a deeper contraction. Mobility restrictions have resulted in a deeper supply shock for services, so easing restrictions resulted in a more rapid resumption. PMI indexes pointed to a more robust resumption of economic activity in Russia's services than in other countries, with the services PMI reaching 53.7 in September 2020, while globally PMI totaled 52 (Figure 17). Q3 GDP growth posted –3.4 percent, y/y (+2.8 q/q, saar).

Figure 15: Negative momentum is expected in Q4



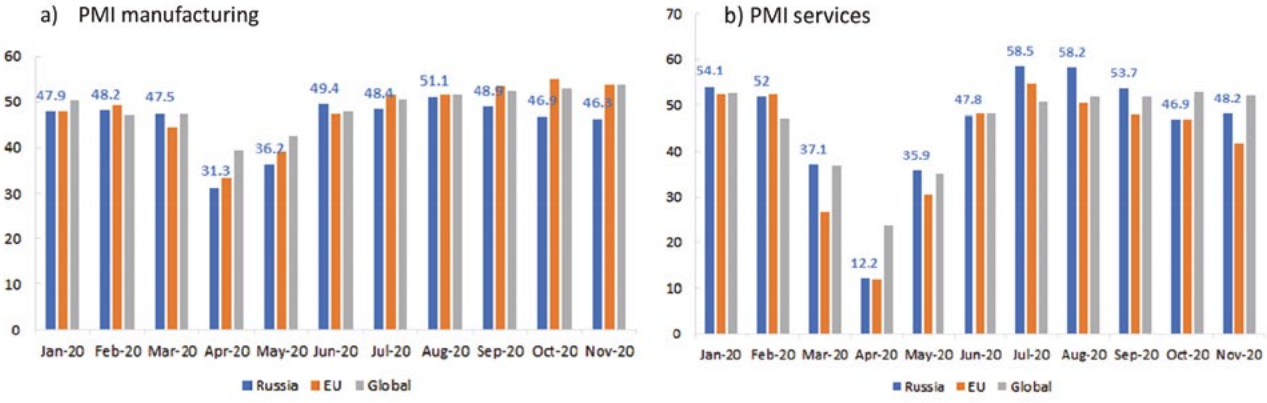
Source: Rosstat.

Figure 16. An increase in general government spending was concentrated in health, social policy and support to economy categories (contribution to an increase in gg spending, y/y, pp)



Source: Haver.

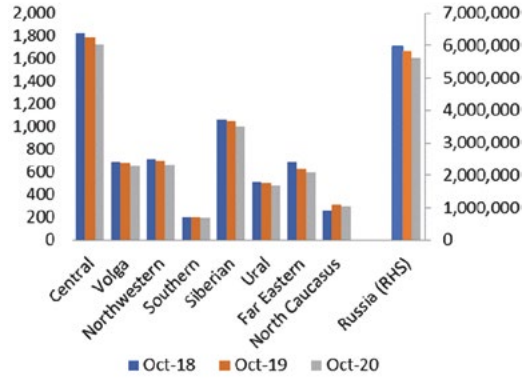
Figure 17: PMI indexes point to more robust resumption of economic activity in Russia's services than in other countries:



Source: IHS Markit.

Meanwhile, in October, economic activity lost momentum amidst growing number of new COVID-19 cases and re-installment of some restrictions. In October, output in five basic sectors registered -5.1 percent, y/y, compared to –3 percent, y/y, in September. Industrial production dropped by 5.9 percent, y/y, and remained flat m/m, with a weaker performance in manufacturing. In October, retail trade performance strengthened, but market services performance remained weak. The economic downturn and the ruble depreciation weakened corporate balance sheets. In January – September, profits of large and medium enterprises dropped by about 40 percent compared to the previous year, with the sectors most exposed to the pandemic recording losses (hotels, tourist agencies, railway and air passenger transportation). Initial data indicates that in the first half of 2020 the number of SMEs has decreased by 4.2 percent, y/y, however the real effect of the pandemic on the number of SMEs will only become clear in 2021 (Figure 18).

Figure 18: The number of SMEs fell by 4.2 percent between October 2018 – 2020



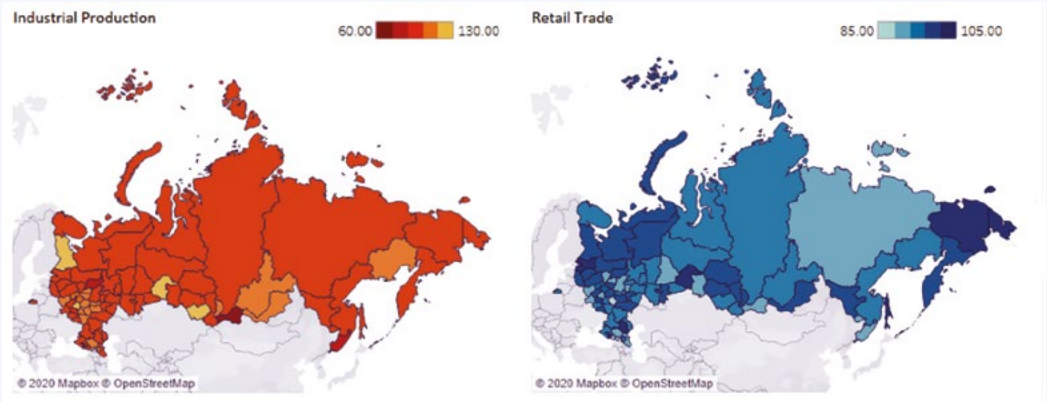
Source: Russia Unified Register of SMEs.
Note: Data refers to the 10th of the respective month.

Box 1 The Covid-19 crisis has affected regions through external and internal demand channels to varying extents based on exposure to the pandemic, pre-existing conditions and the type of activity

Overall, retail trade turnover fell by 4.8 percent, y/y, in the first three quarters of 2020, anticipating a decline in household consumption. In January-September 2020, retail trade growth was only recorded in six regions (Tomsk Oblast, Leningrad Oblast, Tver Oblast, Chukotka Autonomous Okrug, Ryazan Oblast and Sakhalin Oblast), all of which however saw retail trade decline in the second quarter, with the exception of Chukotka Autonomous Okrug – which is remote and has been relatively unaffected by the pandemic.

The dynamics of industrial production in Russia has been negatively affected by the contraction of external and internal demand; industrial production in the regions with high share of mineral resource extraction suffered the most. In the first three quarters of 2020, only 34 regions (vs 72 in the same period of 2019) saw growth in industrial production (Figure B-1). Overall, economic activity remained flat in the manufacturing sector, while declining strongly, by 6.5 percent, y/y, for the

Figure B-1-1: In January-September 2020, industrial production and retail sales in regions indicate varying performances



Source: Rosstat.

extractive industry. The largest declines in industrial production were in the Republic of Tyva (-48.5 percent), accounted for largely by the mining sector, and in the Kostroma region (-15.1 percent), in part due to lower electricity production. At the same time, almost all North Caucasian regions showed positive dynamics of production, mainly due to the important role of the food industry, which was less affected by quarantine restrictions.

Overall, investments decreased by 4.1 percent in real terms in Russia in the first 9 months of the year, with wide regional variations. Investments declined most sharply in the Volga District (-6.6 percent, y/y) and in the Far East (-6.5 percent, y/y), but rose in oil and gas producing regions, notably the Tyumen region (+8.1 percent) and in federal cities (Moscow +11.5 percent, St. Petersburg +5.5 percent).

Figure B1-2: Retail turnover fell most in the North Caucasus (percent)

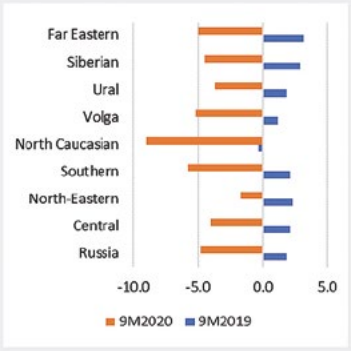


Figure B1-3: Industrial production declined most in the Far East (percent)

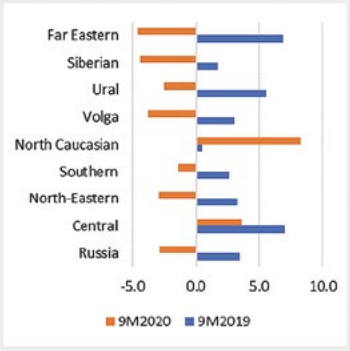
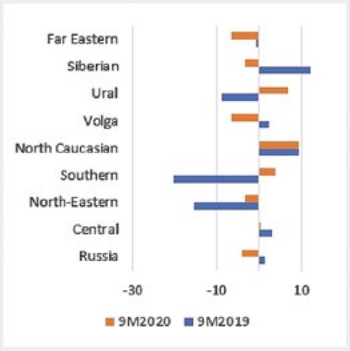


Figure B1-4: Investment rose in Urals and Southern district (percent)



Source: Rosstat.

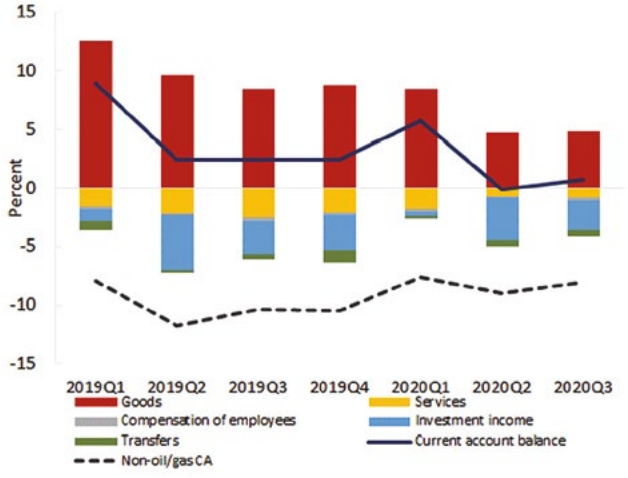
1.3 Balance of payments: Pressures from lower energy export receipts, financial markets volatility and increased geopolitical risks resulted in capital outflow and ruble depreciation

Since March, Russia has been facing a sizable negative terms of trade shock, absorbed through the ruble depreciation and import adjustment. Non-energy exports were quite resilient to the pandemic shocks supported by exports of gold and agricultural products. While the ruble depreciation and drop in real incomes weighed on import dynamics, imports suffered also from COVID-19 mitigation measures restricting tourism. Macro-fiscal stabilization policies and accumulated buffers are helping Russia manage the crisis. Elevated uncertainty, low oil prices, and increased geopolitical risks resulted in higher net capital outflows and adjunctive pressure for ruble depreciation.

With global demand hit by the COVID-19 pandemic and mitigation measures complicating trade logistics, the current account balance weakened in the second and third quarters of 2020. In April-June 2020, the current account balance turned negative and registered -0.2 percent of GDP, compared to 2.4 percent of GDP in the same period last year (Figure 19). In July-September, the balance returned to positive territory (0.7 percent of GDP), yet it was smaller than in the same period last year (2.4 percent of GDP).

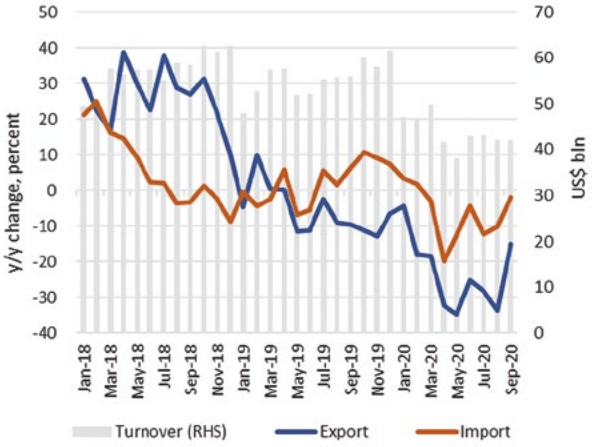
The global spread of COVID-19 and containment measures took a heavy toll on Russia's merchandise exports as well as services exports. Goods exports value dropped by 32 and 26.4 percent, y/y, in the second and third quarters of 2020, respectively, mainly due to declining energy exports (Figure 20). Service exports declined the most in the second quarter, recovering somewhat in the third quarter of 2020 (Figure 20); transport and travel services exports were hit the hardest with restrictions on travel and lower global demand, (the two sectors had contributed over half of services export revenues in 2019).

Figure 19: The current account declined sharply, mostly due to lower goods exports



Source: CBR.

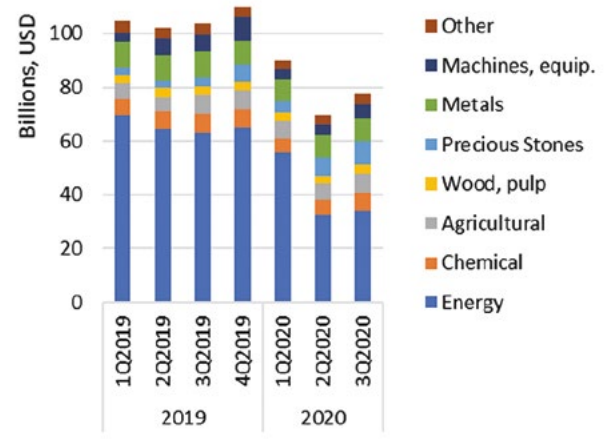
Figure 20: Merchandise exports and imports value fell sharply in 2Q 2020 and 3Q 2020, y/y



Source: Russian Customs.

Imports of goods and services fell sharply in the second and third quarter of 2020, due to the weakening of the ruble, domestic demand contraction and Covid-19 mitigation measures. Imports of goods declined by 12.9 percent, y/y, in 2020Q2 (Figure 22) and slightly less, by 8.4 percent, y/y, in 2020Q3, as economic activity picked up. In April-June, tourism imports values dropped by about 90 percent, y/y -- the largest drop among the imported services items. Despite the lifting of restrictions on travel introduced in August (trips to Turkey, Maldives, and the UAE were allowed), travel abroad remained 90 percent below the level last year, the same as in the second quarter of 2020. This was due to the drop in incomes, ruble depreciation, social distancing requirements and elevated uncertainty.

Figure 21: Goods exports values remained below 2019 levels in the first three quarters of 2020



Source: Russian Customs.

Figure 22: Travel and transport services exports dropped sharply in Q2 and Q32020



Source: Russian Customs.

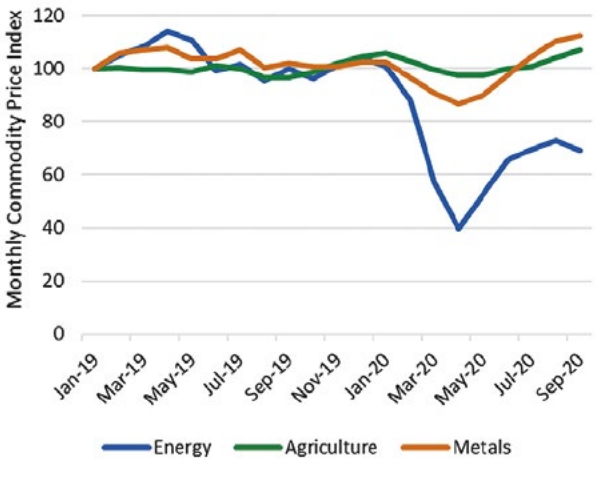
The slump in energy exports value was defined by the price effect in Q2; in Q3, crude oil prices somewhat rebounded, but energy exports volume dropped in line with the OPEC+ agreement. In the second quarter of 2020, crude oil prices fell by 54 percent, y/y as global demand for oil consumption decreased on the back of the pandemic. Meanwhile, energy goods export volume grew by 1.9 percent, y/y, as oil production restrictions came into force only in May and lower prices provided for higher volume of oil products exports (Figure 23). In Q2, the pick-up in economic activity and pent up demand in China supported crude oil export volume, as refineries took advantage of low prices, filling oil storages. Overall, energy exports value dropped by 50.8 percent, y/y, in Q2. In the third quarter of 2020, while crude oil prices somewhat rebounded on the back of the OPEC+ deal, energy goods export volumes dropped in annual terms (Figure 24), and, as a result, energy goods export values dropped by 50 percent, y/y, about the same as in the second quarter. China's crude oil imports in October had fallen to the lowest volumes since April, as independent refiners have largely filled their import quotas for 2020, implying that imports may also remain low in the fourth quarter.

Supported by agricultural products and precious metals, non-energy goods exports appeared to be relatively resilient to the pandemic shock. Non-energy export value remained relatively resilient in Q2 and Q3 (-6 percent and +0.4 percent, y/y, respectively). Non-energy exports were supported by precious metals, notably gold, and agricultural products (Figure 23), as well as in line with a rebound in prices for metals in the third quarter of 2020.

Russia's goods exports value to the EU dropped the most, while exports to China declined relatively modestly (by 14.3 percent) in January-September 2020. Exports value to the EU, Russia's largest trade partner, declined sharply, by 29.2 percent, y/y, recovering somewhat in 3Q2020 (Figure 25). Mineral exports to China declined, y/y, from February to May, and again from June to August, while exports in wood, metals, and agricultural goods have shown some signs of recovery since May. Russia's exports to China have gradually increased over the past decade, notably on the back of increasing shares of energy exports in the mix (see Box 2). As the EU is still the largest consumer of Russian energy exports, declines in mineral exports have driven the dive in exports to the EU. Imports have also dropped most sharply in the second quarter, declining by less, y/y, in the third quarter; imports from China experienced positive growth in the second and third quarter (Figure 26).

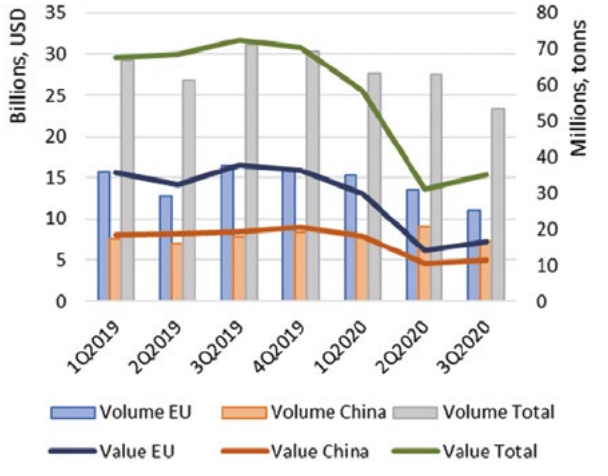
Elevated uncertainty, low oil prices, and increased geopolitical risks resulted in higher net capital outflows in the second and third quarters of 2020. The increase in net capital outflows was entirely due to the non-banking sector. In the second quarter, net portfolio outflows and higher trade credits drove net capital outflows in the non-banking

Figure 23: Commodity prices picked up in the third quarter of 2020



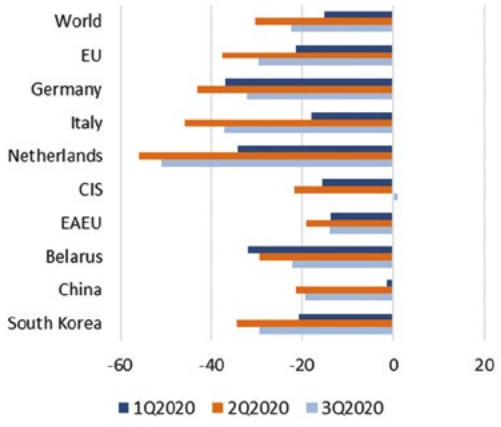
Source: WB Commodity Outlook.

Figure 24: Oil exports volumes to China rose in 2Q2020, y/y, but fell again further in 3Q 2020



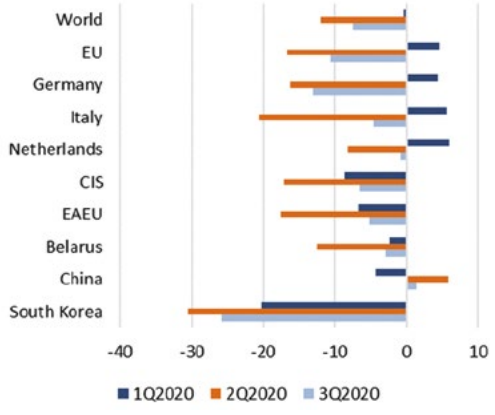
Source: Russian Customs.

Figure 25: Exports to the EU fell sharply, trade with China showed a more moderate decline amidst an earlier recovery (y/y, percent change)



Source: Russian Customs.

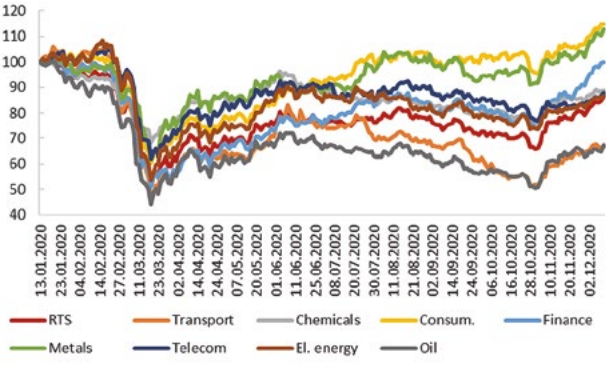
Figure 26: Imports declined most sharply in 2Q2020, with some recovery in 3Q 2020 (y/y, percent change)



Source: Russian Customs.

sector. In the third quarter, lower incoming FDI and a decrease in liabilities resulted in higher capital outflows. While nearly all developing countries, for instance, China (-17 percent), India (-36 percent), and Indonesia (-39 percent)[21], experienced a sharp drop in FDI inflows during the first half of 2020, in Russia FDI dropped by about 80 percent in January – September 2020. The global lockdown measures affected the implementation of existing investment projects. Lower corporate profits and the ruble depreciation reduced reinvested earnings. While EMDEs in general experienced recovery of net portfolio inflows in the third quarter, for Russia net portfolio outflow continued on the back of rising geopolitical risk and increasing numbers of new COVID-19 cases. Unlike in advanced economies, the RTS index did not recover to its pre pandemic values (Figure 27), and the share of non-residents in government bonds dropped from 35 percent in February to 26.8 percent in September.

Figure 27: RTS index did not restore to the pre-pandemic values (Jan 13, 2020 = 100)



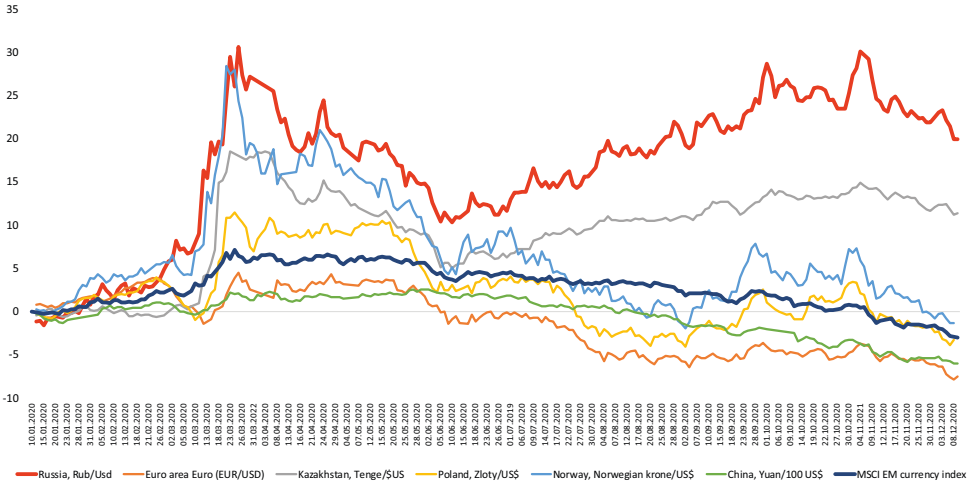
Source: MICEX.

International reserves decreased by US$7.6 billion due to the operations of the Central Bank, reaching US$585.8 billion as of October 1, 2020. The Central Bank adhered to the flexible exchange rate regime, conducting currency sales in the fiscal rule framework. In addition, it conducted sales of foreign currency in the Sberbank deal under the new facility.

After strengthening at the end of the second quarter of 2020 with stabilizing oil prices, the ruble depreciated in the third quarter. Pressure on the ruble increased in the third quarter of 2020, as a weaker current account balance, higher capital outflows were coupled with elevated geopolitical risks (Figure 28). In October, with new Covid-19 cases rising, the ruble reached the levels of financial turmoil in March. It underperformed most of the EMDE currencies and the currencies of commodity-exporting advanced economies. Day-to-day currency volatility has grown. In the period from October – November, the ruble appreciated by 4.5 percent, as geopolitical risks decreased, and the US dollar depreciated to other currencies with increasing investors' appetite for riskier assets. While Russia's exposure to the foreign currencies somewhat decreased, compared to 2013 (see Box 2), the depreciating ruble has increased balance-sheet vulnerabilities for firms with external debt in foreign currency reaching 22 percent of GDP (July 1, 2020).

[21] Phase II: COVID-19 Crisis through a Migration Lens, World Bank, 2020.

Figure 28: Increased capital outflow amidst financial volatility and geopolitical risks put pressure on the ruble exchange rate



Source: MICEX.

Macro-fiscal stabilization policies and accumulated buffers are helping Russia manage the crisis. Since 2014, a floating ruble has acted as a shock-absorber to external disruptions, yet the high share of energy exports makes the ruble vulnerable to oil price volatility. The well designed and implemented fiscal rule has helped to reduce this vulnerability by facilitating gradual macroeconomic adjustment, including the exchange rate adjustment to the benchmark price of 40 USD per barrel (stipulated in the fiscal rule, 2017 prices), as well as by lowering the breakeven price for the budget. As a result, the adjustment to lower oil prices in 2020 could have been much more severe without the fiscal rule. In addition, the CBR currency sales under the fiscal rule framework (US$14 billion) and Sberbank deal (US$4.3 billion) supported the ruble in 2020. Meanwhile, the ruble remains vulnerable to an oil price drop below the price specified in the fiscal rule and, consequently, sizable accumulated macro-fiscal buffers play an important role in reducing external volatility as well. As of December 1, 2020, Russia's sovereign wealth fund – the NWF – reached a robust US$177 billion (13.1 percent of GDP), while its liquid part reached 9 percent of GDP. International reserves stood at a comfortable US$583 billion (23 months of imports). Russia's external debt, at about 33 percent of GDP, favorably compares to the 60 percent EMDE average. And public debt is at 14 percent of GDP compared to 62 percent EMDE average. The track record of the CBR as an independent regulator capable of conducting prudent monetary policy and deepening financial stability have bolstered investor confidence.

Table 1: Balance of payments accounts, US$ bln

	2017	2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	2019	Q1 2020e	Q2 2020e	Q3 2020e
Current Account Balance	**32.4**	**113.7**	33.6	10	10.9	10.2	64.6	22.1	-0.5	2.5
Trade Balance	**83.5**	**164.4**	41	30.5	26.5	30.2	128.1	32.4	15.3	17.0
Non-oil Current Account Balance	**-161**	**-148.1**	-29.7	-48.1	-46.4	-49	-173.3	-29.0	-29.1	-28.2
Capital and Financial Account	**-12**	**-77.9**	-12.3	5.1	7.2	4.6	4.6	17.3	13.6	3.1
Errors and Omissions	**2.6**	**3.4**	-2.6	1.7	-2	1	-2	0.2	1.6	-1.5
Change in Reserves (- = increase)	**-22.6**	**-38.2**	-18.6	-16.6	-15.9	-15.4	-66.5	-5.2	12.9	2.3

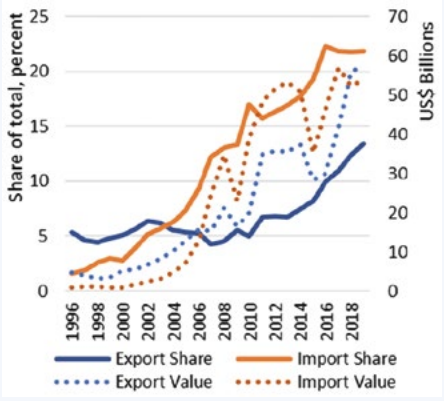
Source: CBR, WB staff calculations.

Box 2 China's share in Russia's trade turnover continues to rise, especially in oil, as the Covid-19 crisis reinforces pre-existing trends

China has become increasingly important for Russia's trade and is the largest single trade partner, not counting country groupings, notably the EU. Russia's trade with China surpassed trade levels with Germany in 2010, albeit remaining below trade levels with the EU as a whole, which still accounts for about double the China trade value. China has become increasingly important for Russia, accounting for 13.4 percent of Russia's exports and 21.9 percent of its imports in 2019 (Figure B2-1). However, in contrast, Russia accounts for a much smaller share of China's trade (2 percent of exports and 2.9 percent of imports in 2019). In the past decade, exports to the EU have begun to follow a declining trend, while exports to China and, to a lesser extent, the rest of APEC show a rising trend (Figure B2-2).

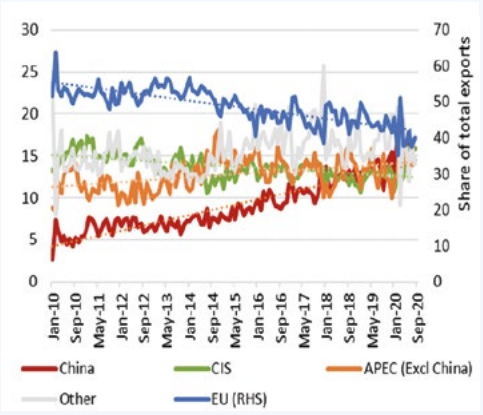
The main driver of export growth was energy, notably crude oil, while Russia increasingly imported machinery and equipment from China. Figure B2-3 illustrates the drastic increase in the share of mineral exports, notably crude oil, in Russia's exports to China over the past two decades; the export share of agricultural goods has also gradually increased. These trends are driven by geopolitical tensions, notably Western sanctions and the U.S.-China trade disputes, the ruble depreciation helped to expand export to China as well. In Q2-Q3 2020, this has been accelerated as China has recovered from the consequences of the Covid-19 pandemic faster than other trade partners. In January-September 2020, China's share in Russian trade turnover reached an all-time high of 18.4 percent, compared to 16.4 percent in the same period last year, despite the decline in oil prices. In addition, since the beginning of the year, Russian companies have announced rising shares of investments in rail and pipeline connections to China.* So far, Russia expanded exports to China mainly through crude oil, yet Russia's potential amount of non-oil and gas exports to China is more than double then actual trade flows**. This suggests that Russia has a large untapped export potential in China's economy, not only in oil and gas products but also in other industries.

Figure B2-1: The share of trade between China and Russia has sharply risen in the past decade



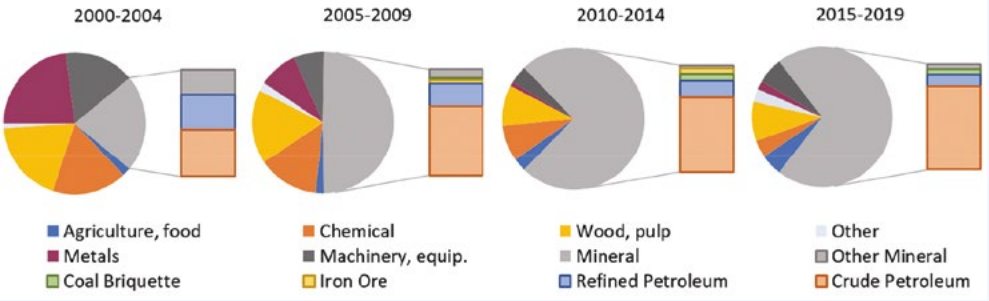
Source: Comtrade, Haver Analytics, Russian Customs, WB staff calculations.

Figure B2-2: As China's share in Russia's exports increases, the share of exports to the EU follows a declining trend



Source: Comtrade, Haver Analytics, Russian Customs, WB staff calculations.

Figure B2-3: The share of mineral, especially crude oil, exports to China has starkly risen in the past two decades.



Source: Comtrade, Russian Customs, WB staff calculations.

* Gabuev, A., Umarov, T., (2020) "Will the Pandemic Increase Russia's Economic Dependence on China?" Published July 8, 2020, Carnegie Moscow Center, [https://carnegie.ru/2020/07/08/will-pandemic-increase-russia-s-economic-dependence-on-china-pub-81893].

** Russia Integrates: Deepening the country's integration in the global economy, World Bank, 2020.

Box 3 The US dollar share in Russia's exports is declining, notably in trade with China and India

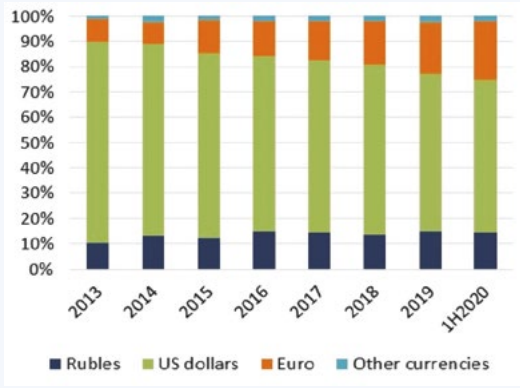
In the period of 2013-2019, the dollar share in Russia's exports settlements has gradually declined, reaching 62 percent in 2019, compared with almost 80 percent in 2013 (Figure B3-1). In terms of exports, most settlements are still denominated in US dollars, as Russia's goods export basket is dominated by hydrocarbons, which are quoted in dollar terms on the world market. In the first half of 2020, the share of US dollars in payments for exports of goods and services declined further to 60.2 percent (from 62 percent in 1H2019), while its share in payments for imports decreased from 35.4 to 35.1 percent. The share of the Russian ruble in exports stood at 14.4 percent, matching levels in the same period of 2019, while its share in payments for imports decreased from 30.9 to 29 percent.

The share of US dollars in Russia's exports has declined the most for exports to India and China, largely driven by bilateral agreements (Figure B3-2). The ruble component in trade with India has grown most strongly in 2018-2019, rising from 38 percent to 76.3 percent; it roughly corresponds to the level of settlements between Russia and Kazakhstan and Belarus. This is in large part associated with a bilateral agreement to settle trade, notably in arms, in national currencies. The share of US dollars in the China-Russia trade decreased to less than 50 percent overall; for exports, it declined from 75.1 percent in 2018 to 38.7 percent in 2019. Russia and China agreed to settle all trade in national currencies instead of US dollars in mid-2019. In October 2019, Russia concluded a similar agreement with Turkey. Companies such as Rosneft and Gazprom have initiated pilot projects for the sale of raw materials in yuan, while Rosneft and Novatek reported they had increased the amount of export contracts settled in euros.

The share of dollar-denominated assets is also decreasing in the reserves of the CBR: over the period from April 2018 to April 2019, the share of US dollar-denominated assets almost halved, falling from 43.7 percent to 23.6 percent. In turn, it noted an increase in the share of the euro from 22.2 percent to 30.3 percent, in the share of gold from 17.2 percent to 18.2 percent, and in the share of the yuan from 5 percent to 14.2 percent.

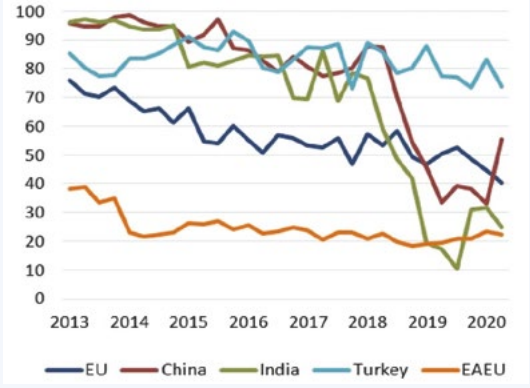
The Russian government has established the goal of boosting the share of the ruble from 20.7 percent in 2019 to 30 percent in external trade settlements by 2024. The growth of the ruble share in the external trade settlements could raise the response of non-energy export volumes to currency depreciation in the short term.* Yet, increased volatility of the ruble amidst elevated uncertainty makes this goal hardly attainable (Figure B3-3 and Figure B3-4).

Figure B3-1: The share of US dollars in payments of exports is declining



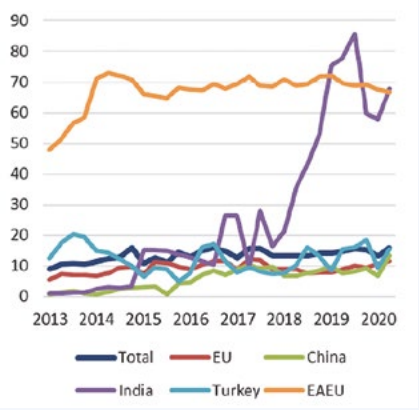
Source: CBR, Russian Customs.

Figure B3-2: US dollar shares in exports have dropped most steeply to India and China



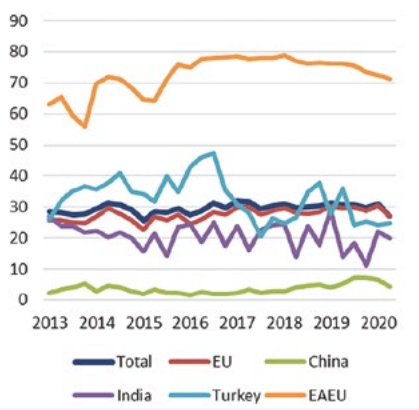
Source: CBR, Russian Customs.

Figure B3-3: The Ruble share in exports has risen for exports to India, but not for other destinations



Source: CBR

Figure B3-4: The Ruble share of imports is highest from trade with the EAEU



Source: CBR

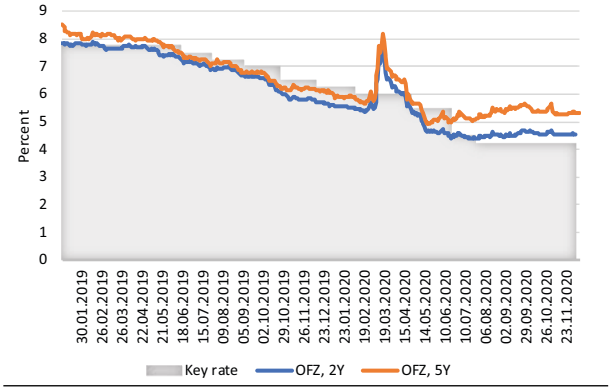
* Dominant Currencies and External Adjustment, IMF, 2020.

1.4 Monetary Policy: The CBR paused its accommodative policy actions

The CBR's monetary policy remained consistent with the inflation-targeting framework. On the back of the increased short-term pro-inflationary factors, the CBR paused its accommodative policy actions, keeping the key policy rate at a record low of 4.25 percent. Monetary policy maintains short-term interest rates close to the key rate. While disinflationary risks prevail, the effect of short-term pro-inflationary factors has increased. Annual consumer price index (CPI) inflation reached 4.4 percent in November. Household inflation expectations and corporate price expectations increased compared to pre-pandemic times.

After significant monetary easing through September, the CBR paused its accommodative policy actions. Given the prevailing disinflationary factors brought about by the pandemic (including because of mobility-restricting containment measures and sluggish economic activity), the CBR lowered its key rate by a cumulative 175 basis points (bps) to a record low of 4.25 percent in order to support the economy and stimulate domestic demand (Figure 29). However, in September, the pro-inflationary impact of the weakening ruble began to increase and the CBR paused its accommodative policy actions, leaving the key policy rate unchanged at the September and October meetings. The monetary policy maintains the short-term interest rates (overnight deposit rate) close to the key rate.

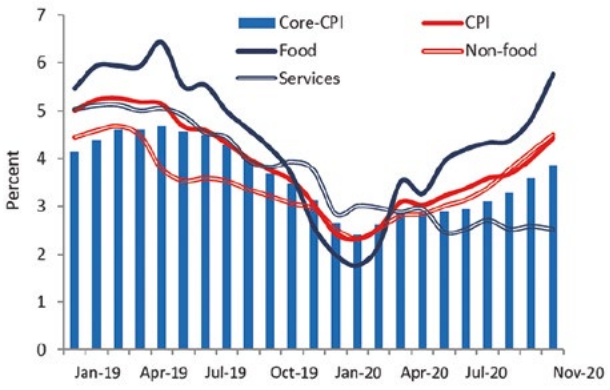
Figure 29: The CBR paused its accommodative policy actions



Source: Bank of Russia.

The CBR's monetary policy together with a more stable situation in external commodity and financial markets contributed to easier domestic monetary conditions. Lending and deposit rates decreased and longer-term federal loan bonds (OFZ) yields declined amid a stabilization of financial and commodity markets. Apart from the key rate reduction, interest rates and lending dynamics were substantially influenced by the subsidized lending and partial credit guaranty programs for SMEs and affected industries implemented by the Government and the CBR, as well as by regulatory relaxations.

Figure 30: In October, the annual headline CPI inflation reached the CBR's target of 4 percent



Source: Haver Analytics.

To ensure that markets continue to operate smoothly, the CBR introduced additional policy tools. Although the banking sector is in structural liquidity surplus[22] as a whole, it is unevenly distributed among banks, in part because of the operation of budgetary policy due to an active borrowing of the MoF in the domestic market. The largest banks accounts for the main part of the inflow of budgetary funds. This has led to some market volatility. In order to reduce this volatility, the CBR in advance, at the end of May, launched one-month and one-year repo auctions to provide ruble liquidity to credit institutions. Longer-term refinancing with the CBR creates additional incentives for banks to restructure existing loans and extend new long-term loans. In May-September, the demand for these auctions was low, but it increased in October on the back of an active OFZs placements on the market to finance future budget expenditures, leading to an outflow of liquidity from the banking sector. Large transfers to the budget happened in October due to the payment of quarterly taxes by bank clients. Overall, in October – December, the banks attracted more than Rub 2.6 trillion. Yet, structural liquidity surplus is expected to hold.

Disinflationary risks prevail, though the effect of short-term pro-inflationary factors has increased. In November, the annual headline consumer price index (CPI) inflation reached 4.4 percent, exceeding the CBR's target of 4 percent and the upper bound of the its forecast interval for inflation, which is 3.9 – 4.2 percent. (Figure 30). The acceleration of food and non-food inflation contributed the most to the growth of the headline CPI, driven mainly by the weak ruble. Meanwhile, inflation in services slightly decreased, restraining CPI growth. In turn, core CPI, which excludes food and gasoline, increased by 3.9 percent. The annual inflation rate in Russian regions ranged from 2.1 to 5.9 percent, accelerating in most regions. CPI dynamics is influenced by multidirectional factors. Some are disinflationary, like the slower recovery of domestic demand compared to the summer months and the complications arising from the pandemic. Others are pro-inflationary, like the weakening of the ruble on the back of increased volatility in global markets, higher geopolitical risks, negative oil-price dynamics and capital outflows due to the COVID-19 outbreak. The impact of the weakening ruble on inflation will continue in the coming months.

Overall, since the beginning of the year, the ruble's nominal exchange rate depreciated by 20 percent with respect to the US dollar. The CBR continued its sales of the foreign currency (FX) reserves from the National Welfare Fund (NWF) under the fiscal rule framework. In March-November 2020, the average price for Urals oil was US$36.3 per barrel (the cut-off price in the budget rule is US$42.2). Overall, under the fiscal rule framework, the CBR sold US$14 billion from March to the beginning of December. In addition, since October 1 the CBR conducted additional operations to sell the FX in the domestic market. These additional operations are the result of offsetting the FX sales related to the Sberbank[23] and Aeroflot[24] deals, the pre-emptive sales of the FX reserves under the fiscal rule

[22] Structural liquidity deficit/surplus is calculated as a difference between the CBR aggregated claims on the banking sector and the CBR aggregated liabilities to the banking sector. The banking sector structural liquidity deficit is the state of the banking sector which implies the existence of bank's permanent need of raising funds with the CBR operations; in case of structural liquidity surplus - permanent need of allocating funds through the CBR operations (https://www.cbr.ru/eng/hd_base/bliquidity/).

[23] In April, the CBR sold its controlling stake in Sberbank. The MoF purchased 50 percent stake using the NWF in one move. The total amount of the deal is Rub 2.1 trillion (US$28 billion).

[24] In October, in order to improve its liquidity position, Aeroflot, Russia's largest airline group, placed newly issued ordinary shares in the amount of Rub 80 billion. The MoF, using funds allocated from the NWF, acquired shares in Aeroflot, totaling Rub 50 billion (US$ 0.6 billion). Therefore, the government owns 57.3 percent in the share capital of the Aeroflot.

framework in March-April, and the FX purchases suspended in 2018 and in March-April 2020. The FX in the amount of Rub 235.4 billion will be gradually sold in the domestic FX market in October - December. These measures will have a stabilizing effect on the ruble exchange rate.

Inflation expectations increased on the back of the weaker ruble and heightened uncertainty. Responding to higher volatility in commodity and financial markets, increased geopolitical risks and the depreciation of the ruble, both household inflation expectations for the twelve months ahead and corporate-sector price expectations for the next three months[25] significantly increased, compared to pre-pandemic times. In November, household inflation expectations increased to 10.1 percent compared to 8.3 percent in March. Corporate-sector price expectations increased to 20.5 percent from 18.1 percent.

Given high levels of uncertainty, the CBR communicated that it stands ready to further ease monetary policy, and to keep accommodative monetary policy conditions throughout in late 2020 and in 2021. In the medium term, and as disinflationary factors are exhausted, a return to a neutral monetary policy (in the 5-6 percent range) is expected.

1.5 Financial sector: the Russian banking sector is weathering the pandemic, but the worst may lie ahead.

The Russian banking sector continued to be under pressure from the COVID-19 outbreak and its associated economic downturn. Policy response measures introduced by the Russian Government and the central bank helped to relieve the immediate pressure. Yet, the weakening asset quality across the corporate, SME and retail segments put pressure on the profitability of banks and amplify macro-financial risks. The system-wide capital adequacy remained largely stable, supported by large-scale regulatory forbearance measures. The real extent of problem loans on bank balance sheets will start emerging by mid-2021, when the remaining regulatory forbearance measures will be lifted. Pre-existing vulnerabilities such as a high share of non-performing loans combined with uncertainty about the length of the second wave of the pandemic and associated economic costs suggests that the worst still may lie ahead.

The COVID-19 pandemic and associated deterioration of economic conditions in 2020 have undermined balance sheets in all sectors in the economy, affecting firms' ability to service and repay debt. In the first nine months of 2020, profits of large and medium enterprises dropped by about 40 percent compared to the same period last year, with several sectors recording losses (notably hotels, tourist services, railway and air passenger transportation). SMEs, which account for a fifth of GDP, were affected even more severely. The deterioration in the operating environment has greatly affected the profitability of banks and the quality of their assets. These trends have had the greatest impact by increasing the volume of potentially problematic loans in bank portfolios.

The banking sector faces risks amid uncertainty about the length of the second wave of the pandemic and associated economic costs. If strict mobility restricting measures are re-introduced by the government and economic activity declines further, this will likely result in deeper asset-quality deterioration and increased pressure on banks. Key risk-transmission channels will persist via the decreasing payment capacity of borrowers (corporate, SME and households) piling on high levels of pre-existing non-performing loans (NPLs), which could be estimated at 16.3 percent if "doubtful loan" category is included in addition to CBR-reported system wide NPLs of 9.3 percent.

Against the backdrop of this economic contraction, a significant negative impact on corporate earnings and credit quality is expected to affect the Russian corporate sector. This could adversely affect corporate loans (about half of the sector's overall loan portfolio) and banks may face further asset-quality deterioration, weakening profitability and capitalization.

Risks in foreign-currency lending have also increased due to the depreciation of the ruble and disruptions in foreign trade. However, the level of dollarization in Russia has been declining and is relatively low: FX credits total

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

19 percent of total credits, and FX deposits about 27 percent of total deposits (down from about 25 percent and 36 percent on January 1, 2015). FX deposits (mainly denominated in US dollars and euros) have been losing their attractiveness in Russia because interest rates in those currencies are near zero.

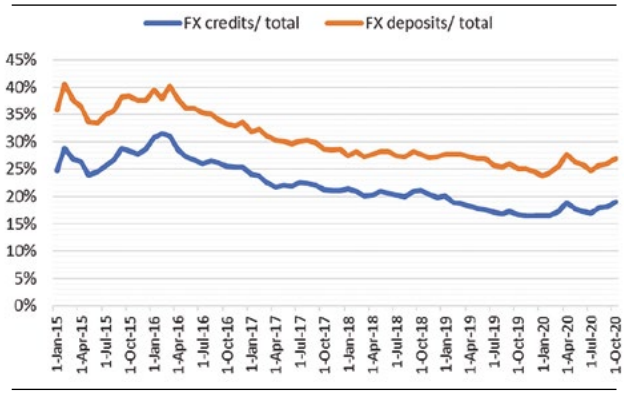
Investment options for bank clients are also somewhat limited, so they are shifting to ruble deposits, resulting in further de-dollarization of banks' balance sheets (Figure 31). Banks' net FX exposures are being carefully monitored by the Central Bank of Russia (CBR) and are close to zero at the system level (0.3 percent for the 20 largest credit institutions, which account for nearly 80 percent of the sector assets).

There has been significant loan restructuring (estimated at above 10 percent of total sector loans in March-September 2020), which may conceal the actual extent of asset-quality deterioration. At the onset of the pandemic, the CBR adopted a broad set of policy measures to mitigate the effects of COVID-19, including granting temporary regulatory forbearance to banks related to loan-loss provisioning. That allowed Russian banks to further postpone, until September 30, 2020, the classification of loans restructured amid the coronavirus pandemic as problem loans. The CBR has recently prolonged forbearance measures regarding provisioning to restructured loans for individuals and SMEs until the end of 2020 with the requirement for banks to fully provision for restructured loans by July 1, 2021. Therefore, a more realistic picture of the sector-wide impact will start emerging only towards the middle of next year. Retail lending, which had been growing in double digits in 2018–2019, could present an additional pocket of vulnerability as household incomes fall, unemployment rises and affected individuals apply for payment holidays and loan restructuring. Unsecured consumer lending accounts for most of the restructuring. A significant portion of restructured retail loans may remain problematic after the relief period, requiring additional reserves and putting pressure on capital.

In October, Russian banks' loan restructuring continued, but the demand from borrowers, both households and corporates decreased. For the period of March 20th to December 2nd, banks restructured 1.7 million loan agreements of individuals, amounting to Rub833 billion. Overall, for the period March 20th to October 31st, the volume of corporate restructured loan debt exceeded Rub4.8 trillion, or 13.8 percent of the total portfolio of the systemically important credit organizations, excluding SMEs. The total amount of restructured SME's loans reached Rub824.1 billion, or over 15 percent of the total portfolio of SME loans, as of December 2nd.

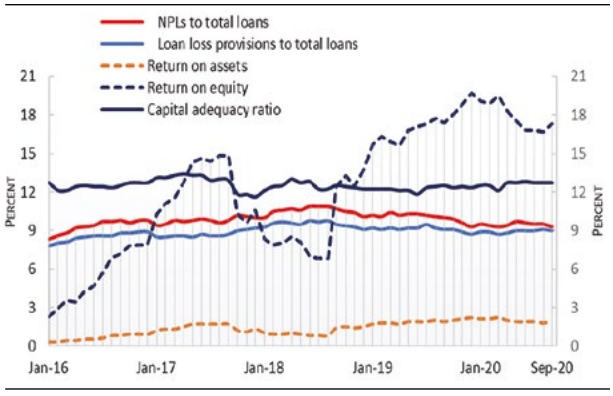
Supported by large-scale CBR regulatory forbearance measures, banks' key credit risk and performance indicators remained largely stable (Figure 32). As of October 1, 2020, the aggregate capital adequacy ratio stood at 12.7 percent (against a regulatory minimum of 8 percent and compared to 12.5 percent at the beginning of the year). Non-performing loans remained broadly unchanged at 9.3 percent of total loans as banks benefited from the regulatory forbearance measures, which delayed the accrual of loan loss reserves on restructured loans. Overall, in January-October 2020, the banking sector's net profit remained substantially lower than in 2019 at Rub1.3 trillion, or US$16.8 billion) compared to Rub1.7 trillion (US$26.4 billion) in the same period in 2019. As of October 1st, the return on assets (ROA) and return on equity (ROE) were 1.9 percent and 17.3 percent, respectively, compared to 2.1 percent and 19.1 percent, respectively, at the beginning of the year.

Figure 31: The de-dollarization of bank balance sheets reduces FX risks



Source: Bank of Russia.

Figure 32: Banks' key credit risk and performance indicators remained largely stable, supported by large-scale regulatory forbearance measures



Source: Bank of Russia.

Credit growth across corporate and retail segments has been maintained throughout the year – supported by declining interest rates (following policy rate cuts by CBR to a record low of 4.25 percent) and government credit-targeted policies (Figure 33). Corporate sector loans have been growing backed by the government programs for the affected industries and systemically important enterprises, while retail lending benefited from the subsidized mortgage loan program launched by the government in April.

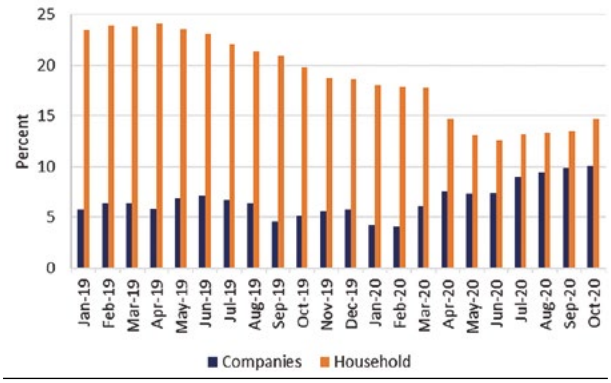
Mortgage lending has experienced the fastest growth since 2009 supported by the government subsidized mortgage program. The program was introduced in April with the aim to support the construction industry and homebuyers in response to the COVID-19 pandemic and has recently been extended into 2021. Under the program mortgages on the purchase of new homes (up to a maximum of 12 million rubles (US$158,000) in Moscow and St. Petersburg, and half that level in the regions) are capped at 6.5 percent and a down payment is reduced to 15 percent.

As a result of the government program, by November 2020, more than a third of household loans were mortgages – 34.6 percent, compared to 21.3 percent a year earlier (Figure 34). The number and volume of mortgage loans issued by the banks nearly doubled since the last year (Figure 35). About 36 percent of the total volume was in the form of government-supported loans. Against this sharp increase in mortgage lending, the level of mortgage NPLs has remained stable so far – at around 3.4 percent.

Meanwhile, property prices are increasing on the back of the increased demand from the population, which could lead to overheating of the real estate market in some geographies. At the same time, real disposable incomes of population are decreasing, which could potentially result in higher NPLs if the economic situation will be worsening. The second half of 2021 will be the test for the market, as government stimulus program ends in July 2021. Given the weak economy and decreasing incomes, the end of these temporary factors supporting demand may hold back growth in housing prices next year.

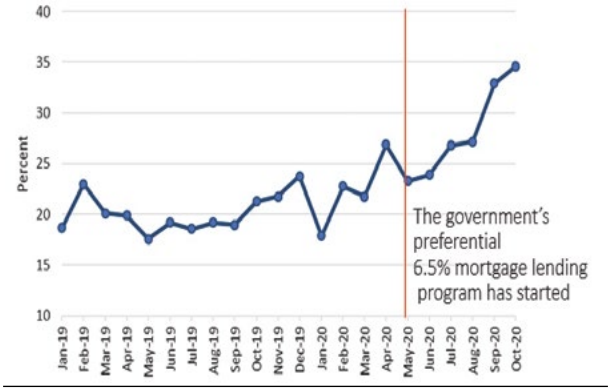
As the COVID-19 pandemic accelerated the use of technology, including in the financial sector, the CBR announced plans to introduce a «digital ruble» to expand the infrastructure for cashless payments. In mid-October, the CBR released a paper on the prospects of introducing a digital currency, which would be called Central Bank Digital Currency, or CBDC.[26]

Figure 33: Credit growth has been maintained due to the public support measures (Ruble credit growth, y/y)



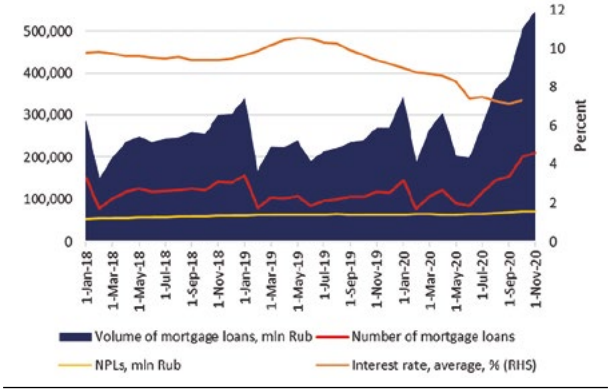
Source: Bank of Russia.

Figure 34: As a result of the government program, the share of mortgage loans in total bank loans issued to households increased sharply



Source: Bank of Russia.

Figure 35: The number and volume of mortgage loans issued by the banks significantly increased



Source: Bank of Russia.

[26] https://www.cbr.ru/StaticHtml/File/113008/Consultation_Paper_201013_eng.pdf

Box 4 Central Bank of Russia is exploring central bank digital currency

Like central banks elsewhere, the Bank of Russia has announced in its recent consultation paper that it "is exploring the possibilities and prospects of the introduction of a digital ruble – the digital form of the Russian national currency" – a central bank digital currency (CBDC). The motivating factors for this exercise include among others, meeting the changing needs of individuals and businesses and promoting innovations in both the financial market and the economy in general. It is also with a view to meeting the demands of the economic agents for greater speed, convenience and safety of digital payment transactions and a reduction in fees, which are possible to be met through the implementation of cutting-edge technologies.

Although several central banks have been testing and piloting a CBDC, no jurisdiction has as of yet launched a CBDC. This might be a sign of the complexity associated with such an initiative, given that it requires coordination of public and private sector stakeholders in many areas (e.g. payments, economics, legal, technology). Nevertheless, central banks see CBDC as a potential solution to issues such as financial exclusion, high costs associated with physical cash, delays in crediting of payee accounts in a payment transaction, commercial money dominating the digital payments arena, thus marginalizing the role of central banks in this context.

Overall, having clear objectives will be important for central banks to gauge whether CBDC is the right instrument or whether alternative mechanisms exist that could fulfil the sought-after objectives more effectively and efficiently. But even if the answer were to point to CBDC, its implementation and design features should be guided by the specific country needs and context. In the process, central banks need to answer important questions regarding the design features: interest bearing vs. non-interesting bearing; token-based vs. account-based; anonymous vs. non-anonymous; accounts held at central bank vs. accounts held at commercial institutions vs. no accounts at all (tokens); cost structure and fees charged to participants and end users. In addition, central banks need to anticipate potential risks associated with the monetary policy and financial stability aspects.

As stated in the consultation paper, the Bank of Russia is seized with the complexities associated with this exercise and emphasises that it "requires an extensive and deep study already now, in terms of both economic and technological implications". It has indicated that it would carry out this work communicating with the public, experts, and financial market participants, with the issuance of the consultation paper as just the first step in this direction for triggering a broad and comprehensive discussion of the topic.

1.6 Fiscal policy: Countercyclical policy with deficit mostly financed through domestic debt issuance as revenues are being strained by the pandemic.

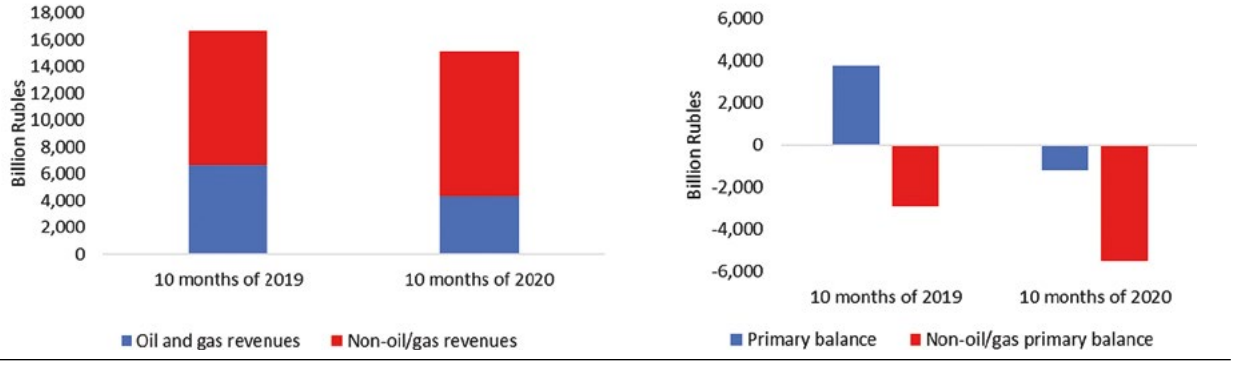
Countercyclical fiscal policy and sizeable buffers have helped contain the impact of the crisis. The fiscal policy response was mostly concentrated on expenditure measures (3 percent of GDP); revenue measures (0.4 percent of GDP); and loans, equities, guarantees (0.6 percent of GDP). Consequently, the federal budget registered a deficit of Rub1,800 billion in January – October 2020. While contained overall, regional debt increased substantially in some regions. The general government deficit is expected to reach about 4.6 percent of GDP in 2020, compared to its surplus of 1.9 percent of GDP in 2019. Economic support measures under the framework of the plan of actions aimed at restoring economic growth and growth of disposable incomes will be rolled over to 2021. After a stronger fiscal impulse in 2020, Russia's fiscal consolidation in 2021 – 2022 will be deeper than in other EMDEs and become a drag on growth. Given relatively low public debt, sizeable macro-fiscal buffers[27], and expected persisting negative output gap, Russia has some fiscal space for more gradual consolidation.

In the first ten months of 2020, the federal budget registered a deficit of Rub1,800[28] billion, compared to a surplus of Rub3,156 billion in the same period last year (Figure 36). This was on the back of higher spending driven by the response to the spread of the pandemic and the need to support the economy amidst lower oil/gas revenues. In January-October 2020, oil/gas revenues dropped by 35.2 percent, y/y, as oil prices plummeted and oil production

[27] As of December 1, 2020, Russia's sovereign wealth fund – the NWF – reached a robust US$177 billion (13.1 percent of GDP), while its liquid part reached 9 percent of GDP. International reserves stood at a comfortable US$583 billion (23 months of imports). Russia's external debt, at 33 percent of GDP, favorably compares to the 60 percent EMDE average. And public debt is at about 14 percent of GDP compared to 62 percent EMDE average.

[28] Since May 2020, the Ministry of Economic Development has not been providing estimates of nominal GDP; thus, fiscal outcomes are reported in billion rubles.

Figure 36: The federal budget surplus turned into deficit in the first ten months of 2020



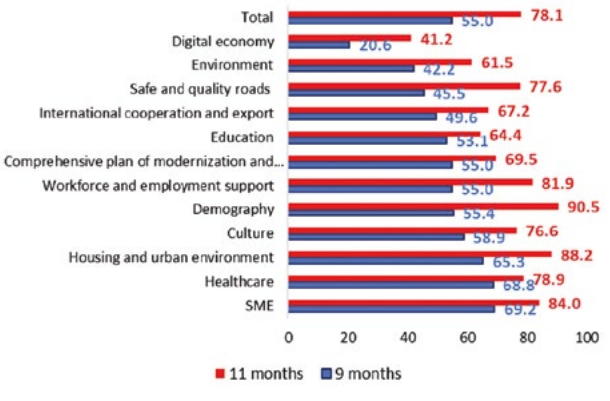
Source: Federal Treasury of the RF.

decreased. A weaker ruble could not fully compensate for the fall in oil prices and the drop in economic activity[29]. Non-oil tax receipts also declined by 2.3 percent:[30] In the first ten months of 2020, VAT receipts dropped by 0.5 percent, y/y, and corporate income tax receipts dropped by 10.2 percent, y/y. Total fiscal revenues decreased by 9.2 percent, y/y, in the first ten months of 2020 (15.2 percent, y/y, not accounting for one-off channelling of the receipts from the Sberbank purchase).

Primary expenditures increased by 26.3 percent in the first ten months of 2020, driven mainly by growth in spending on social policy, health, support to regional budgets, national defence, and the national economy. The fiscal package of about 4 percent of GDP (3.0 percent of which is expenditure stimulus) is expected to be channelled into the economy in 2020. With the announced expenditure stimulus, federal budget primary expenditure could reach Rub 21.7 trillion in 2020 (+23.9 percent, y/y, or +2.2 trillion rubles to the amount planned before the pandemic). As of the end of October, federal budget primary expenditures totalled Rub 16.3 trillion (cash basis). With budget spending usually skewed towards the end of the year[31], even if the full amount of stimulus is spent in 2020, substantial part of its effect on the economy will be felt only in 2021.

In the first nine months of 2020, spending on the National Projects has been slow as the main efforts of authorities were aimed at mitigating the COVID-19 pandemic health and economic impact. According to the Russian Accounting Chamber, in the first 9 months of 2019, spending on National Projects lagged general fiscal spending. Only 55 percent of the planned annual amount was spent on National Projects in January-September (compared to 66.7 percent spending rate of the federal budget funds) (Figure 37), yet the execution accelerated, and in January – November 78 percent of the planned amount was spent. This is comparable to the spending rate of the overall federal budget spending.

Figure 37: In January – September 2020, spending on the National Projects was relatively slow, but it accelerated by end-November



Source: Russian Accounting Chamber.

The federal budget deficit (Rub1,800 billion) was largely financed by means of borrowing in the domestic market. As of end-October 2020, federal government ruble denominated debt grew by Rub 3.2 trillion amounting to 13.6 percent of GDP. After a spike in government bonds yields in March, caused by the global

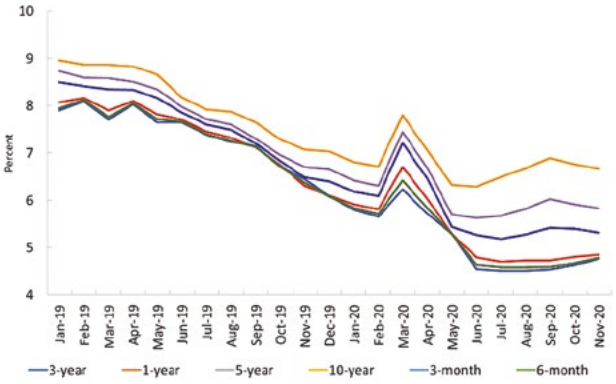
[29] According to the EEG estimates, the ruble depreciation resulted in an increase of federal budget revenues by 0.9 percent in January – September 2020, y/y.

[30] Not accounting for one-off channeling of the receipts from the Sberbank purchase (Rub1.05 trillion).

[31] In Q4 2019, federal budget primary spending reached about 35 percent of the total primary spending.

risk-off investors' behaviour, they stabilized in June, yet medium- to long-term bonds yields have grown since July, possibly reflecting expectations for monetary tightening in the medium-term (Figure 38). By end-November, the ruble nominal exchange rate depreciated by about 22.5 percent with respect to the US dollar compared to end-December 2019. Nonetheless, with the external public debt at about 5 percent of GDP, exchange rate risks for the government are contained.

Figure 38: Government bond yields spiked in March

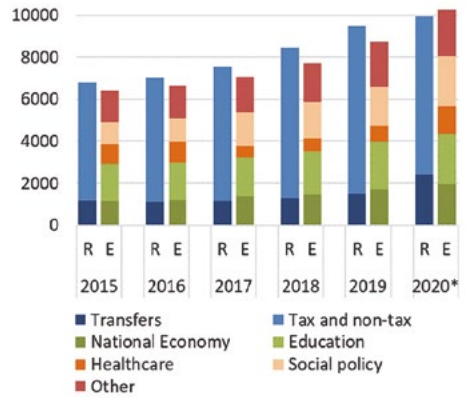


Source: Haver.

Russian regions have fared differently during the crisis, with revenues (tax and non-tax) overall declining by 5.2 percent, y/y, or Rub 408 billion, in January-September 2020, while expenditure rose sharply (Figure 39). At the end of this period, the deficit of the consolidated budgets of the Russian regions stood at Rub 295.7 billion (44 regions in deficit), compared with a surplus of Rub 1.01 trillion at the start of the year (14 regions in deficit). As of October 1, the total expenditures of regional budgets rose by 17.4 percent, y/y, and amounted to Rub 10.3 trillion. This was mostly due to increasing expenditure in healthcare, to cope with the Covid-19 crisis; already in January–July 2020 all regions saw healthcare expenses increase (healthcare expenditure more than tripled in the Saratov Region, and the Republic of Dagestan).

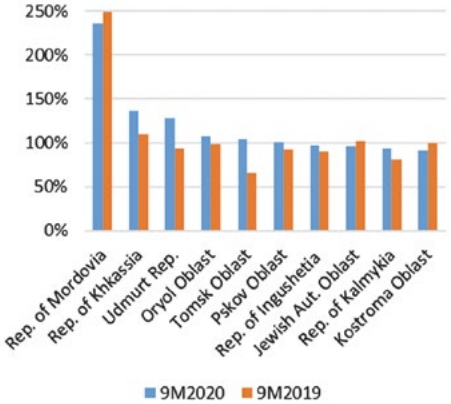
In response to the crisis, transfers from the federal budget to regions were increased, but some regions are disadvantaged as they face limitations on borrowing under state debt restructuring regulations. In January-September 2020, the volume of inter-budgetary transfers provided to the regions amounted to 2.37 trillion rubles, 1.57 times more compared to the same period in 2019. Regions participating in the federal loans restructuring program (73 regions) benefit from its extension from 2024 to 2029. These regions can use the funds equivalent to their previously planned debt repayment in 2020, to make up for lost revenues and finance spending on necessary measures to cope with the Covid-19 crisis. At the same time, these regions face restrictions on the amount they can borrow in the market, with the cap being equivalent to the amount of debt repayment due. While the MOF compensated for revenue fall out to some extent (mostly poor regions), this situation could pose a risk to regions in vulnerable positions, facing limited borrowing space, higher expenditure needs and strong revenue falls.

Figure 39: Regional budget moved into deficit as expenditure rose, revenues increased on the back of transfers



Source: Minfin.
*Notes: refers to first nine months of respective year, R = Revenue E = Expenditure, * = estimate.*

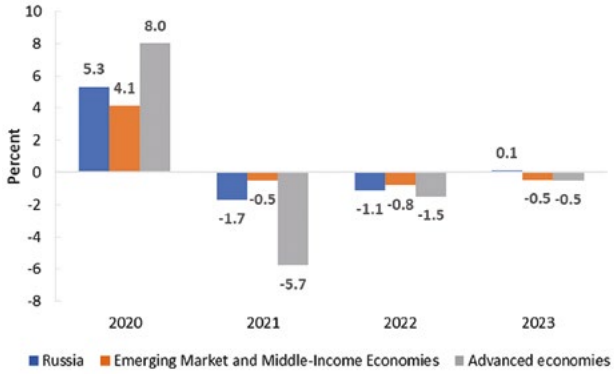
Figure 40: Debt burden rose in the majority of regions (debt/tax and non-tax revenue)



Source: Minfin.

While contained overall, regional debt increased substantially in some regions. The ratio of debt to revenue (tax and non-tax) ranges from zero percent in Sakhalin Oblast to over 200 percent in the Republic of Mordovia. In comparison to the beginning of the year, in January-October 2020 the volume of public debt increased by 5.2 percent to Rub 2.22 trillion; it decreased in 35 regions, remained unchanged in 14 regions, and increased in 45 regions. The largest contribution to the rise in debt is accounted for by St. Petersburg, Sverdlovsk region, Moscow region, and Tomsk region. The lowest ratio of debt to revenue was recorded in Sakhalin Oblast, Moscow, Tyumen region, and Leningrad region. Debt accumulation is explained by the fact that there is limited room for expenditure cuts in regions as long as health and social shocks associated with Covid-19 persist; about 80 percent of budget revenues had been allocated to education, medicine, and social needs. Some regions will be able to reduce debt burden in 2021 - 2022 as growth is expected to rebound in 2021 and 2022. For some regions, debt restrictions will have to be alleviated further or they will require additional transfers from the federal budget. The Ministry of Finance expects general government deficit to reach 4.6 percent of GDP, compared to a surplus of 1.9 percent of GDP in 2019.

Figure 41: Russia's fiscal impulse in 2021 – 2022 suggests deeper consolidation than for other EMDEs and MICs



Source: Fiscal Monitor, IMF.

The budget is facing pressure from increased expenditures and lower than planned revenues in 2021 – 2022 due to the economic downturn. Federal budget deficits are projected to be 2.4 and 1.0 percent of GDP in 2021 – 2022 (please see Outlook section for more details). To avoid abrupt fiscal consolidation and reduce negative fiscal impulse in 2021, the government has adopted a countercyclical policy thereby relaxing the fiscal rule in 2021 as well: the expenditure cap will be raised, and oil/gas revenues[32] will be accounted for without OPEC+ production cuts. Revenues as a share of GDP are expected to remain well below pre-pandemic levels throughout the forecast horizon. Expenditures as a share of GDP, while slowly falling, will remain elevated compared to pre-COVID levels throughout the forecast horizon (also in real terms)[33]. Nevertheless, fiscal consolidation will be a drag on growth in 2021 – 2022. According to the IMF's Fiscal Monitor database, Russia's consolidation will be deeper than for other EMDEs and Middle-Income Countries for the period 2021 – 2022 (Figure 41).

Given relatively low public debt, sizable macro buffers and expected negative output gap, Russia has some fiscal space for more gradual consolidation in 2021 – 2022. In case vaccination roll out appears to be less effective than planned the government could consider more gradual paths for consolidation and further roll out of measures for the economy support (more targeted support to the firms/sectors that are viable (including SMEs), higher unemployment benefits). The planned cuts to regional general transfers in 2022 are concerning. In addition, the generosity of the social support for the poor needs to be increased[34], while taking measures on improving targeting and cost/benefit of social assistance.

The federal budget deficit will be largely financed through domestic borrowing in 2021 – 2023. There are also measures to raise revenues through extraction taxes for metals and chemicals, reconsidering tax expenditures for oil companies, raising tobacco taxes, raising the tax rate for dividend payments to offshore zones to 15 percent, introducing taxation of interest income for deposits exceeding 1 million rubles (including foreign currency deposits)

[32] The government suggests budgeting for oil and gas revenues not accounting for OPEC+ oil production cuts, which would allow to increase expenditures further.

[33] In 2021-2022, primary expenditures would be about 10% higher in real terms than 2017 – 2019 average but 14 percent lower than the high base of 2020, with cuts in spending on the national military program by 5 percent and freezing of public employees' wages, also cuts in such categories as state management, social policy, health, general transfers to regions.

[34] The social-assistance system in Russia does not necessarily prioritize the poor. But even when covered, they receive insufficient support to move out of poverty. The level of means-tested benefits is small: a poor person receives on average around 1/3 of the poverty gap. Simultaneous efforts need to be undertaken to make the social support system more targeted and aim for a performance that yields a high rate of short- and long-term poverty reduction per unit of spending. Please see "Recession and Growth under the Shadow of a Pandemic", Russian Economic Report #43, World Bank, 2020.

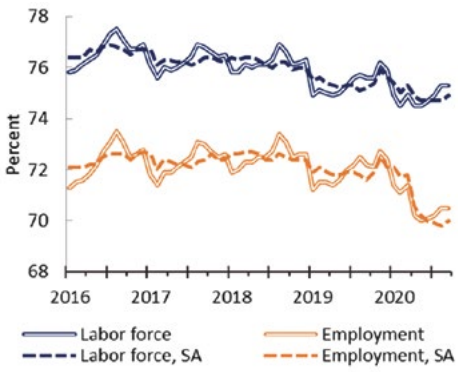
and raising the progressive personal income tax (PIT). According to data from the World Inequality Database, about 0.5 percent of Russian adults have a taxable income of Rub 5 million per year. With an adult population of about 114 million people, this means Russia has 570,000 people who could potentially pay this increased tax (counting only those receiving an income exceeding Rub 5 million). These measures could bring the government 0.4 - 0.5 percent of GDP per year[35]. At the same time the tax burden for SMEs and IT companies would be reduced. In 2021, about 1.1 percent of GDP will be spent on the plan of actions aimed at restoring economic growth and growth of disposable incomes from the federal budget, mainly on social benefits and infrastructure projects. Expenditures on National Projects will be reduced by 0.1 and 0.2 percent in 2021 – 2022 (-583 billion rubles in 2021 – 2022), compared to the pre-pandemic plans. The substantial part of the cut (about 37 percent) are infrastructure expenditures. The government expects the federal budget deficit to be 2.4 percent, 1.0 percent, and 1.1 percent of GDP in 2021 – 2023. In 2022, the government plans to return to the usual fiscal rule practice: a primary deficit of about 0.5 percent of GDP at the threshold oil price to be mostly compensated through domestic borrowing.

1.7 Labor market: COVID-19 reduces employment, but policies seem to blunt impact on poverty

The unemployment rate has increased noticeably from 4.6 percent in October 2019 to 6.3 percent in October 2020 - the highest in the last eight years. The combination of job losses and lower wages led to a decline in average disposable income with two important consequences: on allocation of incomes and on poverty. Allocation of disposable incomes changed markedly. The national poverty rate increased from 12.3 percent at the end of 2019 to 13.2 percent in the second quarter of the current year. The economic deceleration may lead to an increase of the poverty rate of up to 14.2 percent in 2020, but compensatory measures may fully compensate for this increase.

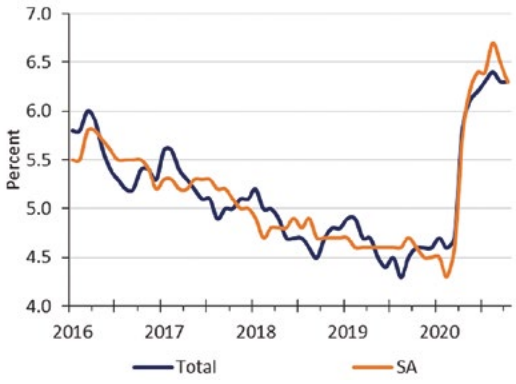
The labor force participation rate declined slightly during the first five months of year 2020, but it bounced back in June, reaching 75 percent in October (Figure 42), just below the level for the same month last year (75.6 percent). In contrast, the employment rate, after also declining during the first half of the year, has not fully recovered yet. The employment rate in October 2020 reached 70.3 percent – almost two percentage points lower than in October 2019 (Figure 43).

Figure 42: Labor force participation rates have not changed noticeably, but employment rates decreased



Source: Rosstat and Haver Analytics.

Figure 43: The unemployment rate has increased by two percentage points over the year



Source: Rosstat and Haver Analytics.

[35] According to the estimate of the Ministry of Finance.

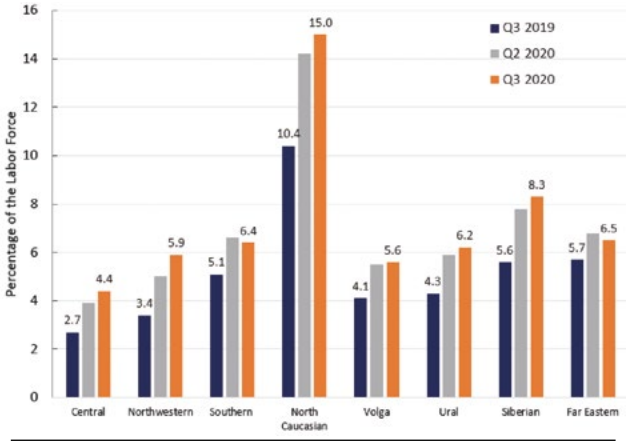
Consequently, the unemployment rate has increased noticeably from 4.6 percent in October 2019 to 6.3 percent in October 2020, the highest in the last eight years. Similar rates have not been seen since the aftermath of the 2008 global financial crisis.

This increase in unemployment started in the second quarter of 2020, when the effects of the pandemic were first felt. Despite Moscow representing the largest share of COVID-19 cases (26 percent of the cumulative infections as of December 8, 2020)[36], all regions experienced a rapid rise in unemployment rates in the second quarter of 2020. This is evidence of a pervasive impact of the lockdown measures across all the territory of the federation, regardless of the incidence of the pandemic (Figure 44). The upward trend in unemployment continued during the third quarter, with the exception of the Far Eastern Federal District, which not only experienced one of the slowest increases in the second quarter, but also saw a decline in the unemployment rate in the third quarter. The Far Eastern federal district may have fared relatively better due to the lower incidence of cases[37], but most likely because of the smaller share of employment in economic activities that have been particularly hit by the crisis. In particular, the region has a larger proportion of jobs in public administration than the national average (approximately 12 and 7 percent, respectively), and they are less affected by market fluctuations. In any case, given the larger population size of the Central and North Western federal districts (and the high incidence of COVID cases in their capitals of Moscow and Saint Petersburg) these regions, despite their relatively lower unemployment rates, represent the largest share of total unemployed as of September 2020 (29 percent) and the largest share of newly unemployed over the past year (38 percent).

In contrast, job losses were concentrated in only a few economic activities. Total employment declined by 1.5 million jobs between the 2nd quarters of 2019 and 2020. Approximately half a million jobs have been lost in each of three large sectors: manufacturing, construction, and retail and hospitality services. These losses are explained by the lock-down measures and the difficulty of tele-working in these sectors. The other sectors have seen smaller changes – some declining, like agriculture and education, others increasing, like professional services, health and civil service. But they compensated each other in a manner that would have no impact on total employment (Figure 45). It was the job losses in manufacturing, construction, and retail/hospitality that constituted the main source of employment decline.

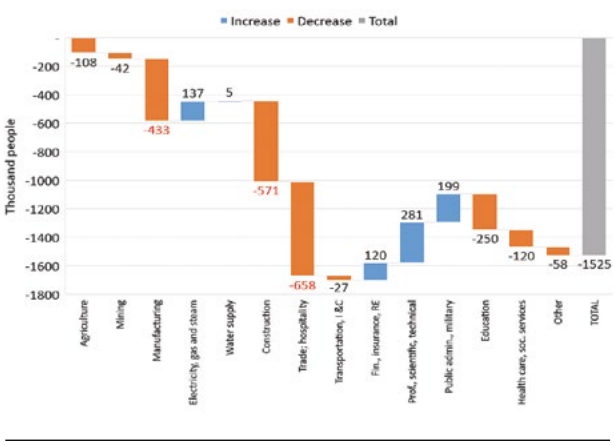
The conditions of the labor market are still loose. Job postings from employers in employment agencies are still well below the total number of unemployed. As of September 2020, the ratio of unemployed to job posts was 2.7, whereas the ratio was 1.9 the same month last year. Interestingly, the number of job postings was not very different from a year ago (around 1.7 million jobs). It is the number of unemployed that has increased, suggesting that these unemployed may come from activities that do not use employment agencies to post job openings.

Figure 44: The unemployment rates increased in all federal districts



Source: Rosstat.

Figure 45: Job losses concentrated in three economic activities: manufacturing, construction and retail/ hospitality services



Source: Rosstat.

[36] Data on incidence of the COVID 19 pandemic, here and in the rest of the note, from Johns Hopkins CSEE (https://gisanddata.maps.arcgis.com/apps/opsdashboard/index.html#/bda7594740fd40299423467b48e9ecf6) as of December 8, 2020.

[37] For instance, the Primorsky krai has had a cumulative incidence of 1256 cases per 100,000 people, significantly lower than Moscow city with an incidence of 5319 cases per 100,000 people.

Informal employment has seen an important decline. This type of employment has fallen by 1.9 million jobs between June 2019 and June 2020, reducing the rate of informal employment from 21.5 to 19.4 percent in the period. Comparing this figure to the figure of total job losses suggests that it is informal workers who have borne the brunt of the crisis. Lacking proper labor contracts and concentrating in activities that cannot telework, informal workers have been most affected by the lockdown, underlining their vulnerability.

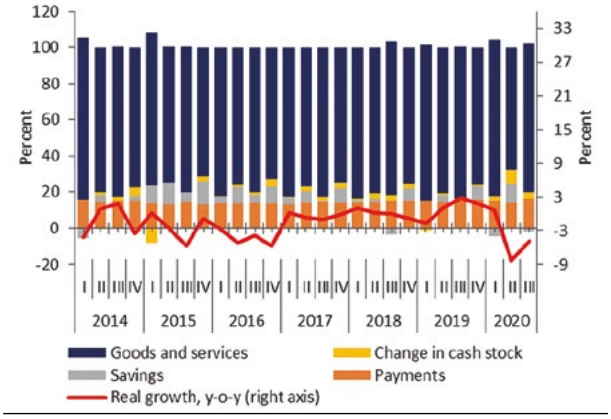
A group particularly affected by lack of jobs and employment losses are migrant workers, who tend to concentrate on activities very affected by the pandemic (i.e., construction, retail/hospitality services) and work under informal contracts. The Russian authorities introduced a series of measures to delay or suspend visa/work permit requirements for migrants, and many of them have been able to keep working in their sectors or work in other sectors; but many others have lost their jobs and returned to their countries or are stranded in Russia, negatively affecting life conditions for them and their families.[38]

Real wages increased 0.1 percent year-on-year as of August 2020. However, this apparent stability masks important differences across economic activities. Real wages increased in agriculture, communications, education and health services, but fell in most of the other sectors, with large declines in hospitality services (-11.0%), construction (-5.8%), retail (-4.1%) and manufacturing (-2.9%).

The combination of job losses and lower wages led to an important decline in average disposable income. Recent data showed a year-on-year decline in real disposable income of 8.4 percent for the second quarter and of 4.8 percent for the third quarter of 2020. These were the largest declines in disposable income in many years. They had two important consequences. First, the allocation of disposable income changed markedly. For the second quarter of 2020, consumption expenditures represented only 83 percent of disposable income, leading to an increase in savings that reached 17 percent of disposable income, again a proportion not seen in many years (Figure 46). This is evidence of a sharp reaction by the public to increase their savings as a result of two factors. On the one hand, usual expenditures on travel and entertainment were postponed while, on the other hand, precautionary savings shot up on the back of the uncertainty created by the crisis. By the third quarter, however, savings returned to levels similar of previous years.

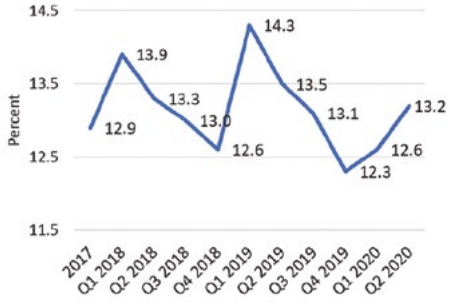
The second impact of the decline in disposable incomes was on poverty rates. The national poverty rate increased from 12.3 percent at the end of 2019 to 12.6 percent in the first quarter and 13.2 percent in the second quarter of the current year. However, the first quarter increase in 2020 was much smaller than the ones observed in previous years. Consequently, the poverty rate in the second quarter of 2020 was still lower than in the same quarter of the previous two years (Figure 47). This is tentative evidence that the social policies adopted earlier in the year are partly compensating the severe impact of the crisis upon employment and disposable incomes.

Figure 46: Disposable Income and its allocation to consumption at lowest levels since 2014 during the 2nd quarter of 2020



Source: Rosstat.

Figure 47: The National Poverty Rate has increased in the first half of the year, but is still below the comparable period of previous two years



Source: Rosstat.

[38] Ivakhnyuk, I. (2020) "Coronavirus pandemic challenges migrants worldwide and in Russia". Population and Economics 42(2) p.49-55.

A projection of poverty rates for 2020

A series of policies designed to attenuate the impact of the COVID-19 pandemic on the labor markets were introduced in the second quarter of 2020. In the case of unemployment insurance, this meant an increase in the maximum level of unemployment benefits from Rub 8,000 (US$103) to Rub 12,130 (US$157) per month. Payment of the maximum level of unemployment benefits to all employees who lost their jobs due to COVID-19 introduced since the beginning of March for three months, and then extended till end 2020, also helped. The policy was introduced with the appropriate administrative facilities for people to register and to claim benefits. Preliminary evidence seems to indicate that these policies are indeed being rolled out. According to ROSSTAT data, by August 2020, 3.4 million out of 4.8 million unemployed workers, or 70 percent, were registered as unemployed and receiving unemployment benefits. This contrasts with only 16 percent of the unemployed being registered and receiving benefits by March 2020.

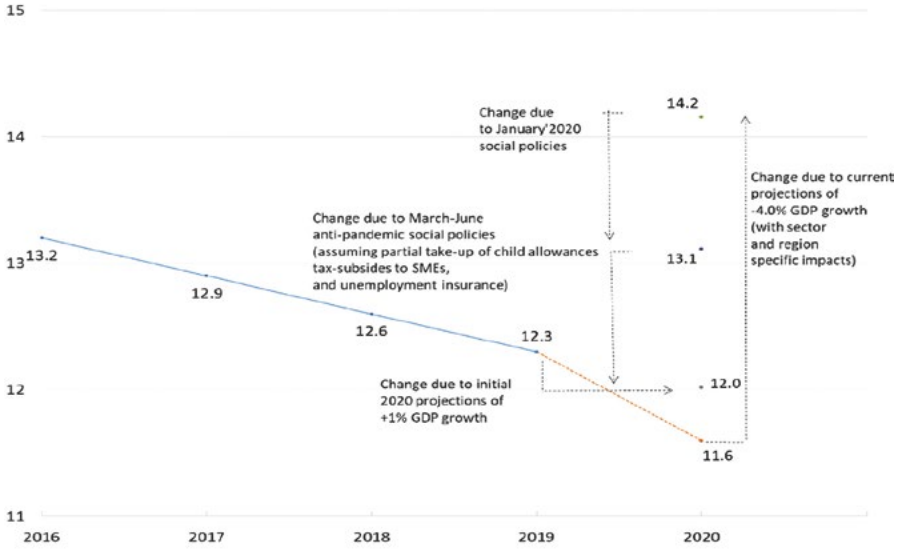
Moreover, a series of family allowances and pension benefits were also introduced between January and June 2020 (a description of these is provided in the previous RER #43, pages 30 and 31). All these policies may explain the fact that poverty rates during the first half of 2020 were not higher than in years 2019 or 2018, despite the severe decline in employment and wages.

A preliminary assessment of the impact of these shocks and policy responses makes use of RUSMOD, a Russian micro-simulation model that runs computer experiments for assessing changes in existing monetary tax-transfer policies implemented at the federal level for a nationally representative sample of the population (see Annex 1 for details and assumptions).

The model was run based on projection of GDP decline of 4 percent in 2020 with the finding that the poverty rate for the year 2020 - using the official poverty line - could increase to 14.2 percent and the compensation policies would lead to a decline of the poverty rate to 11.6 percent, which would be below the counterfactual (Figure 48).

As always, these projections need to be interpreted with caution. GDP projections for 2020 may fail to capture the rise of a new wave of infections observed since early October. Similarly, some benefits were lump-sums or of limited extension (usually three months), although unemployment insurance has been extended until December. But if take up rates are low or field implementation falls short, the compensatory impact may be reduced. For instance, a version of the model using a GDP fall of 5 percent of GDP would render a poverty projection of 12.1 by year's end (slightly above the counterfactual). Even lower growth or less effective policy implementation would render higher poverty rates.

Figure 48: Social policies compensate for the increase in poverty rate



Source: World Bank staff calculations.

National averages in poverty rates hide some important differences across population groups. Our simulations of the differential impact of the crisis across the economy, and the compensatory measures adopted, show that households of single individuals, couples with one child and mixed family structures have experienced a decline in disposable income, while households with two or more children, lone parents and pensioners have seen an increase in disposable income (Figure 49, left panel). This is mostly because of the importance of family-related allowances in recent compensatory measures. In terms of location, rural areas are projected to have increases in disposable incomes, whereas urban areas, particularly regional centers have experienced declines in disposable income (Figure 49, right panel). This is mostly due to our simulation projections of limited impact of the lockdown measures on agricultural activity.

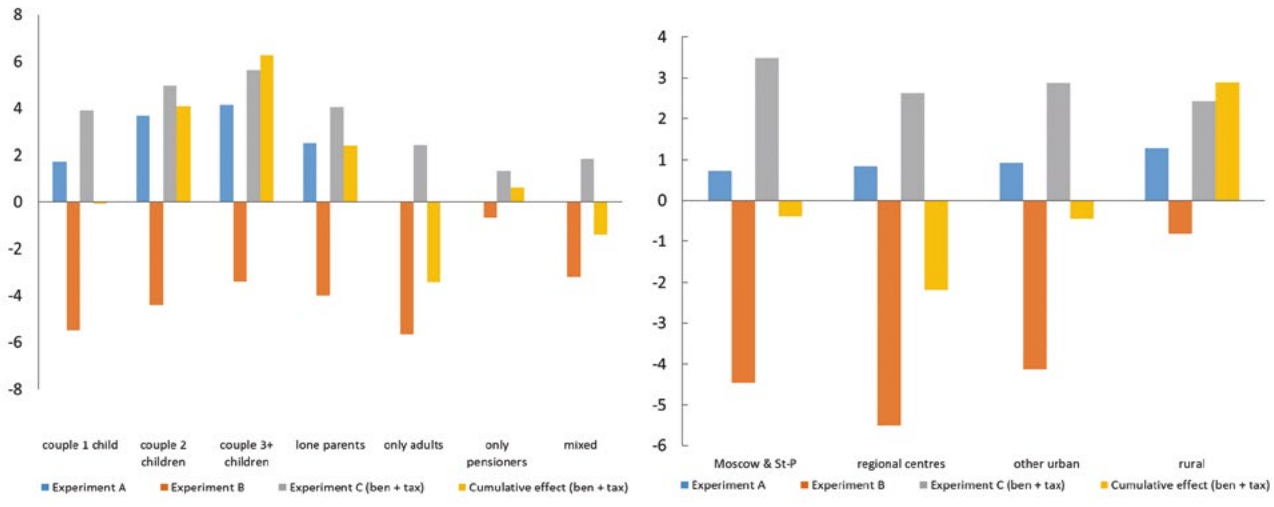
Appendix

RUSMOD was built on the EUROMOD platform, using the Russian Longitudinal Monitoring Survey (see Matytsin, Popova and Freije, 2019; and Popova 2012). It defines a counter-factual scenario using the pre-pandemic projections of +1 percent of GDP growth in 2020 and involves three experiments.

Experiment A assesses the distributional effect of social policy changes announced in January 2020. In particular, it includes the simulation of the following measures: (i) an increase in the coverage of the allowance for the first and second child, including, in each case, children up to 3 years of age in households with income below 200 percent of the regional Subsistence Minimum Level (SML); and (ii) a new allowance for children aged 3 to 7 in households with income below 100 percent of SML.

Experiment B examines the effect of the declines in household income due to the pandemic crisis and the non-working days introduced in many Russian regions in April-May 2020. Experiment B was done under one scenario of household income contraction to reflect early World Bank staff early projection of GDP contraction of 4.0 percent for the year 2020, with differences across sectors (a 1.7 percent growth in agricultural GDP, but contractions of 3.4 and 4.7 percent in secondary and tertiary sectors, respectively). Given the recent data on wages and jobs up to June or September 2020, explained in the main text, we also assume that most of the shock translates into employment and real-wage losses among workers, but only in manufacturing, construction, and retail/hospitality services in urban centers (no impact in rural areas) and particularly among informal workers. An alternative projection using the more recent a forecast of 5 percent decline of GDP was also experimented and preliminary results are included in the main text.

Figure 49: Simulations of changes in disposable income for year 2020 show important differences across demographic and geographic location groups.



Source: Staff calculations using RUSMOD. For an explanation of experiments A, B, and C, see appendix. Regional centers refer to capitals of federal districts and other large cities.
Note: Left axis refers to changes in disposable income.

Experiment C measures the distributional impact of social policies related to the pandemic (in particular, changes to child allowances and Social Security contributions for SMEs). It includes the following measures: (i) a cash payment, from April to June 2020, of Rub5,000 per month for each child up to 3 years, (ii) a lump-sum payment of Rub10,000 for all children aged 3-16 years; (iii) an increase in the size of childcare allowance for the first child up to 1.5 years for non-working parents; (iv) cash payments for pensioners aged 65+ of Rub 4,000 in Moscow (Rub3,000 in Moscow Oblast); (v) a 6.6 percent increase in contributory pensions and a 5.1 percent increase in social pensions; (vi) reduced social contributions rates for those employees of small and medium enterprises (SME) whose earnings are over the minimum wage (Rub12,130 rubles), with reduced rates of 10 percent for pensions contributions, 0 percent for social insurance contributions and 5 percent for health-care contributions; (vii) a tax allowance equal to the minimum wage for the self-employed in the most affected sectors; (viii) cancelation of income taxes and social insurance contributions in the second quarter of 2020 for those employed at SMEs in the affected sectors; (ix) raising unemployment benefits up to the level of the minimum wage; (x) a new unemployment benefit equal to the minimum wage for those who became unemployed within the four most affected industries and locations indicated above, with additional top-ups of 3,000 rubles for each dependent child.

Results shown in Figure 49 correspond to these three experiments using the early –4.0 percent GDP growth forecast. There are assumptions on the take-up for the new benefits. Given the statistics on increased coverage of registered unemployment, the unemployment benefit take-up is assumed to be 50 percent, while the universal child benefits are assumed to be received by 75 percent of the eligible population. There are also a number of other assumptions that drive the results of the model, notably that individuals and households will not change their economic behavior due to the changes in taxes and transfers. This assumption is mostly explained by the short-term nature of this assessment, which does not allow to quickly change the labor-market behavior. Another important assumption is that the economic incidence of all taxes, including labor taxes, falls entirely on workers. In reality, the economic incidence is spread between workers and employers, and thus the positive effect of SIC and tax reductions might be smaller, so the results of social-measure simulations could be seen as upper bounds.

PART II

OUTLOOK: VACCINATION SPREAD IN 2021 IS EXPECTED TO PUT THE ECONOMY ON THE PATH OF SUSTAINED RECOVERY

The pandemic is anticipated to have a prolonged impact on global oil consumption, which is expected to remain 5 percent below its pre-pandemic levels by the end of 2021. Oil prices[39] are forecast to increase to US$44/bbl in 2021 and US$50/bbl in 2022 from a projected US$41/bbl in 2020. The better-than-anticipated economic rebound in the third quarter of 2020 led to an upgrade in Russia's economic outlook for 2020 to -4.0 percent (from the previous projection of -5 percent in September). Consumer and business confidence are expected to improve assuming a vaccine deemed safe and effective is rolled out; this would pave the way for a gradual rebound at 2.6 and 3.0 percent in 2021 and 2022, respectively. The downside scenario assumes a sharper surge in new cases that lasts into the second half of 2021. In such a case, GDP in 2021 is projected to grow by 0.6percent, with consumers and investment demand affected more deeply, and to increase by 2.8 percent in 2022. Risks are firmly tilted to the downside.

Oil prices are forecast to increase to US$44/bbl in 2021 and US$50/bbl in 2022 from a projected US$41/bbl in 2020. The pandemic is anticipated to have a prolonged impact on oil consumption, which is expected to remain 5 percent below its pre-pandemic trend by the end of 2021 (Figure 50). On the production side, OPEC+ is assumed to increase production from January, as currently announced. The outlook for oil production in Russia will depend on the duration and depth of the agreed OPEC+ cuts. In the United States, low levels of new drilling, together with the rapid rate of decline of production from existing shale oil wells, are expected to lower U.S. production from 11.5mb/d in 2020 to 11.1mb/d in 2021 (EIA 2020).[40] This is a marked difference from pre-COVID trends; between 2014 and 2019 rising U.S. production accounted for 70 percent of the total increase in global production.

The main risk to the price forecast is the duration and severity of the pandemic, including the speed at which a vaccine deemed safe and effective is developed and distributed. A further rise in infection rates resulting in more stringent lockdowns and reduced travel will affect oil demand significantly more than other commodities. On the other hand, if a vaccine is developed and distributed more rapidly than currently anticipated, oil consumption could see a stronger recovery in 2021. Risks to the production outlook are chiefly to the upside include an extension of the OPEC+ cuts at their current levels, or a decline in U.S. production if new drilling fails to pick up. However, high levels of spare capacity among OPEC+ countries, as well as still elevated levels of oil inventories, reduce the likelihood of a sharp rise in prices (Figure 51). Any additional weakness in oil demand will place further pressure on oil exporters, including Russia, as they are already facing the combined negative impact of both the pandemic and the fall in oil revenue.

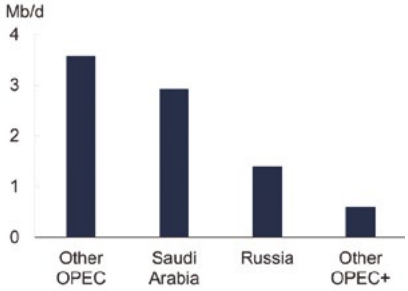
[39] Defined as an average of Brent, West Texas Intermediate, and Dubai.
[40] U.S. Energy Information Administration. 2020. "Short-Term Economic Outlook October 2020." Washington, DC.

Figure 50: The pandemic is anticipated to have a prolonged impact on oil consumption, which is expected to remain 5 percent below its pre-pandemic levels by the end of 2021 (crude oil demand forecasts)



Source: International Energy Agency; World Bank.
Note: Dashed blue line shows IEA November forecast for oil consumption. Dashed red line shows a continuation of pre-pandemic growth rates.

Figure 51: High levels of spare capacity among OPEC+ countries reduces the likelihood of a sharp rise in prices (spare production capacity among OPEC+ countries)



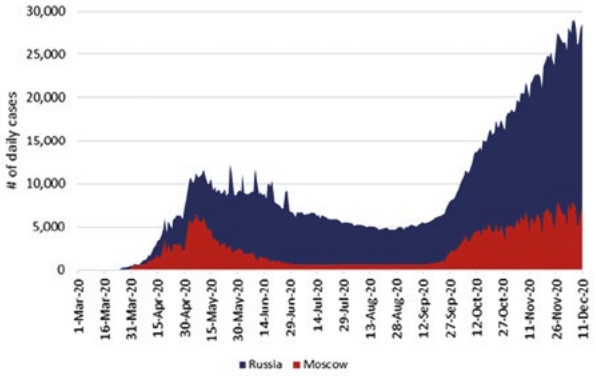
Source: International Energy Agency; World Bank.
Note: Spare production capacity estimated as the difference between a country's maximum output over the past two years and their October production level. "Other OPEC" includes all current OPEC countries except Saudi Arabia, and Iran, Libya, and Venezuela which are exempt from production cuts. Other OPEC+ includes Azerbaijan, Bahrain, Brunei, Kazakhstan, Malaysia, Oman, South Sudan, and Sudan.

Non-energy prices are expected to see a gradual increase in 2021 as the global economy recovers. After a small decline in 2020, base metal prices are projected to increase in 2021, boosted by the pickup in global activity and continued stimulus from China. Risks to this outlook are slightly to the downside, including an intensification in the pandemic and a more prolonged global recession. Precious metal prices are projected to see a modest decline in 2021 following a steep increase in 2020, as the global economy recovers and uncertainty recedes. Agricultural prices are also expected to rise slightly in 2021, with increases across all commodities, although markets remain well supplied at the global level. Despite a modest increase in prices, concerns about food insecurity in several EMDEs have risen. In addition to lowering incomes, the pandemic has created bottlenecks in food availability at the local level due to supply chain disruptions and border closures that have restricted food flows and movements of labor.

A less severe than anticipated annual economic contraction in the third quarter of 2020 led to an upgrade in Russia's economic outlook for 2020 to -4.0 percent (from -5 percent in September). Meanwhile, growth momentum is expected to stall in the fourth quarter of 2020, as the second wave of COVID-19 leads to rising case numbers in Russia and globally. The second wave of COVID-19 is more intensive especially outside of Moscow (Figure 50). Yet, the economic contraction is expected to be less severe than in the second quarter of 2020, with softer mitigation measures (distance learning, quarantines for vulnerable population groups, wearing masks in public places, and keeping social distance) as opposed to a full scale lockdown as in spring (Figure 53 and Figure 54).

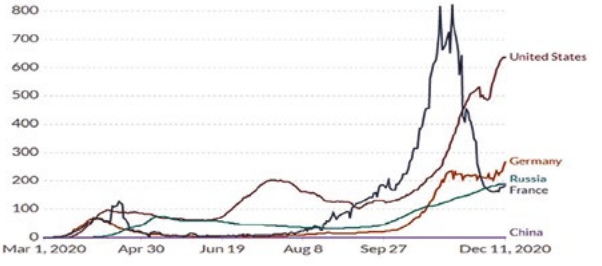
In 2020, domestic demand is expected to drag down GDP growth (-4.3 pp contribution to GDP growth). With stagnant wages and higher unemployment, household consumption is expected to fall by 6.2 percent, y/y. Lower interest rates and measures to protect household incomes will help to contain some of the drop in private consumption. Supported by fiscal stimulus of about 4 percent of GDP, government consumption is expected to expand by 3.2 percent, y/y, being the only domestic demand category that is recording growth. Despite lower borrowing costs, gross fixed capital formation is expected to drop by 7.1 percent, y/y, as the crisis pushed uncertainty to unprecedented highs globally and in Russia, narrowed companies' revenues, and worsened medium-term outlook. Lower global demand and the OPEC+ agreement, which is limiting oil production, are expected to bring export growth down to -7.3 percent, y/y, down from relatively strong performance in the first half of 2020. With a drop in revenues and fiscal stimulus, general government deficit is expected to reach 4.6 percent of GDP.

Figure 52: The second wave of COVID-19 is more intensive especially outside of Moscow



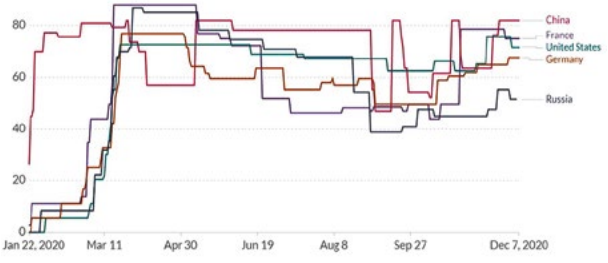
Source: stopcoronavirusrf.

Figure 53: Biweekly cases per million people started rapidly growing since September



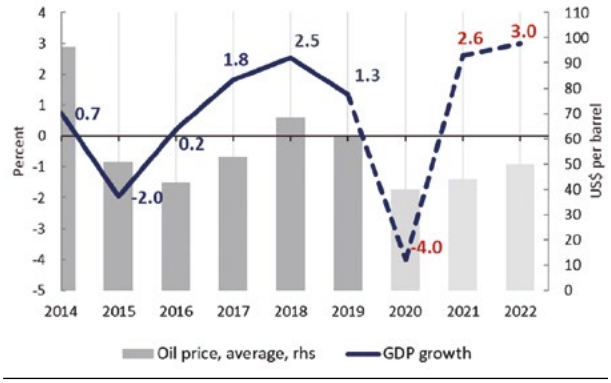
Source: OpenData.

Figure 54: Stringency index increased in September in Russia, but remained below March levels



Source: OpenData.

Figure 55: The growth forecast for Russia suggests a recovery in 2021 (real GDP growth, percent)



Source: Rosstat, World Bank.

Negative momentum will roll over to 2021, and the economy is expected to gain only a fraction of its losses in 2020 (Figure 55). The baseline scenario assumes that the daily number of infections stabilizes in the first half of 2021, owing to a combination of voluntary social distancing and pandemic-control policies. Vaccination, which started in December 2020, is assumed to continue in 2021. Consumer and business confidence are expected to improve assuming a vaccine deemed safe and effective is rolled out; this would pave the way for a gradual rebound at 2.6 and 3.0 percent in 2021 and 2022, respectively. Rebound in consumption on the back of monetary easing and improved confidence is expected to be the main growth driver in 2021 and 2022. In 2021 and 2022, investment is expected to increase by 2.5 and 4.6 percent as uncertainty diminishes. As growth picks up and the crisis subsides, general government revenues are expected to increase, supported by higher oil prices, and expenditures to decrease with gradual expenditures consolidation. General government deficit is expected to improve to 3.0 and 1.2 percent of GDP in 2021 and 2022, respectively. Deficit financing mainly through domestic debt issuance will push the general government debt to a manageable 21 percent in 2022 from 14 percent in 2019. Export value is expected to pick up gradually, with the rebound in global demand. In 2021 and 2022, restrictions on oil production in line with the OPEC+ agreement will gradually fall away, supporting export growth.

The 12-month CPI index is projected to average 3.4 percent in 2020 and to stabilize at the central bank's target of 4 percent in 2022.

Gradually increasing oil prices are expected to push up the current account balance in 2021-2022. Net capital outflow is expected to stay moderate on the back of lower profits, a weaker ruble, and a higher investor confidence based on the macro stabilization policy conducted by the government since 2015.

Table 2: A gradual rebound is projected in 2021-2022 (Major macroeconomic Indicators)

	2018	2019	2020f	2021f	2022f
GDP growth, percent	**2.5**	**1.3**	-4.0	2.6	3.0
HH consumption growth, percent	**3.3**	**2.3**	-6.2	3.1	3.8
Gross fixed capital formation growth, percent	**0.1**	**1.4**	-6.0	2.5	4.6
General government balance, percent of GDP	**2.9**	**1.7**	-4.6	-3.0	-1.2
Current account (US$ billions)	**115.7**	**65.3**	28.7	40.3	38.0
Current account, percent of GDP	**6.9**	**3.8**	2.0	2.7	2.4
Exports (GNFS), bln US$	**508.6**	**482.6**	358.0	390.7	418.8
Imports (GNFS), bln US$	**343.6**	**353.6**	289.3	304.4	334.8
Capital and financial account (US$ billions)	**-79.6**	**3.2**	-47.7	-42.3	-41.0
Capital and financial account, percent of GDP	**-4.8**	**0.2**	-3.3	-2.8	-2.6
CPI inflation (average)	**2.9**	**3.0**	3.4	3.7	4.0

Source: WB staff calculations.

The downside scenario assumes a sharper upsurge in new cases that lasts into the second half of 2021. The meaningful rollout of an approved vaccine is delayed by about three quarters and is limited by a general reluctance to be immunized. Confidence would remain depressed as authorities struggle to contain the pandemic, while financial conditions would deteriorate markedly, in part reflecting news of a delay in vaccine access. In such a case, GDP in 2021 is expected to grow by just 0.6 percent, with consumer and investment demand affected more deeply, and increase by 2.8 percent in 2022.

Poverty

The poverty rate, under the upper middle-income poverty line of US$ 5.5 per day, is expected to decline in 2021 to below 2019 levels as the economy rebounds. An uptick in poverty however in 2020 is possible, if social policies have incomplete up-take or face implementation hurdles or growth decelerates further than expected towards the end of this year.

Risks are firmly tilted to the downside. A sharp increase in new infections could lead to a reintroduction of strict lockdowns negatively affecting domestic demand. Lower-than-expected safety, effectiveness, or acceptance of the vaccine could also delay the economic recovery. New sanctions could worsen Russia's outlook. Banks could face a significant deterioration in asset quality, profitability and capitalization. Mortgage lending, in particular, has been experiencing rapid growth, supported by the government subsidized mortgage program. However, the deterioration in the macroeconomic situation due to the COVID-19 pandemic, falling incomes of the population, growing property prices, lower minimum mortgage down payment could lead to excessive lending to weaker-quality borrowers. Moreover, the current CBR's key policy rate is below the neutral range, meaning that once the economic situation stabilizes, the CBR can be expected to start tightening monetary policy. Therefore, mortgage loan portfolios accumulated under the current environment may become less profitable for banks in a longer run. The CBR has recently prolonged the forbearance on impairment recognition until end June 2021. While these measures should ease regulatory pressure and allow banks to accumulate more profits to cover increases in problem loans, they will also delay recognition of unavoidable and costly losses. The pandemic has also amplified contingent liabilities risk.

While near-term recovery will be contingent on the stemming of the pandemic, longer-term economic prospects will depend on boosting potential growth. Potential growth in Russia has been on a declining trend even prior to the current crisis[41]. Increasing competition is essential in boosting potential growth: product market regulation in Russia is restrictive to competition mainly through direct state control in the economy. The government can foster competition by leveling the playing field and strengthening state-owned enterprises (SOE) governance to make existing SOEs more efficient and competitive by: removing barriers for firms to contest markets where are present; limiting the procedural discretion with which public sector entities —SOEs in particular—procure goods and services; and considering divestiture and privatization in a transparent and competitive process for SOEs in commercial sectors. With about 15 percent of labor force employed by SOEs[42], they could have served as buffers for employment losses during the current crisis and somewhat cushioned the impact of the crisis on disposable incomes. However, SOE reform remains important to address structural constraints to lifting potential growth. The COVID-19 crisis brings opportunities for such reform in the shape of new fiscal and demand-side pressures. The fiscal crunch combined with low commodity prices is forcing the government to search for efficiency improving measures. The SOE sector presents a clear opportunity given its heavy demands on the national treasury. Historically, many countries began their most ambitious SOE reforms after large fiscal shocks, and Russia may be no exception. Digitalization is another area the crisis has unveiled as an opportunity that can speed up Russia's recovery. Russia has made good progress in digital transformation. With 96 million people online, Russia has more internet users than any other European country. E-government infrastructure now reaches more than 103 million users. And Russian digital platforms have established leading positions in many markets. Yandex is among the top-5 largest web search platform in the world; Vkontakte is among the top-5 largest global social media platform; and HeadHunter is the 3rd most popular internet recruitment platform globally. Yet Russia is the sixth restrictive of the 46 economies included in the OECD Services

[41] Okawa, Yoki; Sanghi, Apurva. 2018. Potential Growth: Outlook and Options for the Russian Federation. Policy Research Working Paper; No. 8663. World Bank, Washington, DC.

[42] IMF 2019. "Reassessing the role of SOEs in Central, Eastern, and South-Eastern Europe", data for 2016.

Trade Restrictiveness Index database in digital services such as computing, motion pictures, and sound recording. In computer services, there are relatively high restrictions on foreign entry as well as cumbersome regulations for the hiring of foreign professionals, including intra-corporate transferees, and independent and contractual service suppliers. Removing such barriers would help Russia in improving its quality and quantity of digital services exports and in upgrading in more complex global value chains that rely on imported services (see special focus).

PART III

RUSSIA INTEGRATES: DEEPENING THE COUNTRY'S INTEGRATION IN THE GLOBAL ECONOMY

Over the past two decades, Russia's growth has been supported by sizable investment, rising consumption, exports of energy products, and through greater openness and external orientation of its manufacturing sector. During this time, the services sector has also been an important driver of Russia's economic growth. Despite these developments, Russia is not yet fully integrated into GVCs, trade, and the global FDI network, implying untapped potential.

This part of the report synthesizes the findings and policy recommendations of the analysis of Russia's integration in the global economy. It also investigates the impact of services on productivity in Russia; examines constraints to the development of the services sector and services trade; and identifies areas for policy intervention to support services growth and to deepen services integration in trade and GVCs. Because a large part of GVC integration happens through FDI, it assesses the role played by multinationals in the Russian economy; evaluates Russia's FDI performance in comparison with other peer countries; and reviews the efficiency and effectiveness of Russia's FDI policy and regulatory framework.

1. Motivation

Russia's early development successes resulted from undertaking ambitious structural reforms, a commodity cycle boom, and taking steps to promote greater economic openness, including becoming a member of the WTO in 2012. Between 2000 and 2012, Russia's gross domestic product (GDP) rose on average by 5.2 percent a year, slightly below the 5.8 percent average for all upper middle-income countries over the same period, but above the 2.9 percent average for the global economy as a whole. Per capita GDP in real terms grew by about 80 percent between 2000 and 2012 (from US$14,615 to US$26,013 in purchasing power parity (PPP), 2017 prices). Since 2003, Russia has been the sixth largest economy in the world in PPP terms, moving up from ninth position in 2000. A favorable external environment and strong macroeconomic fundamentals facilitated inclusive growth throughout the 2000s. Structural policies were also key drivers of growth, reflecting the impact of reforms and structural changes launched during this time.[43] Breaking the 2000s decade into early and late periods reveals that structural policies were the key driver of growth in the early 2000s (2000 to 2005). With better terms of trade, the contribution of the external environment to growth improved significantly from 2005 to 2010. Prudent macroeconomic management and booming oil revenues facilitated fiscal surpluses, a reduction in external debt, and a rise in reserves. This helped Russia to respond with strong countercyclical policies to the recession during the 2008–09 Global Financial Crisis, limiting its impact on the economy.

Meanwhile, potential growth estimates for Russia show that it peaked before the Global Financial Crisis and has since continued to decline. The estimated potential growth rate — the rate at which the economy can grow when labor and capital are fully employed — was 3.8 percent in 2000–09 and 1.7 percent in 2010–17.[44] This deceleration was due to a slowdown of productivity growth and a shrinking potential labor force, rather than a shortfall in capital accumulation. In 2014, the economy suffered from adverse oil price shocks and the imposition of economic sanctions, which led to Russia becoming more insular and less integrated globally. One manifestation of this has been reduced foreign direct investment (FDI) inflows since 2014. Although economic activity in Russia has continued to recover from the 2015-16 recession, potential growth has continued to decline. A weakness in potential growth is not specific to Russia. Potential growth has been adversely affected in both advanced economies, where it was evident even before the Global Financial Crisis, and emerging markets and developing economies, especially since 2010-12. However, a faster-than-average decline in Russia's potential growth has raised concerns about its medium-term prospects and the risks of stalled convergence in GDP per capita with advanced economy levels.

These developments have focused attention on the need for a renewed economic strategy and the establishment of new National Goals, which could boost potential growth and productivity for Russia in a constrained environment. The new National Goals were announced in 2018 and suggest, among other things, that Russia will strive to develop export-oriented subsectors with modern technologies and highly skilled labor in its major economic sectors (manufacturing, agriculture).

[43] Pathways to inclusive growth, 2016, World Bank.
[44] Potential Growth. Outlook and Options for the Russian Federation. Yoki Okawa, Apurva Sanghi, December 2018, World Bank.

Further integration into Global Value Chains (GVCs) would be an important step towards achieving Russia's National Goals, as increased GVC participation promotes diversification and economic growth and magnifies the gains of traditional trade. The World Development Report (WDR) 2020 finds that GVC participation, especially in manufacturing, magnifies the effects of traditional trade and contributes to increased productivity, better jobs, and lower poverty (World Bank 2019)[45]. There are opportunities for GVCs to drive Russia's economic growth, by deepening and expanding Russia's participation in manufacturing and services GVCs, through upgrading into higher value-added products, functions, and processes. In turn, deepening the country's integration into GVCs in such a way could promote its National Goals to develop exports of highly technological manufactured and agricultural goods, create jobs in sectors exporting such goods, and speed up Russia's technological development.

The COVID-19 pandemic has reinforced and accelerated changes in GVCs that were already underway and Russia needs to position itself in this context. The pandemic has posed unprecedented challenges to GVCs. There has been a sharp downturn in trade and FDI, after an already subdued performance in 2019, in part due to the disruption of GVCs amid mitigation and mobility limiting measures, including national lockdowns and border closures. While declines in GVC activities have been seen across most sectors, some have suffered more disruption than others particularly those that are concentrated in heavily affected areas or those relying on face-to-face interaction and in-person spending. Before the pandemic, mega-trends towards automation; concentration of market power in some industries (e.g. digital markets and platforms); increased reshoring and regionalization of supply chains; economic protectionism and bi-polarization of US-China relations; as well as a shift towards digitization were steering tectonic shifts in the global economy. The pandemic has reinforced and accelerated these changes. This disruption has led to a rethinking in relation to GVCs, as some firms have recognized the risks associated with dependence on few markets, and advanced countries seek to build more resilient value chains by re-shoring or near-shoring production regionally. Potential GVC reconfigurations could create opportunities for countries such as Russia that are close to major markets, benefitting from possible near-shoring, and have both comparative advantages in relevant sectors and open and conducive trade and business environments.

While there may be no close comparators for Russia, countries such as Canada and Australia provide examples of the trajectory Russia could take in transforming the structure of its economy from primary commodities to advanced manufacturing and services. For instance, as Canada's economy modernized after the First World War, its focus shifted increasingly from farming to industry and services, from rural to urban. While in the early 1980s, Canada's main export sectors consisted of minerals and metals, by the early 1990s the automobile industry emerged as a leading sector. In addition, new sectors emerged — specifically pulp and paper and oil/petroleum, as well as hydroelectricity. By 2015, Canada's export structure showed a balanced distribution between commodities, manufacturing and services with the top sectors being automotives, machinery and equipment and energy, followed by metals and minerals and consumer goods (Cross 2016). Key to its success was trade with international markets and integration into key value chains, specifically those in the USA, which were fostered by the Free Trade Agreement with the USA in 1989 and the North American Free Trade Agreement (NAFTA) in 1994. Similarly, since the early 20th century the structure of the Australian economy has gradually shifted away from agriculture and basic manufacturing towards services, with the mining industry growing in importance relatively recently. Economic activity also shifted towards the resource-rich states of Queensland and Western Australia. Changes in the structure of the economy have been driven by a range of factors including rising demand for services, the industrialization of east Asia, economic reforms, and technical change.

This study therefore assesses how GVCs have contributed to Russia's development over the past two decades as well as the potential for GVCs to drive future economic growth. Based on the opportunities identified for Russia's integration into GVCs, constraints are revealed and several policy recommendations developed to overcome these, covering areas of trade policy, domestic and traded services, and the role of institutional and regulatory quality in boosting FDI. While the analysis portrays Russia in a post-sanctions environment – distinctly less connected to global markets, less innovative, and with an unlevel playing field between public and private sectors that hinders competition – the findings indicate significant potential for Russia to make progress in terms of greater participation in the global economy. And while sanctions remain a first-order constraint for FDI, there are various measures that Russia can nonetheless take to make its business environment more conducive to trade and investment.

[45] Based on I/O-based measures, GVC trade relates to trade flows that cross at least two borders, while traditional trade can be considered trade that crosses only one border.

2. Russia's participation in GVCs

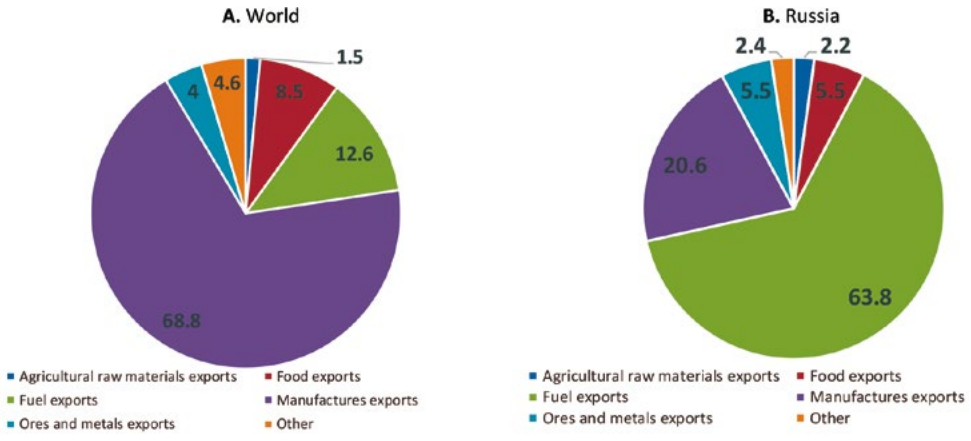
Over the past two decades, Russia's growth has been supported by sizable investment, rising consumption, exports of energy products, and through greater openness and external orientation of its manufacturing sector. During this time, the services sector has also been an important driver of Russia's economic growth and, as in other upper-middle-income countries, the services sector accounts for the largest share of GDP. Despite these developments, Russia is not yet fully integrated into GVCs, trade, and the global FDI network, implying untapped potential. Russia's current position is linked to its comparative advantage in commodities and commodity-intensive manufacturing. However, in recent years, the services sector has also been a driver of increased GVC participation.

Russia's fundamentals determine its type of GVC participation and sectoral specialization. GVC participation is determined by four fundamentals: factor endowments, geography, market size, and the quality of institutions (World Bank 2019). Russia's natural resources, geographical remoteness, and perceived low institutional quality are key characteristics of countries specialized in commodity GVCs. By contrast, Russia is not comparable with the majority of countries in the commodity group (such as Sub-Saharan Africa or Latin America) that are characterized by a smaller market size and relatively cheap labor. Russia's characteristics are consistent with high forward GVC participation, i.e. a high share of domestic value added in its exports that is not directly consumed in the export destination but re-exported, limited backward GVC participation, i.e. a limited share of foreign value-added in its exports, and FDI driven by natural resources. They are also consistent with low export diversification and sophistication, although the country has been diversifying and upgrading in GVCs over the past years.

Russia has untapped potential to integrate further into GVCs, trade, and the global FDI network

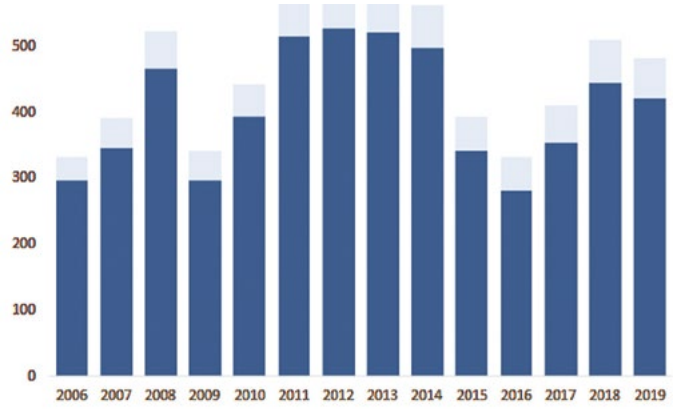
Russia's high sectoral concentration in commodities presents both opportunities and challenges. In 2018, Russia was the 12th largest exporter in the world, accounting for 2.3 percent of global exports. The country's goods exports go mostly to China and the EU, whereas its services exports are mostly to the EU and the USA. Russia specializes mainly in mining and commodity-intensive manufacturing exports, such as metals and chemicals. Russia's RCA – the relative advantage of a country as evidenced by trade flows – is concentrated in oil and gas products, agriculture and forestry, and metals. As a result, Russia's share of manufacturing exports is about three times less than the world's average (Figure 56). Besides commodity-intensive manufacturing exports like metals and chemicals, Russia also exhibits export activity in food and beverages, machinery, electronics, and transport equipment. And while it exports business services, such as wholesale and retail trade, storage, and transportation, the value of goods exports far exceeds that of services (Figure 57).

Figure 56: The share of manufacturing exports in Russia is about three times less than the global average



Source: Comtrade.

Figure 57: The value of Russia's goods exports far exceeds those of services, billion US$



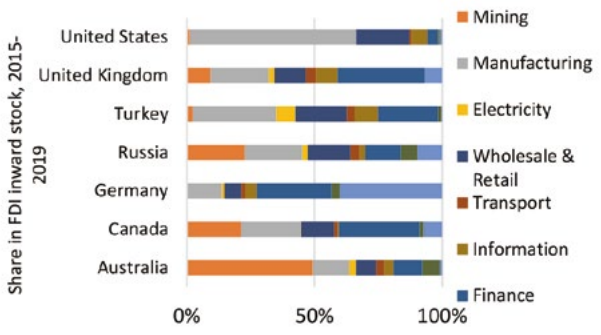
Source: CBR.

Russia's natural resource endowments not only dominate trade patterns, but also its inward FDI stock. Russia's FDI is driven mostly by natural resources rather than skills (Figure 58a): one-fifth of Russia's inward FDI stock is in mining industries, building on the country's comparative advantage in petroleum, natural gas, and coal mining. However, there have been some positive developments in greenfield investments. While 50 percent of mergers and acquisitions concerned oil, natural gas, and mining in 2015-2019, almost 70 percent of greenfield investments went to manufacturing industries. In 2018, 52 percent of Russia's inward investment originated from tax havens (Figure 58b). FDI from a selected group of OECD countries – whose R&D expenditures are high relative to GDP – accounted for only 12 percent of Russia's inward FDI, compared to 22 percent in Turkey and 60 percent in Canada.

While Russia occupies an important position in the European FDI network, there is untapped potential to expand its role globally. A network analysis finds that the USA, the UK, China, Germany, France, and Canada stand out as the dominant nodes of the "real" FDI network, whereas Russia stands in the mid-range, reflecting a limited influence globally but of reasonable importance in Europe. The most influential nodes overlap significantly with the

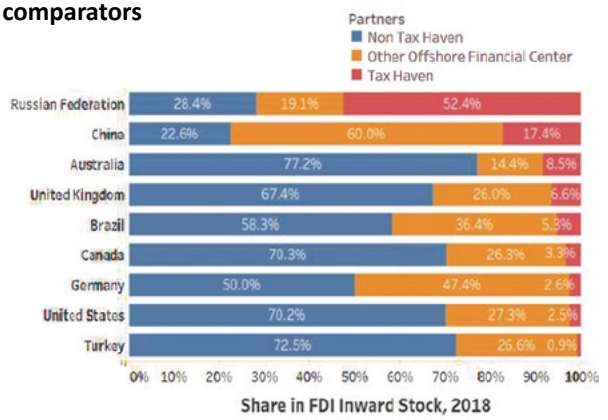
Figure 58: Russia's FDI is largely driven by its natural resource endowments and originates more from tax havens

a. Russia's FDI is driven more by natural resources than skills



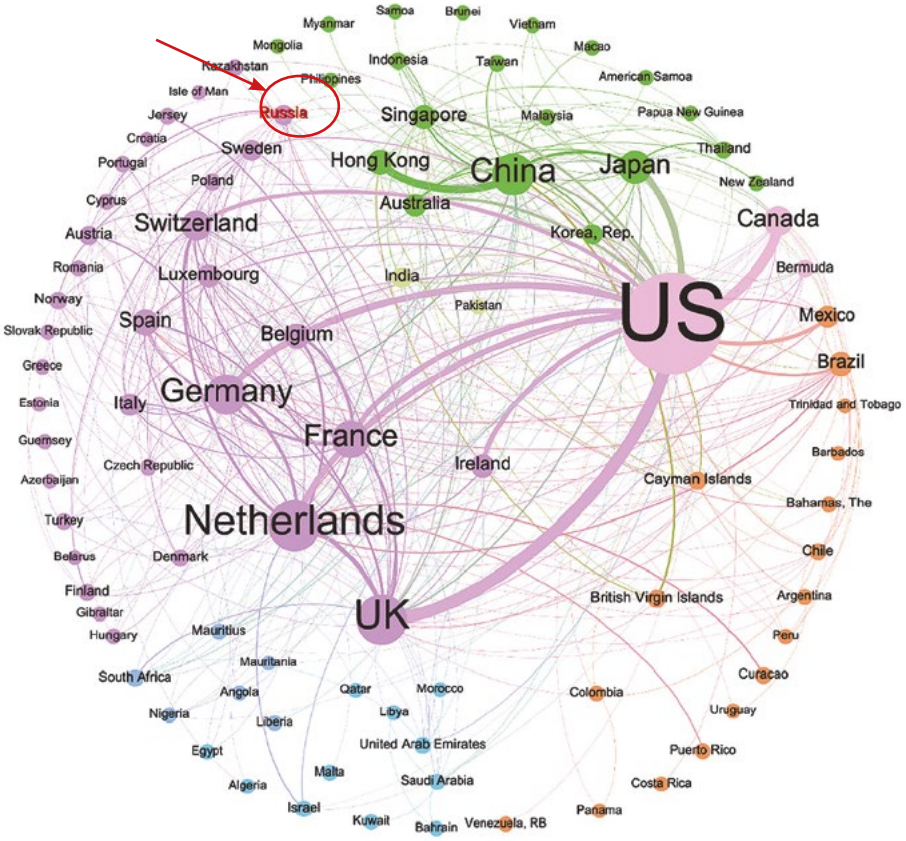
Source: Authors, based on data from the Central Bank of Russian Federation and OECD.
Note: 2019 for Russia and latest available year over 2015-2018 for other countries. ISIC Rev 4 Section-level classification is used. Only top sectors are shown and the total FDI of these sectors are rescaled to 100 percent.

b. Russia attracts more FDI from tax havens than comparators



Source: Authors, based on data from IMF CDIS, and OECD.
Note: The tax haven group includes 28 commonly known low-tax offshore financial centers. The other offshore financial center group includes five offshore centers with a high level of real economic activities.

Figure 59: Russia is second-tier in the global FDI network



Source: Authors based on data from Damgaard et al. (2019).
Note: The graph depicts the network of global "real" FDI stocks in 2017. Each node represents an economy. The colors of the nodes indicate regions. Each link represents the existence of the FDI connection between the corresponding pair of economies, with the width of the link indicating the value of the bilateral FDI stock. The size of each node represents the weighted degree of the corresponding economy. Links with less than US$5 billion FDI stock are excluded for ease of presentation.

largest economies in the world (Figure 59). Positions in the FDI network and in the GVC network tend to correlate. Consequently, Russia is currently a second-tier node in the global GVC network, dominating the networks of fuel and iron ore but playing a more peripheral role in others. Electronics is a case in point: Russia is largely outside of its sophisticated supply chain.

Reflecting the country's comparative advantage, Russia's sectoral specialization in commodities explains the country's pattern of low backward and high forward participation in GVCs, which is typical of commodity exporters. An analysis of value-added in trade reveals that Russia has a low degree of backward participation in GVCs compared to its peers but higher forward participation (Figure 60). A high share of foreign value-added in exports – a measure of backward GVC participation – allows a country to import the necessary inputs to be able to produce exported goods, components, or services. In 2016, Russia's backward integration into GVCs was 10.2 percent, lower than the EU average, lower than Norway and much lower than Turkey and China, which both had shares of around 17 percent each and especially Canada. Forward GVC participation is a measure of a country's value-added that is not directly consumed in the export destination but re-exported. High forward GVC participation means that a country exports more intermediate goods and services used for other countries' exports. Thirty percent of Russia's exports are embodied in foreign country exports, representing the highest share among comparator countries besides Norway. A high degree of forward participation is consistent with the fact that Russian exports are largely commodities, which are not re-exported by Russia's trade partners in their original form but are embodied in processed forms, for example, in partners' exports of parts and components or final goods.

Figure 60: Russia's backward participation is lower compared to its peers, but its forward participation is higher



Source: OECD-WTO TiVA 2018 release. 2016 estimates for backward participation, 2015 data for forward participation.

Russia has been diversifying and upgrading in GVCs

Over the past years, Russia has been diversifying and upgrading in GVCs. Russia's overall potential for economic upgrading has increased, with total goods exports moving closer to final demand and imports moving slightly upstream (Figure 61). A high upstreamness of a country's export or import basket indicates a long distance to the final consumer. The difference between a country's upstreamness of imports and exports can indicate potential for economic upgrading. Nevertheless, there remains scope for more domestic transformation in chemicals and metals. Russia's exports within these sectors are the most upstream compared to peer countries, implying that Russia specializes in segments within the metals (e.g. focusing on basic metals rather than fabricated metal products) and chemicals value chains that require less transformation and create less domestic value addition.

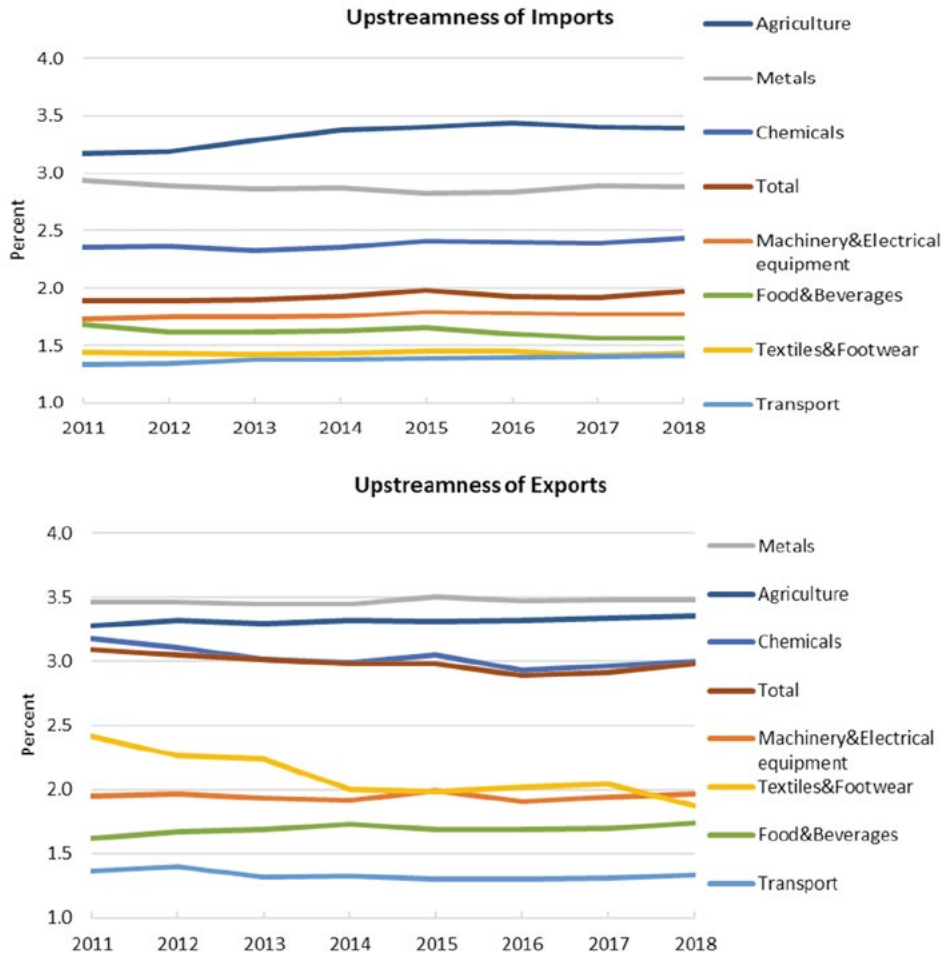
Russia's backward GVC participation has also been expanding but remains at low levels. The country's overall backward integration into GVCs increased slightly between 2011 and 2016. At the broad sector level, this participation increased in mining and business sector services, but declined across many manufacturing sub-sectors. Russia's peers, by contrast, saw their GVC participation fall across all broad sectors. Russia relies predominantly on China, and to a lesser extent the USA, Germany, and Kazakhstan, to provide foreign inputs to use in its exports.

At the same time, Russia's high extent of forward GVC participation has declined. This decline between 2011 and 2015 reflects the country's lower weight of raw commodities and processed fuels relative to exports for final consumption. The decline also reflects a lower contribution of commodity-intensive sectors (e.g. mining, coke, chemicals, basic metals), driven in part by falling commodity prices, and other manufacturing, while that of total business sector services remained constant. This trend has been mirrored by most comparator countries, with the notable exceptions of China and Turkey. Russia relies strongly on final demand from China, the USA, and Germany, which jointly consumed more than 29 percent of the foreign final demand for Russian value added in 2015.

Russia's services sector has been an important driver of increased GVC participation. While Russia's endowments with natural resources explain its current position in GVCs, the services sector also offers important opportunities for increased GVC participation and upgrading. In 2017, as the relative importance of manufacturing and agriculture declined, services contributed 62 percent to Russia's GDP in value-added terms, up from 56 percent in 2000. However, the contribution of services to total value-added in Russia is still low relative to most comparator countries such as the USA (80 percent in 2017) and the EU (72 percent) (Figure 62).

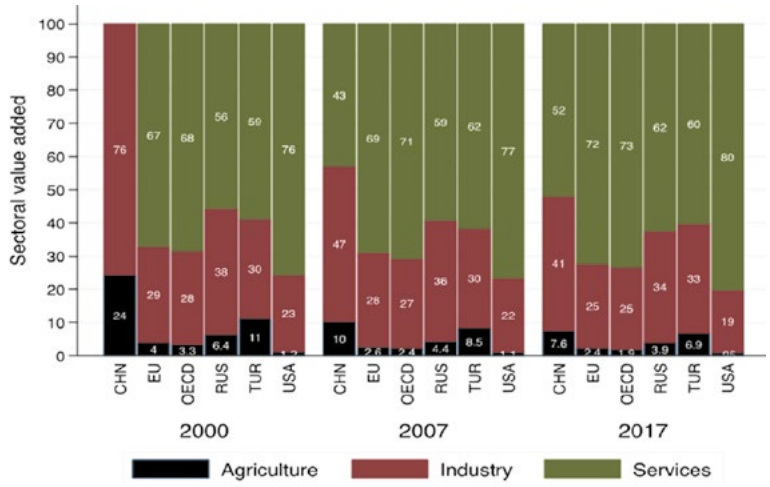
Russia's position in GVCs also explains why its trade openness is lower than in other countries with similar income levels. Russia's external trade in both goods and services (exports plus imports) is a smaller percentage of GDP than

Figure 61: Russia's goods export basket has moved closer to final demand, while imports have moved slightly upstream



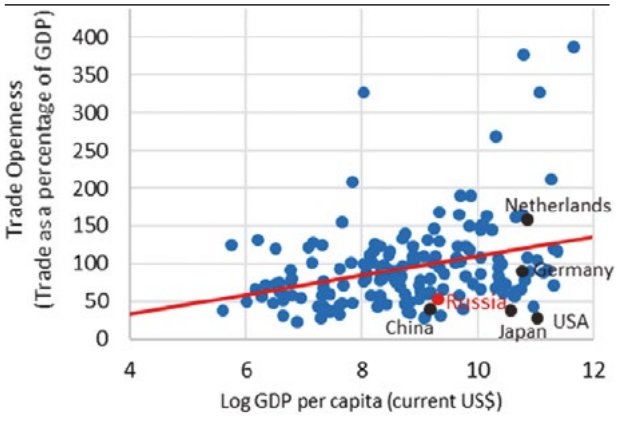
Source: Authors' computations, adapted from Chor (2014) and UN Comtrade.
Note: Upstreamness measures the position of a country in the supply chain in terms of its distance (or number of production steps) to the final consumer. Upstreamness measures at the HS6 product level are used to compute the average upstreamness of a country's export and import baskets based on the country's underlying HS6 goods exports (imports, resp.) and using the country's underlying export (imports, resp.) shares as weights.

Figure 62: The contribution of broad sectors to value-added in Russia (Sectoral value-added shares, 2000-17)



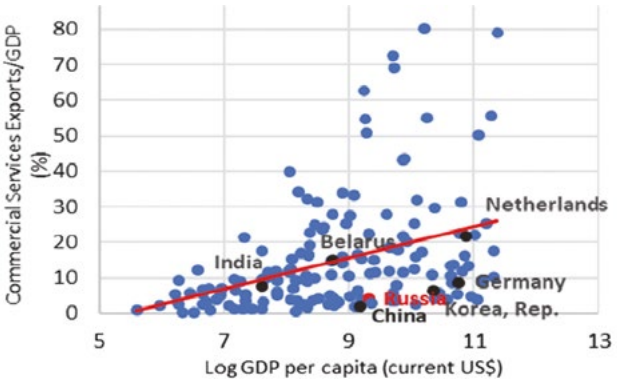
Source: Authors' calculations based on data from WDI.

Figure 63a: Russia's trade openness is lower than expected given its national income level (2018)



Source: WDI.

Figure 63b: Russia's commercial services trade is lower than expected given its national income level (2018)

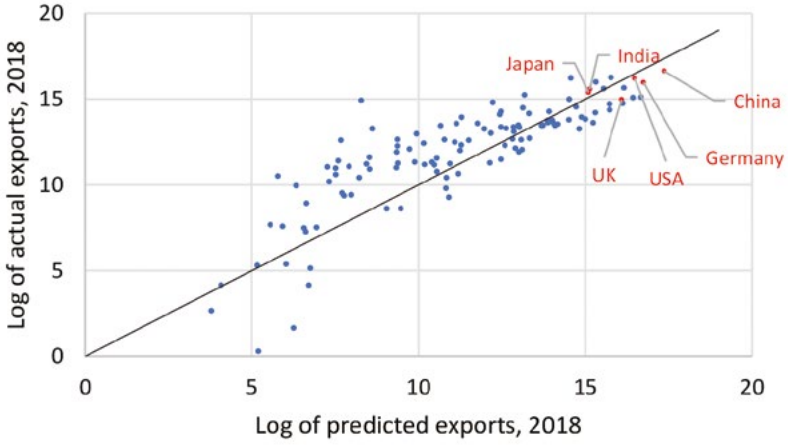


Source: WDI.

in other countries with similar levels of per capita income (Figure 63a and Figure 63b). However, trade openness measures may be somewhat misleading since a low ratio does not necessarily imply high (tariff or non-tariff) barriers to foreign trade but may be due to other factors, such as size of the economy and geographic remoteness from potential trading partners, which can be assessed using a gravity model.

Results from a gravity model of bilateral trade suggest that Russia has the potential to trade more with some large economies, including China (Figure 64). Russia's trade potential with selected countries and country groupings was assessed based on a gravity model of trade, controlling for a country's economic mass, bilateral distance, and other determinants. The model controls for zero trade flows with the use of the Heckman sample selection correction method. Figure 9 shows Russia's predicted non-oil/gas exports for all of the country's bilateral export relationships. The results reveal that Russia under-trades with some of the largest economies in the world, including the USA and China. The gap between actual and predicted trade flows is equivalent to nearly 35 percent of Russia's current trade with China. By contrast, Russia's current level of exports to the CIS countries is significantly higher than predicted levels – more than double – possibly due to active trade policies implemented by Russia and the CIS countries and political ties between those countries. Belarus is the top export partner among the CIS countries, followed by Kazakhstan.

Figure 64: Russia has the potential to trade more with some large economies, including China



Source: Authors' estimates using 2018 COMTRADE, WDI, and CEPII data. Note: Points below the black 45-degree line show those countries that Russia under-trades with.

The quality of Russia's exports of goods and services also have room to improve. In line with the decline in forward GVC participation and export upstreamness, Russia's exported goods reveal a reorientation in recent years from raw commodities and processed fuels towards exports of intermediate goods and to a lesser extent final goods. But despite a higher reliance on non-commodity goods exports, Russia has not improved the quality of its export basket in the past 10 to 15 years as measured by export sophistication and survival rates.

3. Opportunities for GVCs to drive Russia's future economic growth

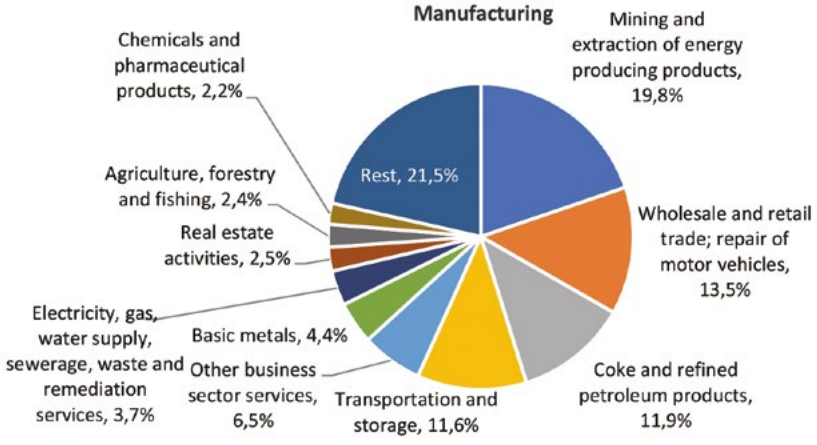
Russia has important opportunities to promote upgrading into advanced manufacturing and services GVCs. Increasing the domestic value added through GVC participation can include engaging more firms and workers (densification), but also integrating higher value-added products, functions, and processes (Taglioni and Winkler 2016). Opportunities for Russia include: (i) deepening and expanding GVC participation in manufacturing, in particular in commodity-intensive sectors such as chemicals, metals, and the food value chain (functional and product upgrading); (ii) upgrading into more complex GVCs such as higher-value added segments within these manufacturing sectors and strengthening the role of higher-value added modern services that can be embodied in manufacturing exports or exported directly (functional and product upgrading); and, (iii) facilitating FDI and spillovers which act as a catalyst for Russian GVC upgrading, due to the potential to deliver productivity and technological spillovers (process upgrading).

Deepening and expanding GVC participation in manufacturing

Diversifying into commodity-intensive manufactured export sectors can help strengthen linkages between GVC actors and local suppliers, capture more domestic value added, and benefit a larger part of the economy. Given Russia's specialization in commodities, the country should seize the opportunity to expand commodity-intensive manufacturing such as chemicals, metals, and food production which is a form of functional upgrading away from commodity exports only. In addition, backward linkages of manufacturing exports to domestic supplying sectors are more diversified compared to mining and business services, where a large share of linkages is within the sector (Figure 65). This implies that the gains from GVC participation in manufacturing could spread more equally across the economy, also leading to reduced macroeconomic volatility.

Improving export sophistication, even of moderate complexity goods for which Russia has a revealed comparative advantage, could be further exploited. Russia continues to rely on commodity exports, and the country exports considerably more goods than services – although the value of the latter has been rising. Over the past five years, notable gains in competitiveness in merchandise exports have been observed in food, machinery, and equipment, which saw the highest growth in volume terms. However, Russia's overall export basket suffers from low levels of

Figure 65: Russia's manufacturing exports show more diversified linkages to domestic upstream sectors



Source: OECD-WTO TiVA 2018 release. 2015 data.
This chart shows the distribution of domestic upstream sectors providing inputs to the manufacturing export sector in Russia.

sophistication. Notably, Russia continues to specialize in basic tasks within the metals and chemicals value chains that require less transformation and create less domestic value addition, revealing room for product upgrading. For example, Russia's metal exports are dominated by manufactures of basic metals such as copper, aluminum and nickel, while fabricated metal products such as parts, containers, structures or household articles play a much smaller role.

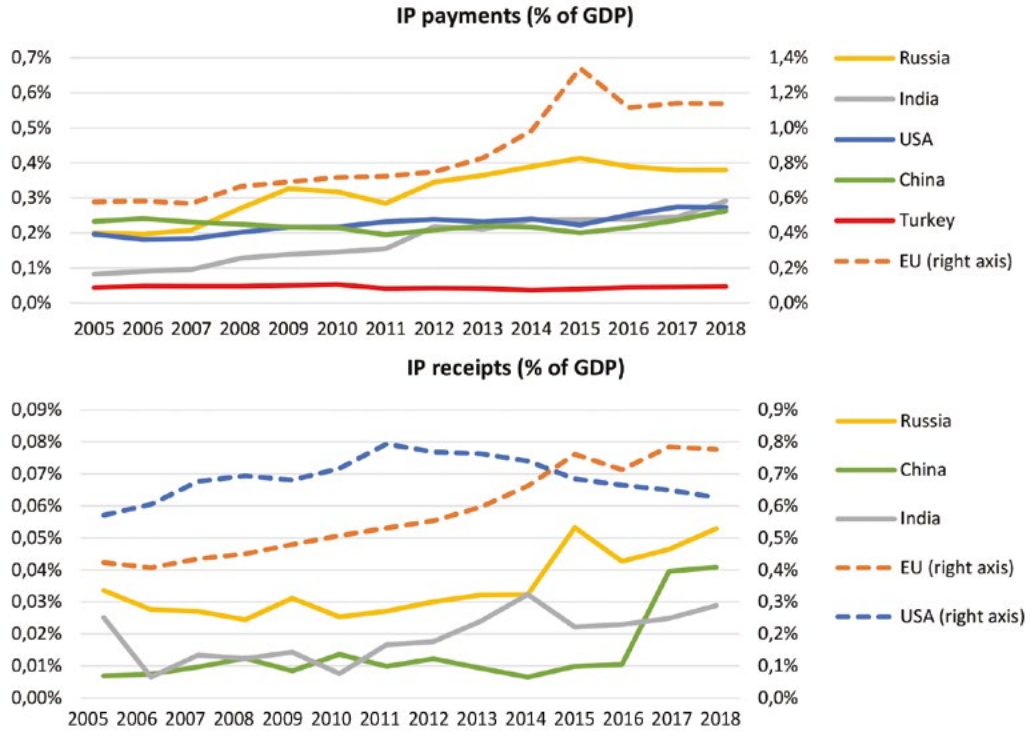
Upgrading into more complex GVCs

High value-added services provide opportunities for Russia to generate new high-productivity, high-paying jobs compatible with a high-income economy. Services are an escalator for economic development. Productivity growth in services has been a key driver of GDP growth for OECD countries as well as developing countries. Services such as those involved in manufacturing (e.g. research, development, design, and marketing and product servicing), as well as logistics, education, medical, and other professional services, provide opportunities for Russia to diversify. The country's payments on intellectual property (IP) as a percentage of its GDP are now higher than for most comparator countries except the EU, following a strong increase over the past years, and IP receipts are higher than in China and India (Figure 66). This could reflect the country's effort to not only benefit from foreign technology (IP payments), but also to innovate (IP receipts).[46] However, export growth of Russia's services sector has so far been weak, particularly in modern services which high-income countries increasingly rely on.

While there is untapped potential to grow modern services, Russia's services exports remain concentrated in lower productivity traditional activities such as transport and travel. In recent years, modern services, such as financial,

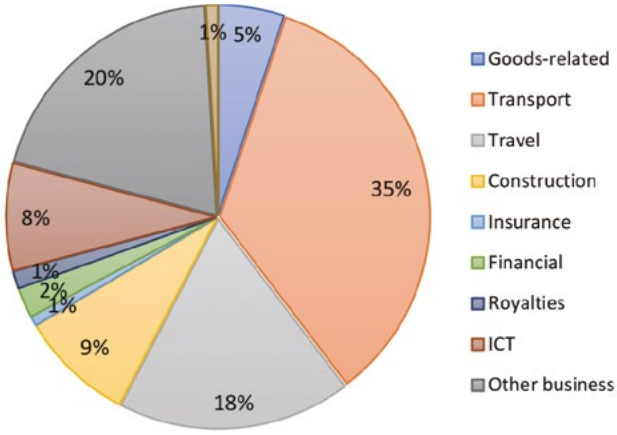
[46] A sectoral analysis reveals that almost 70 percent of IP payments are spent on information and communication technologies (ICTs). One hypothesis could be that this is related to strong increases in military expenses over the same time period (Moscow Times 2019). IP receipts are collected from various sectors, in particular retail and wholesale trade (39 percent), manufacturing (28 percent) and ICTs (19 percent).

Figure 66: Russia's IP payments and receipts as percentage of GDP grew strongly over 2005-2018



Source: Own illustration. Data: World Development Indicators.
Note: IP receipts data for Turkey only available for two years. IP data are based on Balance of Payments data covering payments and receipts between residents and nonresidents for the authorized use of proprietary rights (such as patents, trademarks, copyrights, industrial processes and designs including trade secrets, and franchises) and for the use, through licensing agreements, of produced originals or prototypes (such as copyrights on books and manuscripts, computer software, cinematographic works, and sound recordings) and related rights (such as for live performances and television, cable, or satellite broadcast).

Figure 67: Traditional services and markets dominate Russia's services exports (composition of Russia's services exports, 2018)



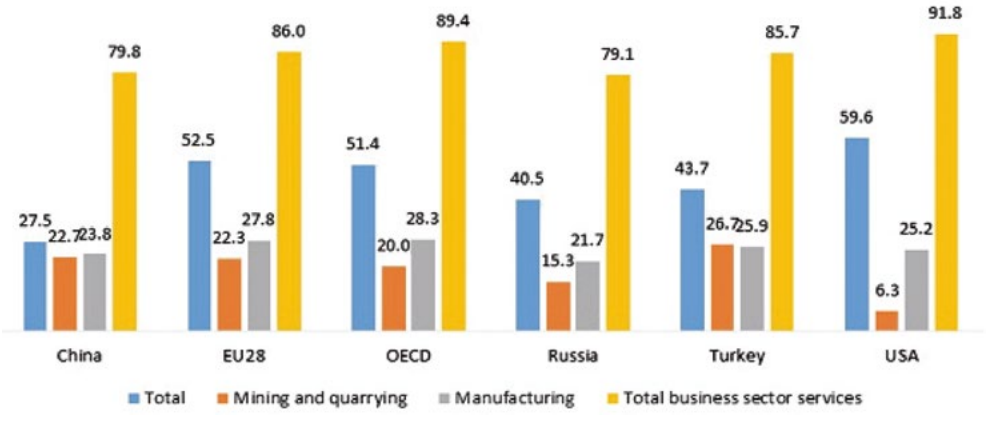
Source: Authors' calculations based on data from UNCTAD.

business, and ICT services, have witnessed dynamic growth. Nevertheless, Russia's services exports remain concentrated in traditional services (notably transport and travel, which accounted for more than half of total service exports in 2018) (Figure 67). Russia's shares of both traditional and modern services exports in GDP are lower than would be expected given the country's level of economic development, implying scope for expanding exports of both.

In an effort to achieve functional upgrading, Russia could also increase the share of domestic services that are embodied in its manufacturing exports. Building a dynamic domestic services sector is a necessary condition for manufacturing to thrive and plays an important role in economic diversification. Access to high-quality and efficient services is a necessary enabler for Russia to leverage global integration through higher value-added participation in both regional and global value chains. To facilitate changes in the services sector necessary to support exports, a focus on forward linkages is therefore necessary. In terms of domestic services integration with other sectors, improved access to services inputs—such as financial, ICT, and professional services—would positively affect the productivity and performance of downstream firms in Russia, boosting the prospects for export diversification and growth in all sectors.

Russia's domestic services value-added share embodied in its manufacturing exports is lower than that of most other comparator countries despite an increase in recent years. Domestic services account for 40.5 percent of total exports in value-added terms (Figure 68) but this is mostly driven by inputs to services exports themselves. The share of domestic services in non-services exports in Russia is much lower compared to its peers. For example, Russia's domestic services value-added share embodied in its manufacturing exports is less than 22 percent, compared to 28 percent across the EU and OECD countries (with the exception of Canada). Similarly, the domestic services value-added share is only 15 percent in mining, while it is more than 20 percent in all the comparator countries except for the USA and Norway. Even within the business services sector, Russia's share of domestic services value-added is less than 80 percent, behind most comparators, especially the USA with its share of 92 percent. There is, therefore, scope for Russia to increase value addition by further embedding domestic services, particularly in its non-services sectors.

Figure 68: Russia's share of domestic services in non-services exports is lower compared to its peers (Domestic services value added in exports (%), by export category, 2016)



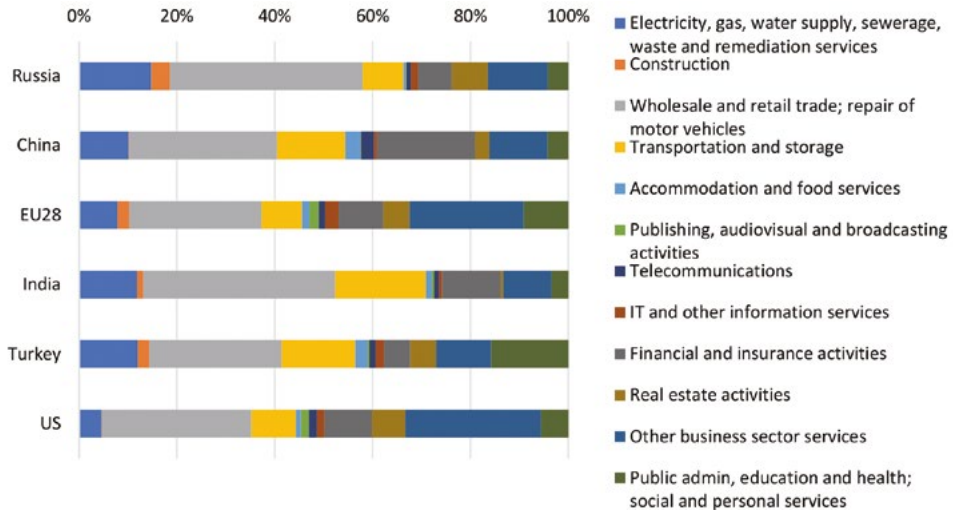
Source: OECD-WTO TiVA 2018 release. 2016 estimates.

Compared to peer countries, manufacturing in Russia relies most strongly on traditional services inputs and less on modern services. In manufacturing, domestically-supplied modern services such as business services, ICT, and financial services only make up about 22 percent of services inputs. This is the lowest of all comparator countries except Turkey, with modern services accounting for 35 percent of services inputs in China, 37 percent in the EU, 24 percent in India, 41 percent in the USA, and 20 percent in Turkey (Figure 69). Thus, there appears to be room in Russia to increase modern domestic service provision into manufacturing sectors. It is also worth noting the relatively high share of electricity, gas, and water inputs in Russia compared to other comparator countries, which is consistent with the capital-intensive manufacturing processes used.

Facilitating FDI and spillovers

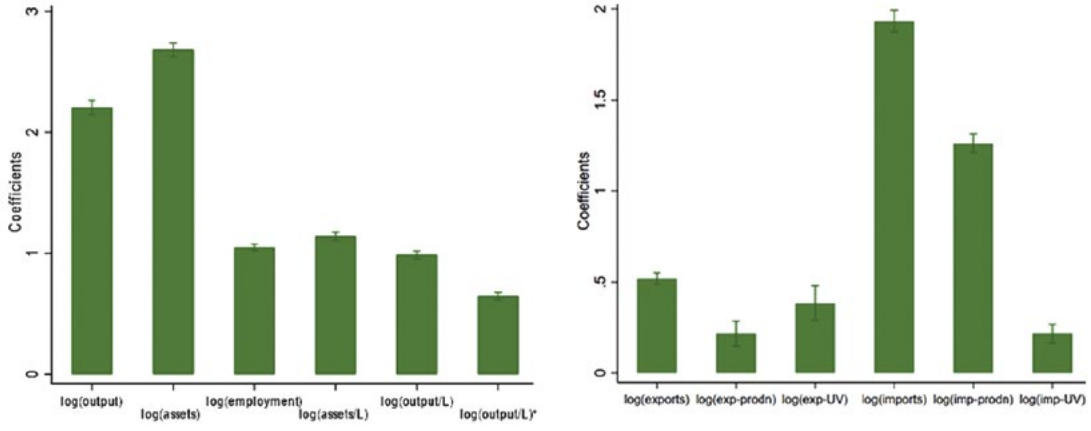
FDI can act as a catalyst for Russia's GVC upgrading. In Russia, multinational firms are investing more in fixed capital, creating more and better jobs and registering a higher productivity (Figure 70). The labor productivity of multinationals is twice as high as that of Russian firms after controlling for capital intensity, suggesting better management and

Figure 69: The share of modern services used for manufactured exports in Russia is relatively low (Composition of domestic services value added in manufactured exports, Russia and comparator countries, 2015)



Source: TiVA 2018 release.

Figure 70: Multinationals are larger, more productive and more successful in tapping into GVCs



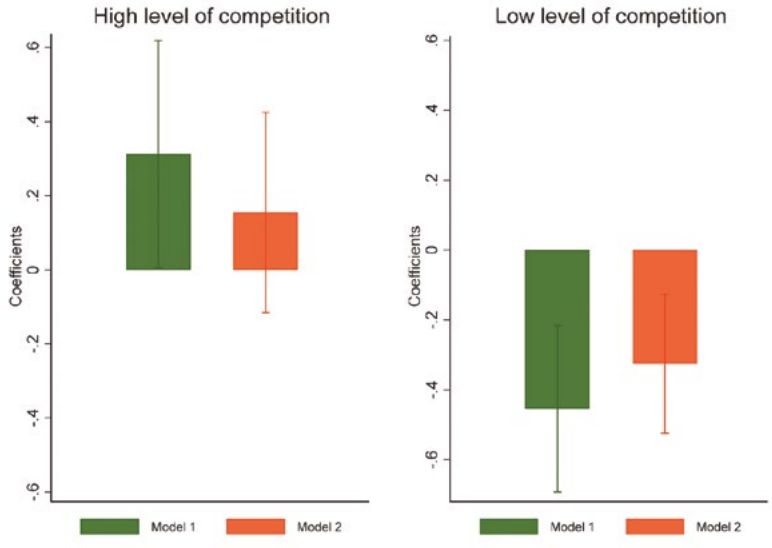
Source: Authors based on firm-level data from Ruslana and the Russian Customs.
*Note: "assets" refers to fixed assets and "L" refers to employment. * indicates the regression controlling for capital intensity. "prodn" denotes the number of products and "UV" denotes unit value. The bars represent the performance premia of multinationals over Russian firms for the outcome variables. The height of a bar indicates the estimated premium and the capped spike reports the 95% confidence interval.*

improved processes and technologies. And, they are more successful in tapping into GVCs than Russian firms. Even among GVC participants, foreign participants trade more products at higher unit values than domestic participants. Multinationals that export sell nearly 20 percent more products abroad at a 46 percent higher unit value than their domestic counterparts. On average, multinationals can act as a catalyst for Russia's GVC upgrading.

The extent to which Russian firms benefit from FDI spillovers depends significantly on whether the industry is competitive. Productivity spillovers from foreign to domestic firms are positive in competitive markets. A 10 percentage point increase in the output share of multinationals is associated with a 3 percent rise in the labor productivity of Russian firms in the same industries (Figure 71). Competition limits monopolistic behavior, allowing more productive firms to enter and grow and less productive incumbents to exit. In markets with higher contestability, domestic firms are more productive. Therefore, they are more likely to benefit from technology spillovers. In sharp contrast, spillovers are negative for firms in uncompetitive markets, and the magnitude of the impact is larger than on average—the same change in the share of multinationals will lead to a 4 percent decline in productivity. Multinationals invest in both types of markets.

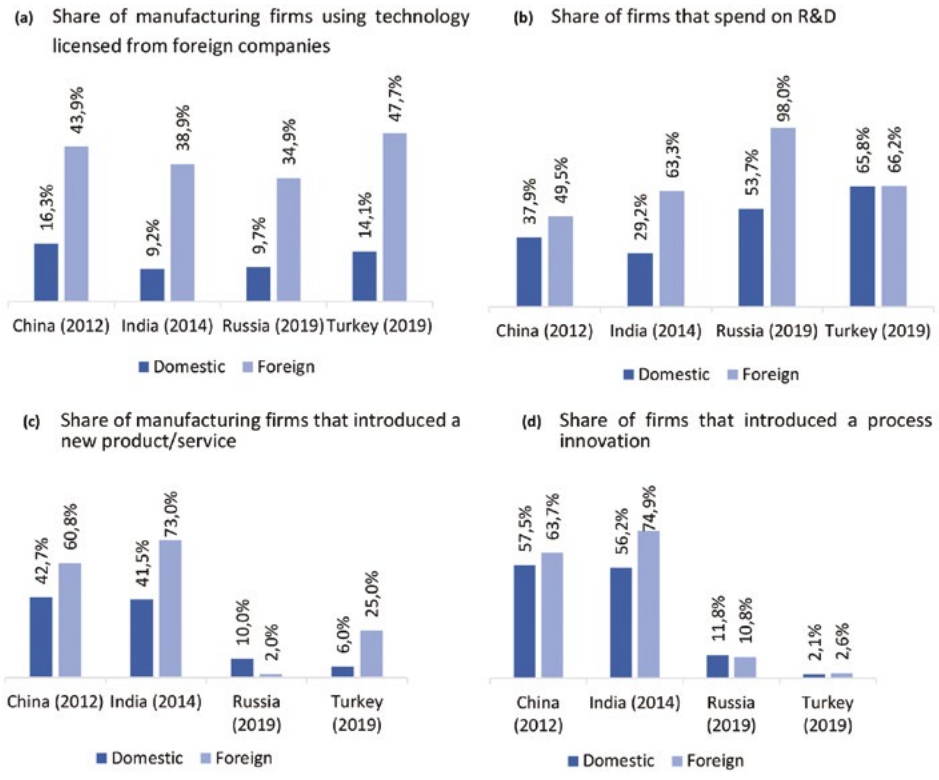
Increasing technology licensing and innovation would boost the potential for technology spillovers from foreign firms in Russia. According to Enterprise Surveys, just 35 percent of foreign firms in Russia use technology licensed from foreign companies – which could serve as a proxy for higher technology intensity – compared to a coverage reaching about 40 percent or more in Russia's peer countries, in particular Turkey (Figure 72, panel a). Despite the apparent low potential for technology spillovers in Russia currently, the coverage of foreign firms that spend on research and development (R&D) is extremely high, reaching 98 percent (panel b). The high coverage should not mask the fact that foreign manufacturing firms in Russia also often fail to innovate. The share of firms introducing a new product is just 2 percent, by far the lowest among peer countries (panel c). Foreign firms are only slightly better at innovating new processes (panel d). In both cases, foreign investors in China and India show shares of 60 to 70 percent. However, national intellectual property payments and receipts data show that Russia is spending a relatively high and increasing amount on intellectual property as a percentage of its GDP, even exceeding the USA, and it also receives higher receipts on intellectual property than China and India. These numbers suggest that Russia is making important strides in benefiting from technology spillovers and innovation.

Figure 71: Spillovers from foreign firms to domestic firms in Russia are positive in sectors with more competitive markets



Source: Authors based on a panel data of firms operating in Russia from Ruslana.
Note: The bars represent the estimated impact of the presence of foreign firms in the same manufacturing industry on the labor productivity of domestic firms. The height of a bar indicates the estimated impact and the capped spike reports the 95 percent confidence interval. The colors of the bars represent the regression model: green for a model including the presence of foreign firms in the same industry, their presence in upstream industries and in downstream industries, and year fixed-effects; orange for a model also including the labor productivity of the domestic firm in the previous year.

Figure 72: While many firms in Russia spend on R&D, few firms innovate



Source: Own illustration. Data: Enterprise Surveys.
Note: Foreign ownership = 10% or more foreign ownership share. The graphs show the percentage of domestic versus foreign firms, respectively, not controlling for sectoral or other differences. These differences are not statistically significant, i.e. differences in firm size or sector allocation between foreign and domestic firms can also explain differences in technology and innovation patterns.

4. Policy recommendations for Russia to seize the gains from GVC opportunities

While sanctions remain an important constraint to Russia's trade and investment, there are various policy measures that Russia can nonetheless take to make its business environment more conducive to economic diversification and GVC upgrading. Key policy recommendations fall broadly into three areas, namely: (i) trade policy reforms to reduce trade costs and promote participation and upgrading in GVCs; (ii) measures to enhance the role of domestic and traded services in the economy; and (iii) facilitating FDI and spillovers through improved institutional and regulatory quality and reduced restrictions. Before discussing each in more detail, these recommendations need to be contextualized along three dimensions.

First, Russia needs to be cautious of import substitution policies in the longer run and explore new ways to diversify its economy and exports. Import substitution policies are associated with challenges as a strategy to raise quality and competitiveness of domestically produced goods. Since 2014, Russia has been expanding import substitution policies – supported by a "Made in Russia" strategy, limiting access of foreign companies to public procurement – to reduce its dependency on imports, especially from Western countries. Import substitution programs are currently in place for 22 industries such as pharmaceuticals, medical, radio-electronics, transport, construction, and metallurgy, affecting about 2,000 products. While backward GVC participation in manufacturing remained constant overall (although at low levels), the drop was especially large in electrical equipment, motor vehicles, and other transport equipment which may be a result of these programs. However, this strategy has shown mixed results in terms of achieving higher domestic production levels, in large part because of low availability and quality of inputs and dependence on imported machinery and equipment from Western countries. Where goals are being achieved

– notably in the agricultural sector – a shift to exporting has indeed taken place. Yet, domestic retail prices for food products have risen while production rose only moderately in volume terms, which indicates that in this sector the cost of this policy has predominantly fallen on Russian citizens.

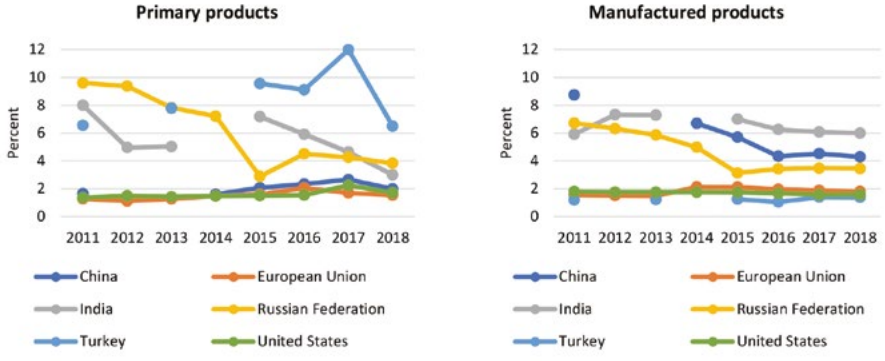
Second, some of the most important steps to supporting inclusive growth through GVC participation are synonymous with good practice structural reforms, in particular, making state presence more effective including through increasing competition. Multinationals in Russia account for significant shares of investment, employment, and output: between 2012 and 2018, they accounted for 9 percent of total fixed assets investment, 7 percent of total employment in Russia's modern sectors, and 15 percent of total output. Multinationals are on average larger, more capital intensive, and more resilient to economic shocks. This is not surprising given their control of proprietary assets, their ability to exploit firm-level economies of scale, and their location-related advantages. Consequently, multinationals in Russia are seven times more likely to participate in GVCs than comparable domestic firms, crowding them out. However, the main inhibiting factor that prevents Russian firms from benefitting from the presence of multinationals is a lack of competition. Such negative spillovers from multinationals are present only in monopolistic sectors. Spillovers from multinationals to Russian firms are positive in sectors with competitive markets. Lack of competition is also a major constraint to boosting the role of services in Russia.

Third, diversification of Russia's exports has been progressing only slowly as the economy remains structurally highly dependent on hydrocarbons. This underscores that economic diversification is possible, but more is needed. The share of mineral fuels in Russian exports dropped to 62.1 percent in 2019, compared to 70.6 percent in 2013. Russia's concentrated export structure is coupled with a low complexity of its export basket compared to other countries at similar income levels. The Economic Complexity Index (ECI) shows that the principal contribution to Russia's export growth has been provided by moderate complexity products, notably cereals, and iron and steel products, while processes of structural transformation remain largely absent. Besides low complexity, Russia struggles with low long-term export survival rates. Yet, some diversification has been achieved as 17 new products (for example, corn, precious metals ore, soybean oil) have been added to Russia's export basket since 2003, equivalent to US$54 of per capita income in 2018. However, the overall export volume of these new products remains limited. In the past five years, Russia has started more actively pursuing non-energy non-commodity export promotion policies to encourage diversification, including by establishing the Russian Export Center, which supports firms, and creating the National Project on International Cooperation and Export with five federal programs. These projects include goals to improve global competitiveness in manufacturing, agriculture, and services.

Trade policy reforms to reduce trade costs and promote participation and upgrading in GVCs

Trade liberalization can improve access to high-quality inputs of both goods and services and expand effective market size, helping promote participation and upgrading in GVCs. In particular, functional or product upgrading may require inputs from abroad to faciliate more sophisticated production at home. While import tariffs on manufactured and

Figure 73: Import tariffs on primary and manufactured products in Russia have fallen but they remain higher compared to some comparator countries



Source: WDI.
Note: Weighted import tariffs. Weighted mean applied tariff is the average of effectively applied rates weighted by the product import shares corresponding to each partner country.

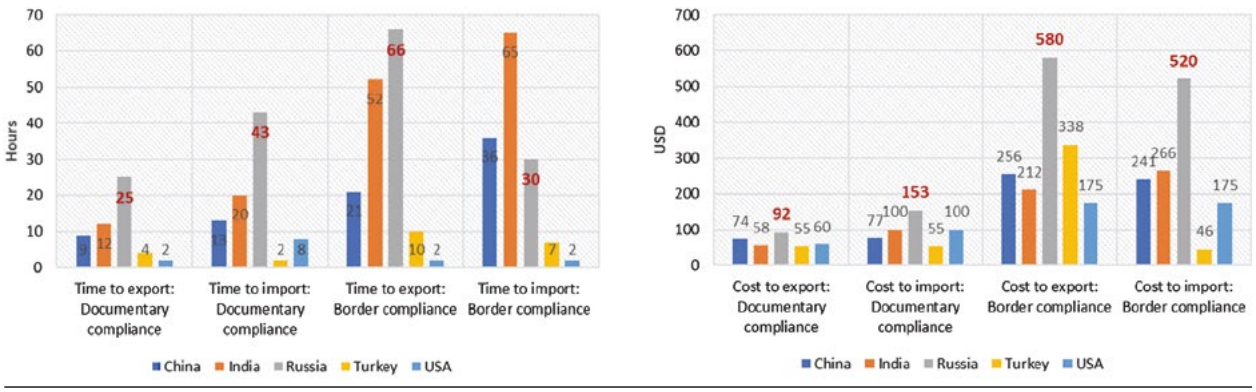
primary products have fallen strongly in Russia since its accession to the WTO in 2012, tariffs remain at levels above several peer countries (Figure 73). The weighted average of import tariffs on manufactured products in Russia fell from more than 6 percent in 2011 to 3.1 percent in 2015, but increased slightly to 3.5 percent in 2016-18. While Russian import tariffs on manufactured products are lower than in India and China, they are still twice as high compared to those imposed in the EU, the USA, and especially Turkey. And in terms of primary products, Russian import tariffs fell from almost 10 percent to 2.9 percent, but climbed back to 3.8 percent between 2016 and 2018. They remain significantly higher than in China, the EU, and the USA, highlighting room for further tariff reductions in Russia.

Lowering non-tariff trade costs could also help strengthen Russia's participation in regional value chains (RVCs) and GVCs. Estimates suggest that if Russia and other Eurasian Economic Union (EAEU) countries reduced time in trade costs, this would likely have strong impacts on trade with other EAEU member countries and likely participation in RVCs. A 20 percent reduction in the ad valorem equivalents (AVE) of the time in trade costs among EAEU members is found to lead to a 2 percent increase in Russian exports. Seven sectors in Russia are found to show an expected increase in exports of more than 8 percent: textiles and apparel; paper products and publishing; mineral products; metals; transport equipment; electrical equipment and machinery; and other manufactures. However, since the EAEU is not a well-integrated trading bloc globally, trade impacts are found to be much greater if there are spillovers to reducing trade costs with third countries. For example, if in addition to the 20 percent reduction in AVE of the time in trade costs on imports and exports within the EAEU there is a 10 percent reduction in AVE of the time in trade costs with respect to all external regions, then Russian exports could increase by 3.6 percent with 10 sectors witnessing an estimated increase in exports of between 9 and 19 percent (Figure 75).

There is much scope to lower the time and costs of trading cross-border in Russia (Figure 74). Exports in Russia are subject to lengthy documentary and border compliance procedures, taking an average of 25 and 66 hours, respectively, compared to only 4 and 10 hours in Turkey or 2 hours each in the USA Compliance times on the importing side only look better with regard to border compliance (30 hours), while documentary compliance takes an average of 43 hours, more than twice as long as in India, the second-lowest performer. The longer time required to import and export in Russia translates into significantly higher costs of roughly US$670 for a standardized container of goods, compared to roughly US$230-350 in China, India, and the USA.

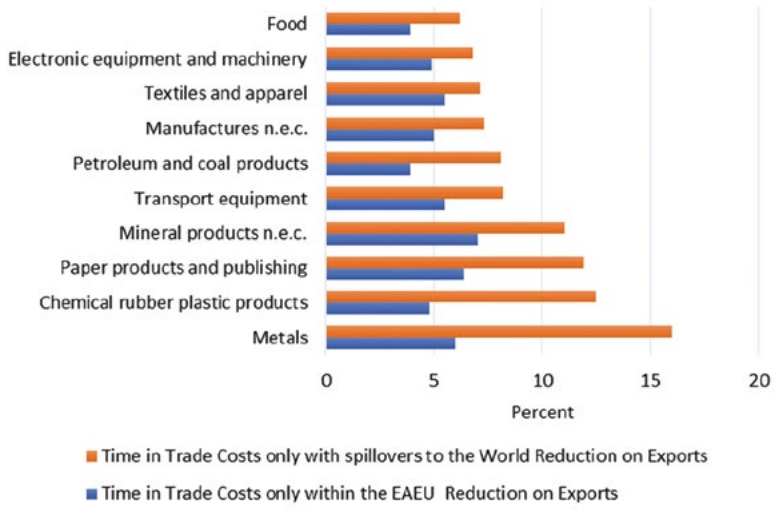
A major component of non-tariff trade costs are complex and outdated technical regulations. Standards that provide excessively detailed specifications of product characteristics and processes should be phased out, as should any standards that lack a firm scientific basis related to major policy objectives. Voluntary standards should be used in all other cases to govern other product attributes, such as quality, and should be set by private stakeholders. Aspects of products and production processes not tightly linked to major policy objectives may not need to be regulated at all. Private stakeholders may meet in national and international standards bodies when issues such as interoperability or agreement on a recognized set of product attributes arise. The emergence of international private technical standards in information and communications technology, in agro-food sectors and in the ISO process generally, provide illustrative examples.

Figure 74: Russia faces the longest times and highest costs to trade across borders



Source: Doing Business Indicators 2020.

Figure 75: Reductions in non-tariff trade costs would deepen Russia's integration in RVCs and GVCs (Estimated annual percentage change in exports of goods in the Russian Federation from the EAEU reduction of time in trade costs in goods, with and without spillovers to the rest of the world. Results are the percentage change in exports from the initial equilibrium)

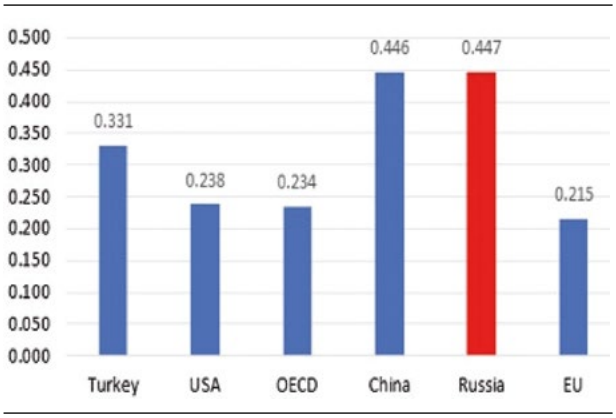


Source: Unpublished results from the model of Knobel et al. (2019).

Measures to enhance the role of domestic and traded services in the economy

Russia is trade restrictive especially in transport services, digital services, and towards the movement of natural persons particularly suppliers of computer, engineering, and architecture services. Restrictive services trade not only affects services that are exported, but can also pose barriers to upgrading in more complex GVCs that rely on imported services. The overall Services Trade Restrictiveness Index (STRI) for Russia is almost twice the average for OECD countries, the EU, and the USA. Russia also exhibits a higher level of restrictiveness than Turkey but is on par with China (Figure 76). While Russia's STRI score is above the OECD average in almost all sectors, it is especially closed in transport services. The country exhibits the highest restrictions in rail freight transport, cargo handling, and storage and warehousing services (despite some improvements, Russia also shows the lowest performance across all sub-components of the World Bank's Logistics Performance Index). Russia is the 6th worst out of the 46 economies included in the OECD STRI database in digital services such as computing, motion pictures, and sound recording. In computer services, there are relatively high restrictions on foreign entry as well as cumbersome regulations for the hiring of foreign professionals, including intra-corporate transferees, and independent and contractual service suppliers. Russia is also restrictive towards movement of natural persons. Among all countries in the OECD STRI database, averaged across all sectors, Russia is the fourth most restrictive in "mode 4" services trade (i.e. services provided by a foreign national as an independent supplier or employee of a service supplier). At the sector level, in terms of restrictions to the movement of people, Russia has a relatively high STRI in computer, engineering, and architecture services.

Figure 76: Russia is services trade restrictive (average STRI across all sectors, 2018)



Source: OECD STRI (https://stats.oecd.org/Index.aspx?DataSetCode=STRI)
Note: The average score for the EU does not include the following EU members, for which data is not available: Bulgaria, Croatia, Cyprus, Malta, and Romania.

Compared to other OECD countries, in Russia, other sources of trade costs in services are high, in particular institutional regulatory capacity of governments and regulators. A large part of trade costs in services is driven by non-discriminatory aspects of trade policy. Factors such as the quality of the regulatory environment and the rule of law are important enabling factors, as is regulatory transparency. Such costs appear to be the highest for Russia among its peers (Figure 77).

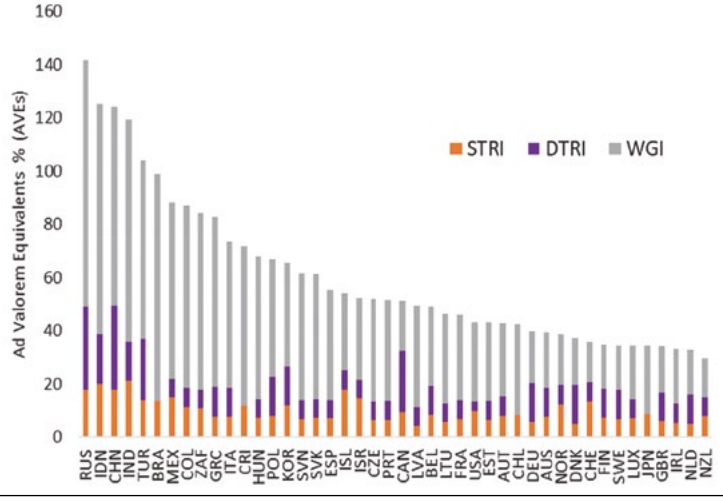
Policies to support services growth and deepen their integration in Russia can be divided into horizontal and vertical measures. Horizontal measures include reducing distortions to competition, developing the skills base and human capital, and improving access to finance. Vertical measures would apply to key services sectors such as banking, insurance, telecommunications, tourism, health and education services, air transport, and rail.

Horizontal (economy-wide) measures include:

Building up the stock of human capital to meet the demands of the services sector. Most jobs in the modern services sector require technical/vocational, soft interpersonal, and problem-solving skills, which are often not acquired at school but instead through market-oriented technical and vocational institutions, with intensive on-the-job learning opportunities. This puts a premium on expanding vocational education programs in close collaboration with the relevant services industries to provide a market-ready, skilled employment base. Introducing incentives to adjust the content, forms, and methods of skills training by training providers, including firms themselves, would help. Facilitating the entry of foreigners with relevant skills for Russia's services sector to temporarily alleviate some of the constraints could also be considered. This could include introducing guest worker programs and loosening entry requirements in sectors with labor shortages using a sector-based, skill-based approach. Russia could also move in the direction of countries that use various quota systems aimed at making decisions on admission of foreign workers on the basis of economic needs, and allow in certain cases lower-skilled foreign workers in guest worker programs, as well as certain services sectors to enter into direct agreements with the government to fill labor shortages.

Increasing foreign exposure to services would also increase the performance and productivity of Russian firms in all sectors. Promoting reforms that reduce the costs of services trade and FDI in upstream industries from both regional and global sources can serve as an engine for advancing Russian exports through inter-sectoral, product and functional upgrading. In addition, developing a modern services-based economy also requires an open, investment-friendly, transparent, and sound regulatory environment for the services sector. Trade and investment reforms that reduce the costs that foreign services suppliers face in accessing the Russian market should be addressed (see section below on FDI).

Figure 77: Russia's trade costs in services are the highest among peers (Sources of services trade costs in terms of ad valorem equivalents)



Source: Van der Marel and Shepherd (2019).
Note: Services trade costs are estimated associated with market access policies in services and transparency measures as proxied by the OECD STRI (STRI); regulatory measures related to the cross-border movement of data as proxied by the Digital Trade Restrictiveness Index developed by the European Center for International Political Economy (DTRI); and the institutional regulatory capacity of governments and regulators as proxied by the simple average of the regulatory quality and government effectiveness indicators of the World Bank's Governance Indicators (WGI).

Improving access to finance and transportation. Access to finance in Russia seems to be a larger issue for deepening services integration compared to electricity and water supply, ICT usage, and transportation (although transportation is a growing obstacle). If Russia's services sector is to grow, the capacity of the domestic financial sector to fund investments should also be improved. Beyond measures to promote competitive access by Russian firms to domestic debt and equity financing (CBR 2016), expanding access to finance will require i) continued efforts to close weak banks; ii) diversification of the financial sector away from the banking-sector-dominated model and diversification of financing products, especially those better suited to SMEs such as microfinance, guarantees, and leasing; iii) enforcement of market disciplines in the banking sector, including encouraging greater private sector participation; iv) improving the financial literacy of SMEs; and v) re-examining unnecessary and cumbersome requirements of currency regulation and control that adversely affect services exporters. More specifically, services exporters are bound by an obligation to repatriate earnings from export contracts and they face restrictions on handling foreign accounts. The existing requirements related to currency regulation impose restrictions on transborder payments for services using e-money, which presents a barrier to exports of services via the internet.

Vertical (sector-specific) measures apply to key services sectors such as banking, insurance, telecommunications, tourism, health and education services, air transport, and rail, and in essence involve removing sector-specific barriers to firms contesting services markets:

- *In financial services*, foreign capital and foreign quota limitations for the banking sector and insurance services, respectively, could be increased.
- *In insurance services*, prohibitions on the establishment of foreign branches for the provision of non-life and life insurance could be relaxed.
- *In telecommunications,* improving competition requires regulatory reforms – including establishing a national independent regulatory authority with enough institutional capacity to implement regulatory reforms and enforce ICT sector regulations – and setting standards and procedures for shared use of infrastructure. Exclusivity rights granted to the state-owned enterprise (SOE) Rostelecom to provide internet services to healthcare providers should also be revisited.
- *In transport,* efforts should be expanded to ensure that airlines have non-discriminatory access to airport facilities and services. Efforts should also be geared to reforming the designated carrier status for the national carrier on international routes. For rail services, the government could consider separating the infrastructure and services segments of Russian Railways (RZD).
- *In tourism*, measures could include the simplification of visa procedures and expansion of the e-visa system and developing and distributing advertising and information materials about tourism opportunities, including for healthcare and educational purposes. It is also necessary to expand opportunities for foreign tourists to have value-added tax (VAT) returned upon departure after purchasing goods in Russia.

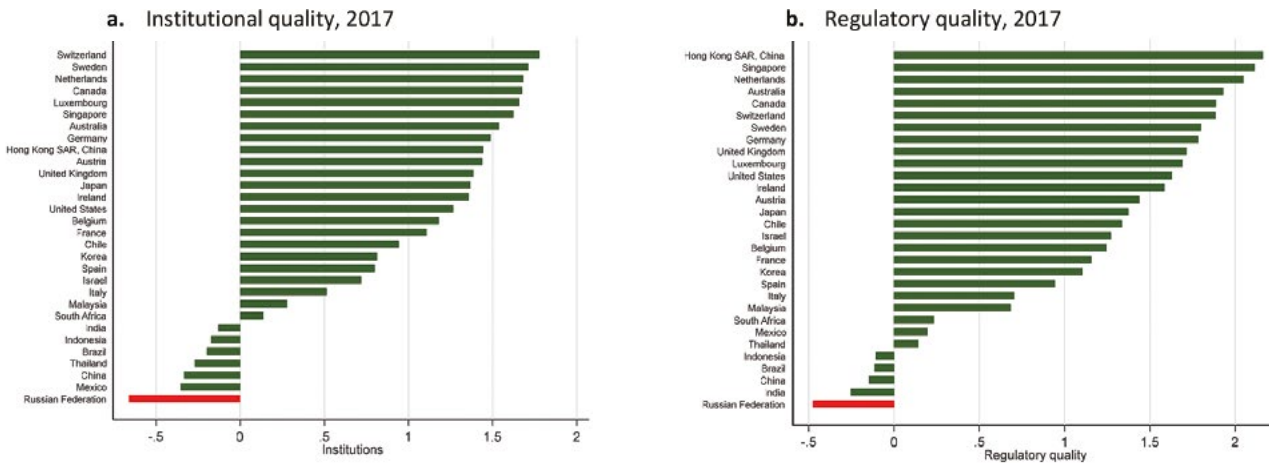
Facilitating FDI and spillovers through improved institutional and regulatory quality and reduced restrictions

A perception of low institutional and regulatory quality, the restrictiveness of the FDI regime, and high investor and expropriation risk are all factors deterring FDI in Russia. Among the top 30 FDI destination countries, Russia is at the bottom in terms of the overall institutional and regulatory quality (Figure 78, panels a and b). It is also one of the most restrictive regimes among the top 30 destinations in terms of both foreign equity and land/repatriation restrictions (Figure 78, panels c and d). And even before the COVID-19 pandemic, Russia was assessed to be a relatively risky environment for investors. Among the same top FDI destinations, Russia comes close to the bottom of the list of the International Country Risk Guide (ICRG) on overall investor risk. Regarding expropriation risk, Russia is rated as the seventh riskiest destination of the 30 countries.

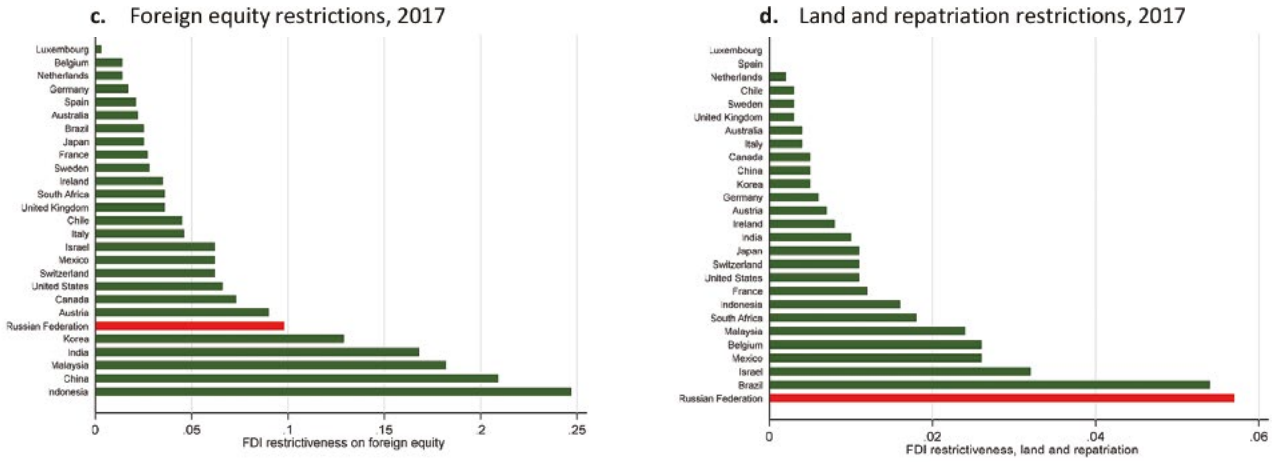
Policy measures to boost FDI and thus facilitate FDI spillovers would include:

Establishing a national, empowered investment promotion institution with an extensive network of regional branches is a first step towards nurturing a better institutional environment for foreign investors. Evidence suggests that a key element for effective FDI attraction and retention is a national-level investment promotion agency that is strategically aligned with the national development plan and corresponding FDI policies, has a strong institutional

Figure 78: Perceptions of low institutional and regulatory quality in Russia deter FDI



Source: Authors, based on data from WGI.
Note: Each WGI indicator ranges between -2.5 and 2.5, and larger numbers represent higher quality.



Source: Authors based on data from the OECD.
Note: Each FDI restrictiveness index ranges from zero to a positive number, and greater values indicate high levels of restrictions.

structure, and focuses on investor service delivery. Such agencies have played pivotal roles in a diverse set of countries such as Brazil, India, Ireland, Korea, and Vietnam. Indeed, investment promotion agencies at the subnational level are also important, especially in large decentralized countries. Countries such as Germany, Spain, the UK, and Ireland have successfully implemented models with strong networks of national and subnational investment promotion agencies. Russia has numerous institutions working on investment promotion at the federal and regional levels, however, there is no national-level institution coordinating functions across different agencies, with the capacity to provide the full set of services to foreign investors. Publicly available information on the performance of the various investment institutions is limited. While a comprehensive assessment of Russia's FDI institutional framework is required to determine how best to align it to good practice, the need for a more empowered national-level agency is evident. There is also a need for a national FDI strategy to provide the agency with strategic direction and outline the key principles governing the investment policy.

Simplifying foreign investment regulations and bringing about greater transparency is equally important. Russia has a complex legal framework, including the Foreign Investment Law (FIL), the Strategic Investment Law (SIL), and New Investment Law (NIL) (i.e. Federal Law "On the Protection and Promotion of Capital Investments and the Development of Investment Activity in the Russian Federation"). A consolidated investment law that clarifies the

institutional framework, investment entry, and protection rules would be preferable, signaling respect for property rights. Transparency on the applicable rules can also be improved. For example, the FIL provides that foreign investors can freely invest in Russia unless it is prohibited, but it does not expressly mention specific prohibitions and restrictions. There are restrictive measures on FDI across sectoral laws – for example in aviation, mass media, and banking sectors. The dispersed restrictions make it difficult for foreign investors to identify upfront the relevant rules. Some countries, including China and Ethiopia, address this issue by having a negative list of sectors and activities in which FDI is subject to conditions. Others provide updated policy summary documents every few months with an overview of the main restrictions.

The most severe FDI restrictions come from the Strategic Investments Law (SIL), whose framework should be simplified and streamlined to reduce excessive discretion. The SIL enumerates 42 strategic activities that are restricted for foreign investments. However, there is wide discretionary authority – an approval requirement may be imposed even on activities that are considered connected to strategic activities or that are believed to affect state defense and security. The 'conditions' for granting an approval are also not pre-determined or well defined. They can be imposed on a case-by-case basis, including in a separately signed Strategic Contract. In contrast, where countries choose to impose approval requirements for strategic interests, it is good practice to impose the requirement for a set of well-defined and limited activities, to outline clearly the process and requirements, and to prescribe time periods which are to be complied with. Excessive discretion is also seen in the availability of unbound exceptions to certain rules. Overall, discretion results in higher costs for foreign investors on top of the restrictions, and they should be reduced.

Russia's current legal framework provides key investment protection guarantees, but several are missing and others are incomplete. For example, the foreign investment law (FIL) does not include the fair and equitable treatment clause, which protects investors from arbitrary state actions and guarantees due process. The FIL's expropriation clause does not specify fully the legality conditions—that is, expropriation can only be conducted for public purpose, in a non-discriminatory manner, following due process, and on payment of prompt, adequate, and effective compensation— and does not explain the calculation of the compensation. The FIL's provision on investor-state dispute settlement does not include any information on the options and procedures for dispute settlement. Importantly, there is a gap between the FIL and Russia's international investment agreements (IIAs), with the latter providing more elaborate investor rights.

The extensive use of stabilization clauses setting investors' terms over long time horizons should be reevaluated. For example, the NIL includes a provision on a «stabilization clause» that guarantees investors the stability of the regulatory and fiscal terms for the period of the project. However, stabilization clauses are not considered the ideal way of providing stability to investors because they come with significant drawbacks, such as challenges in implementation and distortionary effects. Having overarching clauses that also stabilize regulatory frameworks can 'tie the hands' of states even when legitimate changes may be needed. Therefore, instead of reliance on instruments like stabilization clauses, more emphasis should be put on broader systemic issues of transparency and investor protection.

The implementation of investment protection rules, such as establishing investor grievance management mechanisms, should be enhanced. Russia's weak performance on several key indicators on investment protection, including indices on dispute settlement, which is fundamental to the effective enforcement of legal rights, reflects poor implementation. Russia has a high number of investor-state disputes, 26 publicly known ones. The most frequently alleged breach by investors is expropriation. To prevent costly investor-state disputes, and ultimately retain and expand investment, countries have been setting up investor grievance management mechanisms. This is particularly important for Russia, where foreign investors lack trust in domestic courts and where there are limited preferred dispute settlement options for investors, because it is not a Contracting State to ICSID (Russia signed the ICSID convention but has not deposited instrument of ratification). Overall, Russia could consider establishing concrete mechanisms for better implementation of investment protection rules and reducing investor risk.

Greater domestic competition and stronger linkages to domestic suppliers would enhance the contribution of multinationals to the Russian economy. Positive FDI spillovers cannot be taken for granted. While foreign investor characteristics are important, domestic firm capabilities to absorb spillovers and supportive policies are critical, too.

Sufficient firm capabilities to develop supplier linkages with multinationals and benefit from technology spillovers are important. Competitive markets to limit monopolistic behavior and reduce a crowding out of firms have also shown to matter for spillovers. These findings are consistent with two recent World Bank reports that identified low capabilities of Russian firms and limited competition as key bottlenecks preventing multinationals from relying more on local suppliers. Addressing these issues through competition policy reforms and enhancing domestic firms' capabilities including through strategic linkage development programs is critical for Russia's GVC upgrading through FDI spillovers.

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SPECIAL FOCUS: RUSSIA INTEGRATES: DEEPENING THE COUNTRY'S INTEGRATION IN THE GLOBAL ECONOMY

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