
The Russian economy

Will Russia ever catch up?



IN-DEPTH ANALYSIS

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This publication aims to provide an overview of Russia's economy, explaining the current situation against the backdrop of historical developments and long-standing structural issues. It also discusses the economic outlook for the medium and long term.

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EXECUTIVE SUMMARY

Over the past 25 years, Russia has undergone dramatic economic changes, with the difficult reforms and catastrophic economic collapse of the 1990s, the boom years of the new century, the global economic crisis and the current downturn.

Despite all these developments, many of the structural economic challenges faced by Russia remain unchanged since Soviet times. Bountiful natural resources have helped to fuel growth, but at the cost of an unhealthy dependency, as the current situation so clearly illustrates. This problem is acknowledged by the Russian government, which under Dmitri Medvedev's presidency in particular, declared its intentions to diversify and modernise the economy. However, the continued flow of gas and oil money has removed the incentive to undertake serious economic reforms, and these have faltered as a result.

Many of Russia's structural problems are inherited from Soviet and even Tsarist times. Large swathes of the economy remain under state control, and there are numerous barriers to both domestic and international competition. Businesses struggle with red tape and ubiquitous corruption. Despite Medvedev's stated objective of developing an 'intelligent economy', and the country's traditional strengths in research, development, innovation and education, Russia continues to underperform in these areas.

Over the past few years, the Russian government has simplified bureaucratic procedures, launched a high-profile anti-corruption campaign, privatised state-owned companies, overhauled the education system and invested in innovation. However, such initiatives have brought measurable improvements in only a few areas.

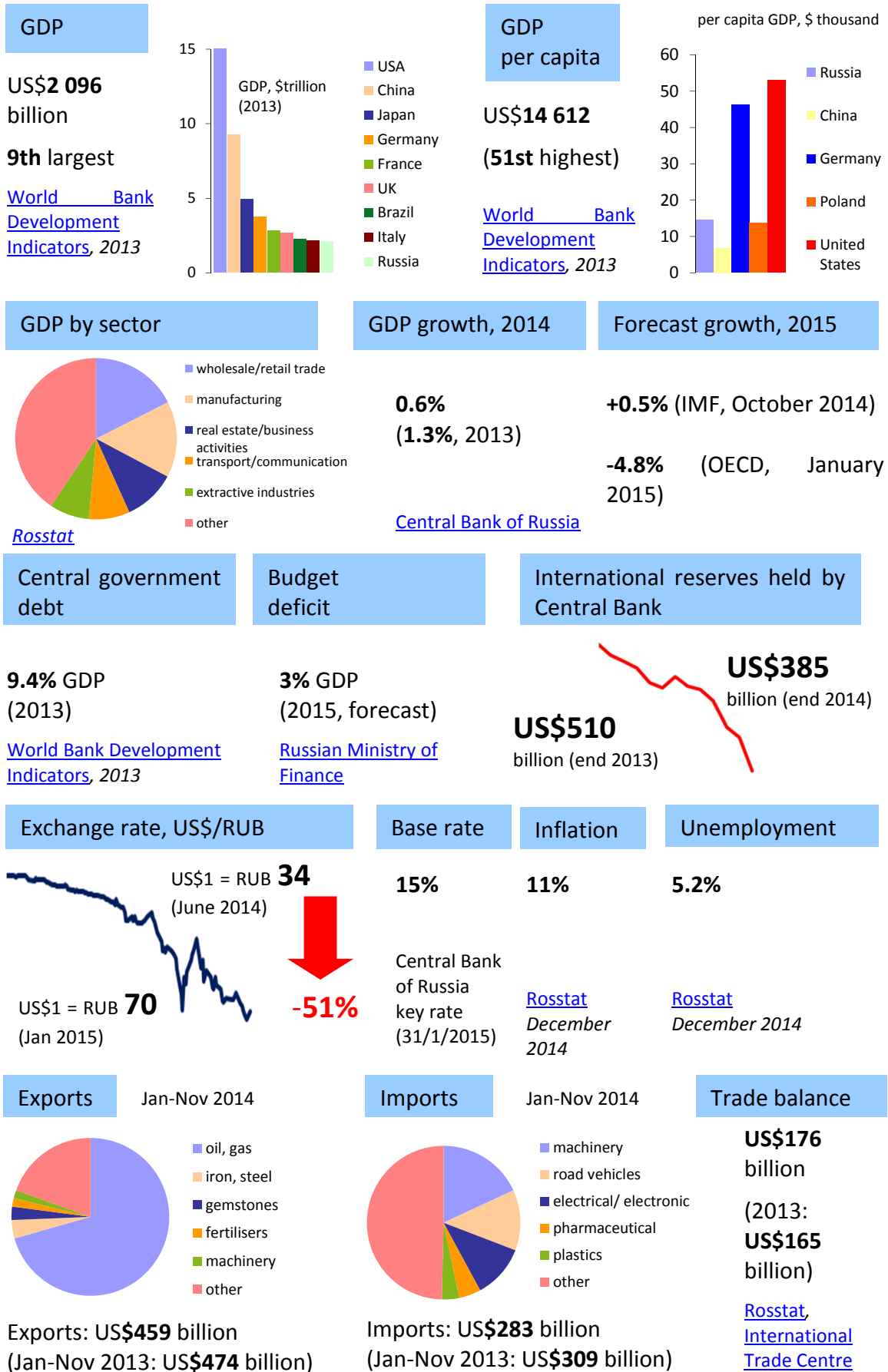
Aggravated by these structural issues, falling oil prices and economic sanctions have led to a rapid deterioration in the economic situation. The rouble has lost half its value, inflation has shot up, formerly sound public finances look increasingly shaky, and the economy is forecast to tip into recession in 2015.

How quickly Russia recovers from its current difficulties will depend on whether or not oil prices pick up and sanctions are eased. Regardless of these, however, structural problems are likely to continue hampering the process of economic modernisation for the foreseeable future.

TABLE OF CONTENTS

| | |
|---|----|
| 1. Macroeconomic indicators | 3 |
| 2. The past: from command to market economy | 4 |
| 2.1. 1988-91: <i>perestroika</i> and the Soviet planned economy | 4 |
| 2.2. 1991-98: <i>katastroika</i> , catastrophic economic liberalisation..... | 4 |
| 2.3. 1998-2008: the boom years | 5 |
| 2.4. 2009 to present day: economic crisis..... | 5 |
| 3. The present: structural factors | 5 |
| 3.1. Russia has vast mineral wealth | 6 |
| 3.1.1. The danger of reliance on natural resources..... | 7 |
| 3.2. Structural obstacles to Russian competitiveness..... | 7 |
| 3.2.1. Lack of liberalised and competitive markets | 8 |
| 3.2.2. Research and development: poor performance by international standards..... | 10 |
| 3.2.3. Innovation is scarce in the Russian economy | 11 |
| 3.2.4. Education: mediocre performance despite high participation | 12 |
| 3.2.5. Labour markets — reasonably efficient, although with some areas of concern | 14 |
| 3.2.6. Regulatory environment: solid progress, but still a long way to go | 15 |
| 3.2.7. Corruption: a major barrier to Russia's competitiveness | 15 |
| 4. The current economic situation | 17 |
| 4.1. External factors | 17 |
| 4.1.1. Falling oil and gas prices | 17 |
| 4.1.2. Economic sanctions | 17 |
| 4.2. The rouble | 18 |
| 4.3. Public finances..... | 19 |
| 4.4. Employment | 20 |
| 4.5. GDP growth | 20 |
| 5. Future prospects..... | 21 |
| 5.1. For the coming year | 21 |
| 5.2. Longer term prospects | 22 |
| 6. Main references..... | 23 |

1. Macroeconomic indicators



List of main acronyms used

| | |
|---------------|--|
| BRICS: | Brazil, Russia, India, China, South Africa |
| EBRD: | European Bank for Reconstruction and Development |
| GDP: | Gross Domestic Product |
| IMF: | International Monetary Fund |
| OECD: | Organisation for Economic Co-operation and Development |
| PISA: | Programme for International Student Assessment |
| RUB: | Russian rouble |
| WTO: | World Trade Organization |

2. The past: from command to market economy

2.1. 1988-91: *perestroika* and the Soviet planned economy

In **1988**, under Mikhail Gorbachev, the first modest steps to reform the stagnant Soviet economy were taken, with legislation granting companies greater autonomy from state planners and allowing limited private-sector activity. However, these measures, intended to correct deficiencies in the command economy rather than replacing it with a market economy, had only a limited impact.

2.2. 1991-98: *katastroika*, catastrophic economic liberalisation

The collapse of the Soviet Union in **1991** brought political and economic chaos. In line with International Monetary Fund (IMF) recommendations, newly elected Russian president Boris Yeltsin announced radical economic reforms to introduce a market economy.

Price controls on 90% of goods were lifted on 1 January **1992**. Over the next two years, 70%¹ of the economy was transferred to private ownership, through auctions and a voucher scheme.

Despite the initial enthusiasm of the Russian government and its western advisors, the effects of the reform process were disastrous: over the period from 1991 to 1998, GDP shrank by half.² Ironically, given Yeltsin's 1992 statement that 'we need millions of owners rather than a handful of millionaires',³ the privatisation process brought vast wealth to a few oligarchs, but left one third of the population living below the poverty line by the end of the period. Average real wages (often paid several months in arrears) fell by 38% and life expectancy at birth by five years (for men, a catastrophic decrease to 57.6 years, putting Russia below countries such as Pakistan and Bolivia), while crime and murder rates doubled.

¹ Economic data in this section are from the EBRD's [Transition Report 1999](#).

² However, economic data from this period are highly unreliable given widespread unrecorded economic activity (due to corruption, tax evasion, bartering, etc.), estimated at over 40% of GDP (Kaufmann and Kaliberda 1996).

³ Cited by A. Åslund in [Russia's Capitalist Revolution: Why Market Reform Succeeded and Democracy Failed](#), Peterson Institute for International Economics, 2007.

Finally, Russia's economic collapse appeared to bottom out in **1997**. However, just one year later, the August 1998 Russian currency crisis arrived, caused by, among other things, a chronic budget deficit (ranging from 5.4% to 42.6% of GDP over the period 1992 to 1998). As a result, Russia defaulted on its debt and the rouble lost two-thirds of its value.

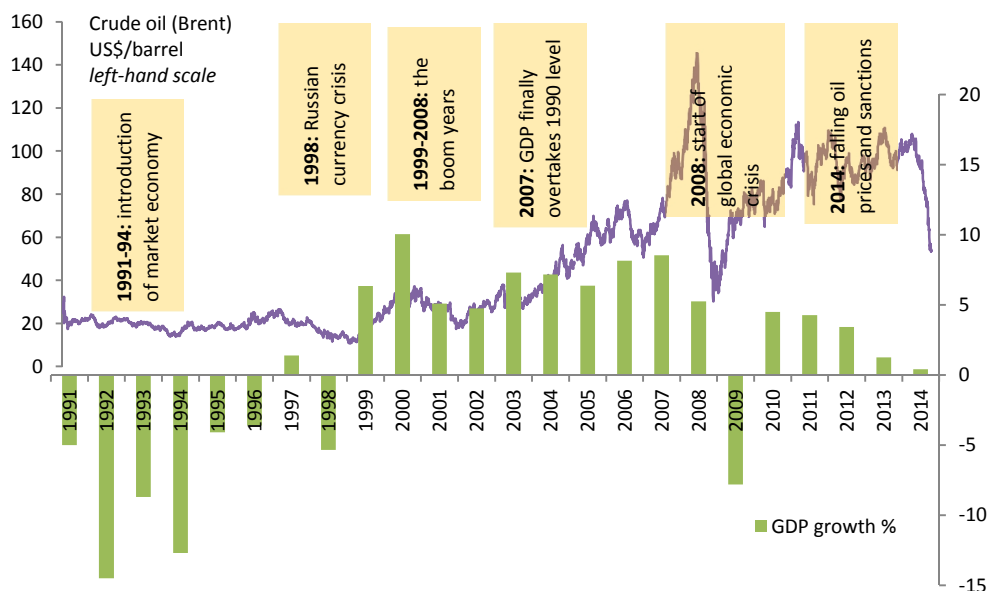
2.3. 1998-2008: the boom years

Paradoxically, the 1998 crisis made the Russian economy more competitive thanks to the severely devalued rouble, thus finally triggering faster growth. This was also helped by higher oil and gas prices. Between 1999 and 2008 growth averaged 6.4% a year.

2.4. 2009 to present day: economic crisis

With the onset of the global economic crisis, the economy shrank by 7.8% in 2009. After this, growth resumed at a lower rate, until the current crisis once more brought the economy to a standstill in 2014.

Figure 1: Key dates in Russian economic history in relation to GDP growth/oil price



Data: [IHS Connect](#) (GDP); [US Energy Information Administration](#) (oil).

3. The present: structural factors

Thanks to rapid economic growth, the Russian economy has almost doubled in size since bottoming out in 1998. At the same time, there have been dramatic improvements in a wide range of socioeconomic indicators — for example, life expectancy at birth has increased by six years to 71 years, general crime and murder rates have halved, and the percentage of the population below the poverty line has decreased from 35% to 11%.⁴ Setting the current problems aside, Russia might appear to have finally put the legacy of the Soviet planned economy and the difficult transition years behind it.

⁴ Unless another source is cited, statistics in this publication are taken from Rosstat (Russian [Federal State Statistics Service](#)).

However, the country's economic performance is less impressive than it appears at first sight. First of all, though Russia has grown faster than many EU countries, compared to fellow BRICS (Brazil, Russia, India, China, South Africa) countries it is well below the group's average of 6.5% for the past five years. Growth in the early 2000s started from a low level, and has done little more than to reverse the decline of the preceding decade; indeed, Russia did not overtake its 1990 level until around 2007. It is therefore pertinent to ask whether the country has succeeded in building a modern competitive economy. The following sections look at some of the structural issues.

3.1. Russia has vast mineral wealth

Figure 2: Russian natural resources



Russia is one of the world's most resource-rich countries. In 2005, the World Bank⁵ put the country in first place for total value of subsoil wealth (oil, gas, coal and minerals); a more recent estimate⁶ puts the value of the country's natural resources at US\$75.7 trillion — again, in first place. Apart from gas, oil and coal (proven reserves: 1st, 7th, 3rd place respectively; production: 1st, 3rd, 6th place⁷), Russia is in the world's top ten for a wide range of minerals, including iron, nickel, platinum, gold and diamonds.

Natural resources have brought Russia economic wealth. The World Bank estimates⁸ that natural resource rents (calculated as production value minus costs) contributed around 18.7% of GDP in 2012 (13.9% from oil and 2.3% from gas). The impact on exports is particularly significant: in 2013, 68% of these came from oil and gas (21% petroleum products; 33% crude oil; 14% natural gas);⁹ 'metals and precious stones' accounted for a further 11.1%. Moreover, oil and to a lesser extent gas contribute around 50% to the federal budget (mostly extraction taxes and export duties).¹⁰

Thanks both to high crude oil prices (which quadrupled during the period from 2000 to 2007), and rising output (from 6 million barrels a day in 1996 to 10 million in 2013),¹¹ oil in particular has driven the Russian economic recovery. Natural resource wealth has

⁵ [Changing Wealth of Nations](#) database.

⁶ [The World's Most Resource-Rich Countries](#), 24/7 Wall St, 2012.

⁷ [International Energy Statistics](#), US Energy Information Administration.

⁸ World Development Indicators, 'Contribution of natural resources to GDP'.

⁹ [International Energy Statistics](#), US Energy Information Administration.

¹⁰ [Russia – Analysis](#), US Energy Information Administration.

¹¹ [International Energy Statistics](#), US Energy Information Administration.

enriched not only oligarchs (four Russian billionaires are listed by Forbes¹² as being among the world's 100 wealthiest people; all made their fortunes from oil, gas or metals), but also average Russians, whose living standards doubled over the period from 2003 to 2013.

3.1.1. *The danger of reliance on natural resources*

Reliance on natural resources can, however, be dangerous. For a start, oil and gas wealth has made it easier for the Russian government to avoid carrying out the economic and political reforms needed to modernise the country. Without these reforms, the country risks resembling wealthy, but in many other respects underdeveloped petro-states such as Saudi Arabia, rather than the dynamic emerging economies of fellow BRICS countries. Of course, oil and gas will run out one day; there are already signs that current production levels are unsustainable given the lack of investment in new reserves,¹³ of which many are geographically remote or technically challenging. Moreover, even at current high levels, the sector is unable to employ more than a small percentage of the population.¹⁴ Worst of all, as the current economic situation shows, Russia's economy is at the mercy of global oil prices. Comparing GDP growth and crude oil, a clear correlation emerges (see Figure 1, *Key dates in Russian economic history*, above).

Outside the flourishing energy sector, the economic situation has always been much less encouraging, not just during the current crisis. For example, manufacturing output has declined by 10% since 2003. In 2013, manufactured goods made up just 17% of Russian merchandise exports, compared to 83% for Germany, 77% for Poland and 86% for South Korea.¹⁵ Manufacturing productivity, though rising, is still only around 40% of the Organisation for Economic Co-operation and Development (OECD) average, with particularly low levels in the machinery, equipment and transport equipment sectors¹⁶.

Russia's leaders have repeatedly drawn attention to these dangers. For example, in a 2009 article entitled 'Go Russia',¹⁷ President Medvedev denounced the country's 'primitive economy' with its 'humiliating dependence on raw materials'. Russian finished products were, he claimed, 'plagued by their extremely low competitiveness'.

3.2. Structural obstacles to Russian competitiveness

Accordingly, Medvedev called for economic modernisation, with a shift away from natural to 'intellectual resources: the so-called intelligent economy, creating unique knowledge, exporting new technologies and innovative products'. But which factors favour or impede the modernisation process?

Russia has numerous strengths, such as a highly educated workforce and a track record of technological achievement. However, these have not translated into economic competitiveness. An analysis of individual competitiveness factors reveals

¹² ['The World's Billionaires'](#), *Forbes*, 2015.

¹³ Dina Khrennikova, ['Russia Confronts Stagnant Oil Production After Crude Price Slump'](#), [www.bloomberg.com](#), 19 January 2015.

¹⁴ Rosstat does not publish separate statistics for employment in the energy sector; however, in 2013 2.2% of the labour force was employed in extractive industries.

¹⁵ [World Development Indicators](#), World Bank, 2015.

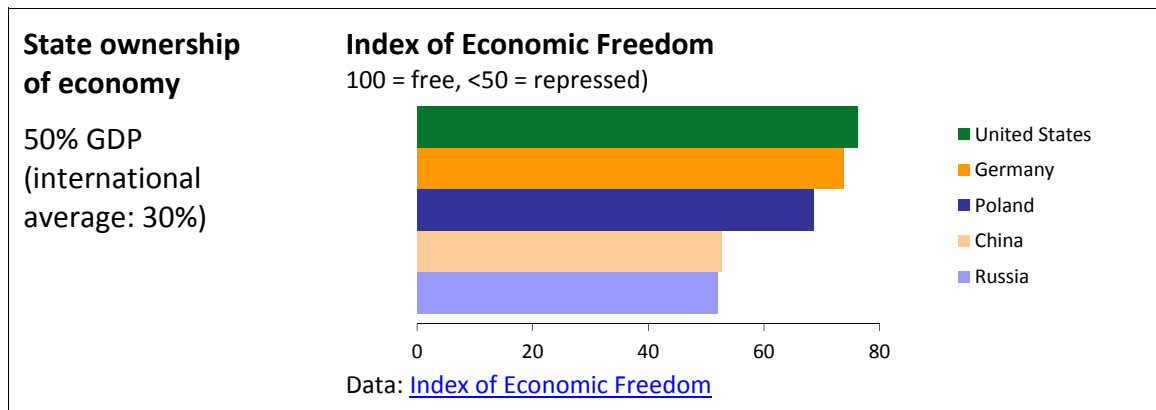
¹⁶ [The Russia Competitiveness Report 2011](#), World Economic Forum, 2011.

¹⁷ Dmitri Medvedev, ['Go Russia'](#), 2009.

inefficiencies, many of them inherited from the Soviet era or even earlier, which continue to hamper the country's full modernisation.

3.2.1. Lack of liberalised and competitive markets

Figure 3: Russian market liberalisation



In the early 1990s, some 70% of the economy (measured by GDP) was transferred to the private sector. However, since the beginning of Vladimir Putin's first presidency in 2000, state ownership has made a comeback. Private assets, mostly in the oil and gas, banking and transport sectors have been taken over by enterprises in which the state has a controlling interest — mostly through purchases, but in some case through expropriation, as in the case of Yukos (following Mikhail Khodorkovsky's arrest in 2003 for alleged fraud, or more recently in the case of Bashneft, seized from Vladimir Yevtushenkov in 2014). In 2012 the state-owned sector was estimated¹⁸ at around nearly 50% of GDP, compared to an international average level of 30%. This includes 40-45% of the oil sector (up from 10% in 1999 — Rosneft), 49% of the banking sector (Sberbank, VTB), 73% of the transport sector (Russian Railways, Aeroflot), and Gazprom, which produces most of Russia's gas, owns the distribution network, and has a monopoly over exports.

On average, Russian state-controlled companies are less efficient than their counterparts in full private ownership, with labour productivity as low as 30% of the sector average in some industries.¹⁹ Reasons for this include the fact that commercial goals often come second to implementation of government policy, for example Gazprom's US\$2.2 billion subsidy of the 2014 Sochi Winter Olympics, Rosneft's financing of social programmes in oil-producing regions, and Russian Railways' bail-out of the ailing KIT finance company.²⁰ The monopoly or dominant position which many of these companies enjoy (e.g. Gazprom), and the presence of political appointees in senior management (such as ex-Deputy Prime Minister Igor Sechin, Rosneft's Executive Chairman), also contribute to a lack of competitiveness.

In 2011 a programme to privatise state assets²¹ was launched, and this is to continue over the next two years, with, for example, the sale of the Russian lottery and shares in ports, research institutes, mines and banks. In a Presidential Decree²² signed immediately after his election in 2012, President Putin ordered the government to

¹⁸ Tseplyaeva J. and Yeltsov Y., [Russia: The land of the bountiful giants](#), BNP Paribas, 2012.

¹⁹ *ibid.*

²⁰ *ibid.*

²¹ As [reported](#) by RIA Novosti (in Russian).

²² [Presidential Decree No 596 of 7 May 2012 on Long-term Economic Policy](#) (in Russian).

disinvest from the non-oil sector by 2016, 'with the exception of natural monopolies and defence-related companies'. However, so far 'privatisation' has usually meant selling off minority shareholdings rather than relinquishing state control; meanwhile, continued acquisitions by state-controlled enterprises (for example, of BP-TNK by Rosneft in 2012, for US\$53 billion) mean that overall, the level of state ownership is, if anything, increasing. Referring to BP-TNK, former Russian Finance Minister Alexei Kudrin denounced²³ a process of 'creeping de-privatisation', pointing out that its value considerably exceeded that of the assets planned for privatisation during the same year.

Given the existence of large state-controlled companies, it is not surprising that Russia has a large share of highly concentrated markets — 47% according to the OECD.²⁴ Competition policy is seen as ineffective: based on responses from over 250 Russian business leaders to the question 'In your country, to what extent does anti-monopoly policy promote competition?', Russia comes 102nd out of 144 countries;²⁵ similarly, the 2015 Index of Economic Freedom²⁶ based on data from sources such as the IMF, OECD, Economist Intelligence Unit, etc. rates Russia 143 out of 178 countries on overall economic freedom, with particularly low scores for 'open markets'.

The dominance of large companies explains why Russian SMEs account for a relatively low share of employment and GDP — around one-fifth of both²⁷ — compared to 66% and 57% respectively for their EU counterparts.²⁸

The picture of uncompetitive markets is completed by the existence of trade barriers protecting Russian companies from their international competitors. Russia only joined the World Trade Organization (WTO) in 2012, and although it has committed to lower tariffs (previously as high as 30%, e.g. in the automotive sector), technical barriers to trade remain; for example a 'recycling tax' on imported cars, currently the subject of a WTO dispute²⁹ with the EU, to say nothing of the current import ban on agricultural products from a wide range of Western countries imposed in response to sanctions. While it is true that tariff and non-tariff barriers to trade with the four other Eurasian Economic Union countries (Armenia, Belarus, Kazakhstan, Kyrgyzstan) are being removed as part of the process of creating a Eurasian single market, the impact on Russian businesses will be limited, given that these countries account for a mere 11% of Russia's total foreign trade.

²³ See '[Russia "amid creeping de-privatization"](#)', *Russia Today*, 2012.

²⁴ [Economic Survey of Russia 2009](#), OECD, 2009.

²⁵ [The Global Competitiveness Report 2014–2015](#), World Economic Forum, 2015.

²⁶ [2015 Index of Economic Freedom](#), Heritage Foundation, 2015.

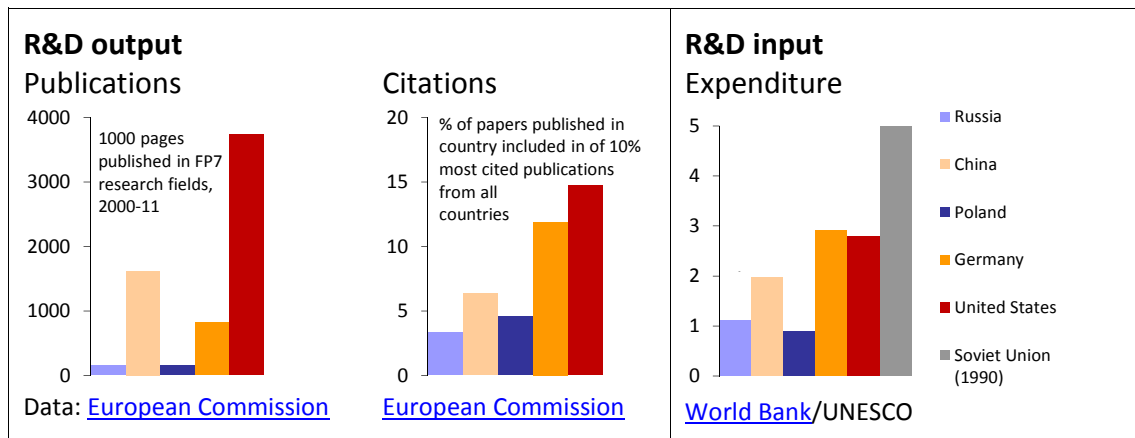
²⁷ [OECD Economic Surveys: Russian Federation 2011](#), OECD, 2011.

²⁸ [A Recovery on the Horizon? Annual Report on European SMEs 2012/2013](#), European Commission, 2013.

²⁹ Dispute DS462, [Recycling Fee on Motor Vehicles](#).

3.2.2. Research and development: poor performance by international standards

Figure 4: R&D indicators



In the Soviet Union, scientific achievements in fields such as space exploration and theoretical physics (seven Nobel Prizes) reflected a high level of investment — in 1990, R&D expenditure amounted to around 5% of GDP.³⁰ Since then, this figure has slumped to 1.12% of GDP,³¹ due to the decline of Russia's military-industrial complex (accounting for 60-80% of Soviet-era R&D expenditure, according to some estimates³²), and the manufacturing sector in general. Meanwhile, the flourishing minerals sector has done little to compensate — a 2008 Gazprom report³³ cites R&D expenditure of Gazprom, Lukoil and Rosneft at 0.15%, 0.12% and 0.02% of turnover respectively, much less than their international competitors (Royal Dutch Shell: 0.28%; Total: 0.32%).

It is true that even at these lower levels of R&D expenditure, Russia still compares reasonably well to countries such as Spain and the United Kingdom (1.3% and 1.72% of GDP respectively), and is well ahead of most of the central European states formerly within the Soviet sphere of influence such as Poland (0.90%).³⁴ However, a bigger problem is that Russian researchers are not particularly productive, with only 4% as many scientific publications³⁵ as their counterparts in the United States, and are even outperformed by much smaller countries such as Sweden or Switzerland. Despite excellence in fields such as aeronautics and physics, they also score below the world average in terms of specialisation and citations.³⁶

This relative ineffectiveness probably reflects a range of factors: there are funding-related issues such as antiquated equipment (of which 25% and 12.3% is over 10 and 20 years old respectively³⁷) and uncompetitive salaries (8.5% higher than the average

³⁰ According to UNESCO figures, cited in 'Productivity', M. Schaffer and B. Kuznetsov, in *Can Russia Compete?*

³¹ World Development Indicators, World Bank.

³² *The Estimation of Soviet Defense Expenditures for 1955-75: An Unconventional Approach*, W. Lee, 1977.

³³ Gazprom [Report to the Committee on Modernisation and Technological Development of the Russian Economy](#) (in Russian).

³⁴ Figures from [World Development Indicators](#), World Bank.

³⁵ Measured by page count, in research fields covered by the EU's 7th Framework Programme for Research and Technological Development; Report on [Country and Regional Scientific Production Profiles](#), European Commission, 2013.

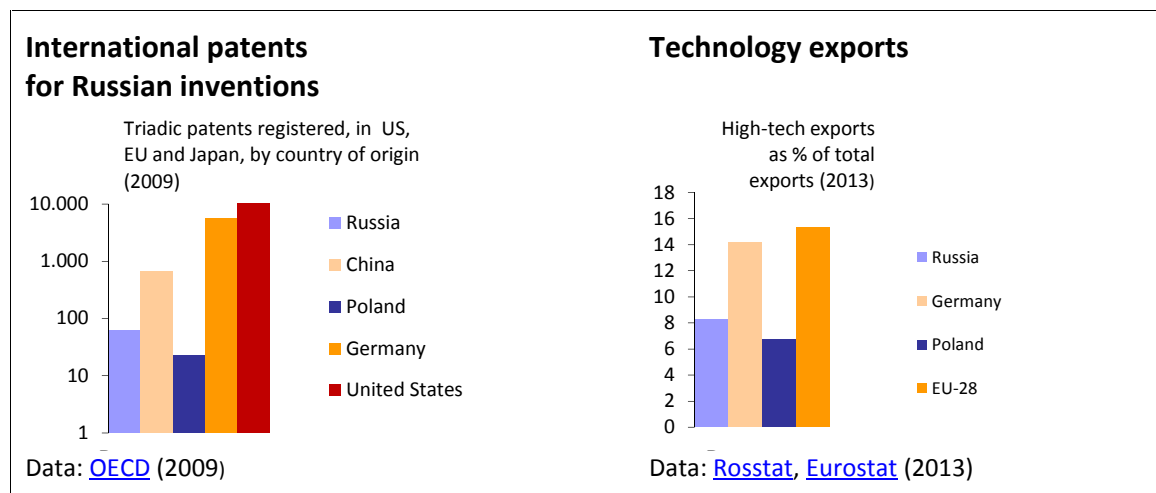
³⁶ Report on Country and Regional Scientific Production Profiles, op. cit.

³⁷ [UNESCO Science Report 2010](#).

for the economy as a whole,³⁸ but not particularly attractive relative to average earnings in large cities such as Moscow, let alone by international standards). On top of this, there is the structure of the research sector, little changed since Soviet times: most research is government funded (63%)³⁹ in state research institutes, with a mere 6.8% of researchers working in industry,⁴⁰ the exact opposite of trends in most market economies, such as the United States (59% of research funding from business⁴¹). Institutional reforms to boost the effectiveness of the state research sector, such as the establishment of a government agency to supervise the Russian Academy of Sciences in 2014, appear only to have added red tape.⁴² Nor in the current budgetary climate are there any prospects of increased funding.

3.2.3. Innovation is scarce in the Russian economy

Figure 5: innovation indicators



Not surprisingly, given the above-mentioned lack of corporate R&D, research does not translate into commercial results. It is true that the number of patents registered in Russia is fairly high (nearly 45 000 in 2013⁴³); however, a more reliable indicator of the commercial potential of Russian R&D is the number of international patents registered by Russian patentees — given the much higher cost of registering such patents, only those with commercial promise are likely to be registered outside the country. On this score, Russia does very badly, with a mere 63 triadic patents in 2009 (i.e. registered in the US, EU and Japan), compared to 279 for Denmark, or 13 715 for the United States.⁴⁴

There is a general lack of innovation activity in Russian business — in 2013, just 10% of Russian businesses engaged in technological, organisational or marketing innovation,⁴⁵ a figure which has remained essentially unchanged over the last five years. In contrast,

³⁸ *ibid.*

³⁹ 'Productivity', M. Schaffer and B. Kuznetsov, in *Can Russia Compete?*

⁴⁰ *Science and Technology. Innovation. Information Society. Data Book*, Higher School of Economics, Moscow, 2010.

⁴¹ [Science and Engineering Indicators 2012](#), National Science Board.

⁴² [Academy "reform" is stifling Russian science](#), *Nature*, 2014.

⁴³ Russian [Federal State Statistics Service](#).

⁴⁴ [OECD Factbook 2011-2012, Patents](#).

⁴⁵ Russian [Federal State Statistics Service](#).

the average for EU-27 companies is 53%.⁴⁶ Similarly, the share of high technology products in total exports is just 8.3%,⁴⁷ compared to 15.3% for the EU.⁴⁸

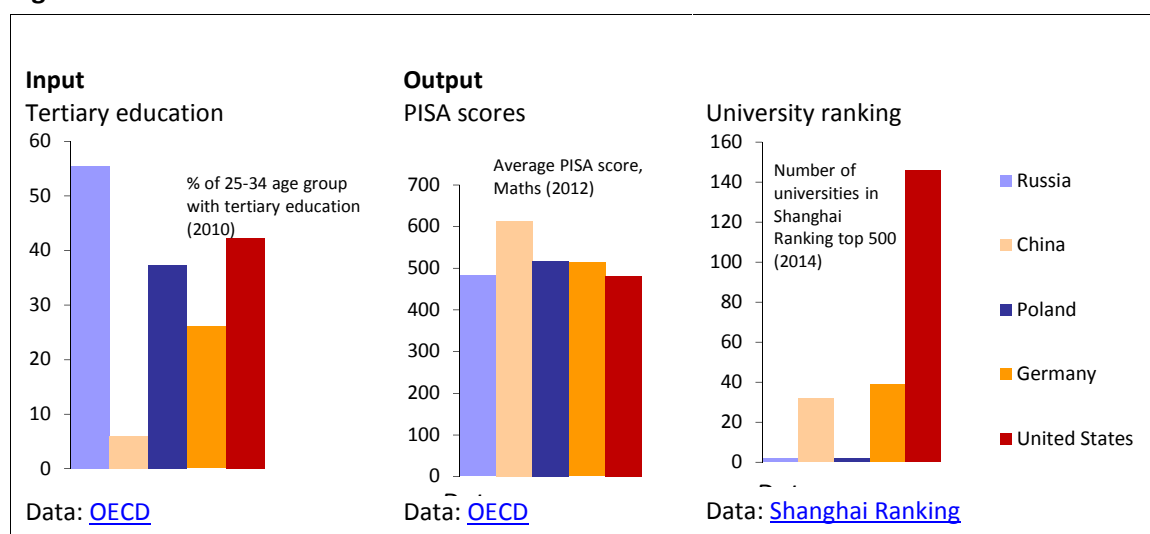
Mindful of Russian under-performance, the government has made innovation a priority, investing billions of dollars in areas such as:

- tax breaks: profits from licensing of intellectual property are exempt from VAT (since 2008); companies investing in priority R&D areas such as nanotechnology receive tax benefits;⁴⁹
- establishment of the Russian Venture Company (2006), which invested RUB 14.8 billion (US\$280 million) through public-private partnerships in the hi-tech sector;
- technology parks: some 60 of these have been established, including Russia's 'Silicon Valley', the Skolkovo Innovation Centre near Moscow, which was launched in 2010.

As most of these initiatives are fairly recent, it is too early to assess their impact. On the one hand, Skolkovo Innovation Centre has succeeded in attracting international partners such as IBM, Siemens and Boeing. On the other, isolated technology enclaves such as Skolkovo, created by top-down government action, are not translating into a wider market-driven culture of innovation.⁵⁰ Furthermore, current tensions between Russia and the West are likely to hamper the participation of foreign technology companies.

3.2.4. Education: mediocre performance despite high participation

Figure 6: education indicators



Alongside research, education is another traditional area of strength for Russia. For example, Russia is fourth out of 36 OECD/G20 countries in terms of numbers of adults with a tertiary education qualification (54%, up from 44% in 1994).⁵¹ Class sizes are

⁴⁶ [Innovation statistics](#), Eurostat, 2015.

⁴⁷ Russian [Federal State Statistics Service](#).

⁴⁸ [Hi-tech exports, % of exports](#), Eurostat.

⁴⁹ [UNESCO Science Report 2010](#), UNESCO, 2010.

⁵⁰ 'Russia scores poorly in international innovation rankings; government's top-down approach shows mixed results', *East-West Digital News*, 2012.

⁵¹ [Education at a Glance: OECD Indicators 2012](#).

relatively small (17 per teacher in primary schools). On the other hand, despite having increased substantially since 2000, spending is still significantly below the OECD average both in absolute terms and relative to GDP.

In terms of output indicators, the picture is less encouraging. The OECD's PISA 2012⁵² educational survey shows Russian 15-year olds scoring below the average for 65 countries in mathematics, reading and science, although in the first two subjects their scores had improved significantly since the previous survey (2003). Russian universities also compare poorly to their international counterparts: only two (Moscow and St Petersburg) make it into the top 500 of the 2014 Shanghai Ranking.⁵³ Most European countries do much better — for example, Belgium has seven.

Reasons cited⁵⁴ for Russia's poor educational performance include: antiquated curricula; severe funding disparities between regions — with, for example, per-pupil funding twice to three times higher in Moscow than in neighbouring regions;⁵⁵ and poor teaching standards — no doubt exacerbated by severe underpayment of teachers (salaries in the education sector were just 79%⁵⁶ of the national average in 2013, although this figure is still an improvement on the level of 60% recorded ten years earlier).

Studies⁵⁷ reveal a mismatch between the Russian education system and labour market needs, reflected in the fact that half of university graduates, and 80% of those graduating from vocational education institutions, do not work in their fields of study.⁵⁸ This mismatch, combined with a shrinking labour force (see below), explains why a shortage of 'workforce skills' has been identified as the third most significant business constraint.⁵⁹

A recent reform⁶⁰ of Russian schools and universities includes some potentially positive measures, for example introducing competition to tertiary education by concentrating funding on the most successful universities and allowing secondary school students to choose some of their subjects. However, as this only came into effect in September 2013, it is too early to assess its impact.

⁵² [PISA 2012 Results in Focus](#), OECD.

⁵³ [Shanghai Academic Ranking of World Universities](#).

⁵⁴ See for example [Educational Scores: How Does Russia Fare?](#)

⁵⁵ L I Jacobson, *Budgetary Relations in Modern Education*, 2002 (in Russian).

⁵⁶ Russian [Federal State Statistics Service](#).

⁵⁷ See for example the [Economic value of skills](#) study from the Centre for Labour Market Studies at Moscow's Higher School of Economics (2008), or the [Hays Global Skills Index 2012](#).

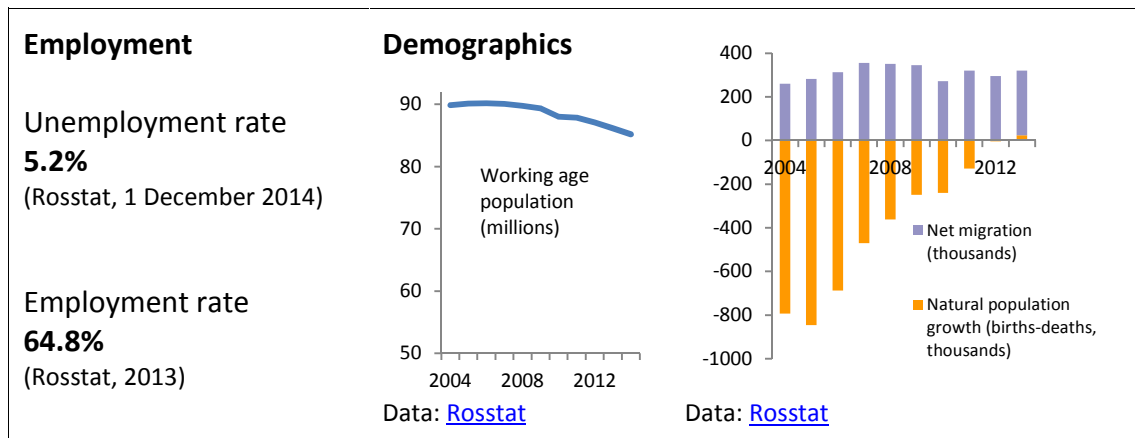
⁵⁸ [Labour Force Survey](#), Rosstat, 2013.

⁵⁹ [The Business Environment and Enterprise Performance Survey](#), EBRD, 2013.

⁶⁰ ['Education Reform Inching Forward'](#), *Moscow Times*, 2012.

3.2.5. Labour markets — reasonably efficient, although with some areas of concern

Figure 7: labour market and demographic indicators



From a competitiveness perspective, Russian labour markets function reasonably well: in the World Economic Forum's Global Competitiveness Report for 2014, (based on feedback from Russian entrepreneurs, Russia scores above average compared to international competitors — 45th place out of 144 for general labour market efficiency, 28th place for flexible wage determination, 41st for hiring and firing practices. There are however concerns about earnings inequalities, enforcement of labour standards and a lack of collective bargaining.⁶¹

Demographic constraints are a more serious issue. Though close to its historic high, the labour force is shrinking (down 0.2% from 2012 to 2013). In the medium term, natural growth in the working age population will remain negative as the demographic dip of the 1990s continues to feed through. However, longer-term trends are more positive, with the fertility rate currently at its highest ever post-Soviet level and natural growth (births – deaths) of the total population positive for the first time in two decades. In the meantime, the shortfall in labour supply is being met by migration from ex-Soviet republics — in particular, Uzbekistan, Ukraine, Kazakhstan and Tajikistan (respectively, 118 000, 55 000, 52 000 and 51 000 migrants to Russia in 2013).⁶²

The relatively tight supply of labour is reflected in low unemployment rates (on a downward trend since 2000; currently around 5%), and skills shortages in certain areas (as of 31 October 2012, unfilled vacancies represented 2.8% of total employment, with research and healthcare some of the areas worst affected).⁶³

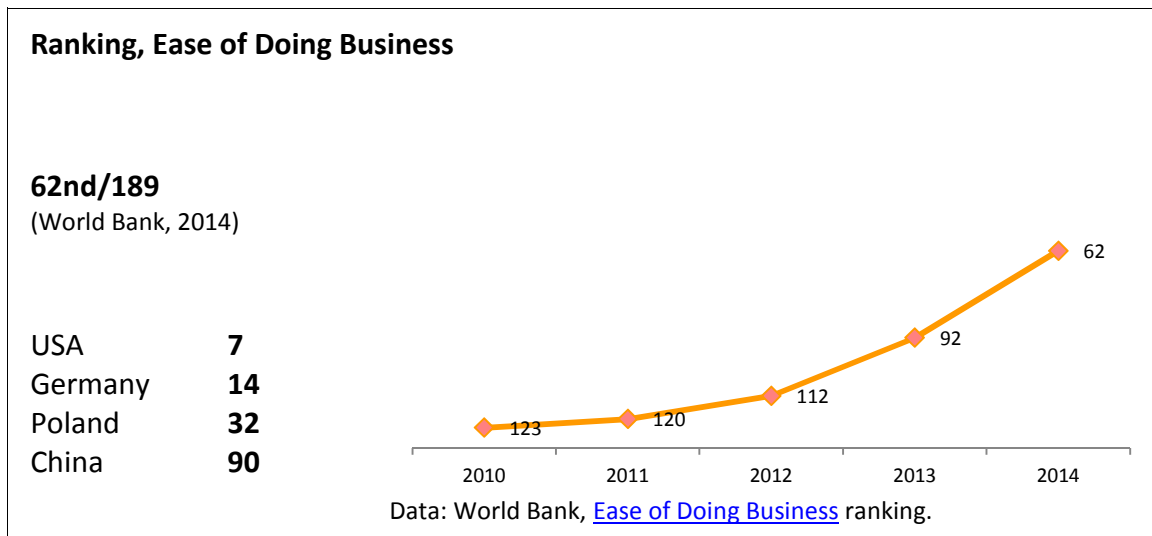
⁶¹ See for example [OECD Reviews of Labour Market and Social Policies: Russian Federation](#), OECD, 2011.

⁶² All data in this paragraph from Rosstat.

⁶³ Russian [Federal State Statistics Service](#).

3.2.6. Regulatory environment: solid progress, but still a long way to go

Figure 8: regulatory environment indicators



Even after the economic liberalisation of the 1990s, the regulatory environment for business remains very challenging. For example, in the World Bank's 'Doing Business 2013' report (with data from 2012), the country was still ranked 112 out of 185, behind countries such as Guatemala and Zambia. However, the last two years have shown a dramatic improvement, moving to 92nd place in 2013 and 62nd in 2014.⁶⁴ While the 2013 and 2014 results are not wholly comparable, due to the inclusion of new indicators in 2014,⁶⁵ improvements highlighted over the last two years include simplified procedures for registering new companies and purchasing properties. By contrast, construction permits, cross-border trading and connecting to the national electricity grid (despite slight improvements in the latter) are areas in which Russia remains near the bottom of the international league table.

3.2.7. Corruption: a major barrier to Russia's competitiveness

| | | |
|--|---------------------------|-------------------------|
| Corruption Perception Index | Cost of corruption | Corruption is |
| 136th/175 | 50% GDP | 'indestructible' |
| (Transparency International , 2014) | Average business bribe | according to |
| | US\$244 000 | 38% |
| | (INDEM, 2005) | of Russians |
| | | (Levada Centre, 2014) |

A bigger problem than the regulatory environment is what happens outside it. Compared to the other factors discussed here, corruption is the area in which Russia does worst. International surveys, for example Transparency International's 'Corruption Perception Index',⁶⁶ consistently show Russia as being among the most corrupt countries in the world — in 2014, 136th out of 175 countries, not only below the other G20 and BRICS countries, but also countries such as Honduras, Pakistan and Nepal.

⁶⁴ [Doing Business 2015, Going Beyond Efficiency](#), World Bank, 2015.

⁶⁵ Including the same indicators in the 2013 ranking as for 2014 would have given an improvement from 64th (instead of 92nd) to 62nd place.

⁶⁶ [Corruption Perception Index](#), Transparency International, 2014.

Corruption has a severe economic impact. A survey of managers from 4 200 Russian companies identified corruption as the country's number one business constraint.⁶⁷ In 2011, Rosstat estimated that total corruption only amounted to 3.5-7% GDP, but if the country's low ranking in the Corruption Perception Index is at all indicative of reality, this is almost certainly an under-estimate. In contrast, in 2005 a World Bank-sponsored survey of 1 000 entrepreneurs estimated the amount of bribes paid by Russian business at a staggering US\$316 billion per year, an average of US\$244 000 per company, nearly 50% of GDP;⁶⁸ the truth probably lies somewhere between these two figures. It is clear that bribery is a normal business practice,⁶⁹ essential in order to obtain government contracts and permits, deal with the tax authorities, and generally get things done. Apart from adding to business costs, Russia's reputation for corruption also deters international investors.⁷⁰

In 2008 President Medvedev adopted a National Anti-Corruption Plan.⁷¹ Measures taken since then include higher fines for receiving bribes and an obligation⁷² for organisations (such as companies) to develop and implement internal controls to combat corruption. However, these efforts are being undermined by the government's own actions — for example, the abuse of politically motivated fraud or corruption charges to discredit opposition activists such as Aleksei Navalny (most recently in December 2014),⁷³ or to seize valuable assets (such as the Bashneft oil company).

At present, there is no hard evidence of an improvement. It is true that Russia has improved its Corruption Perception Index ranking, from 2.1 (out of a maximum of ten points) in 2008 to 27 (out of 100) in 2014, but given that this measures perceived corruption, it could reflect government announcements of anti-corruption action rather than real improvement. Supreme Court statistics⁷⁴ are another indicator; these show that in 2012 and the first half of 2013, 6 014 and 1 850 persons respectively were convicted of corruption. As these figures have only been published since 2012, there are not enough data to show a clear trend, but one interesting fact is that officials receiving bribes are much less likely to be convicted than those paying them — for example, in the first half of 2013, bribe-payers were two and a half times more likely to be convicted, and five times more likely to be imprisoned, than bribe-takers, suggesting a pattern of relative immunity for government officials.

One certainty is that corruption is a perennial feature of Russian society going back to Soviet and even Tsarist times — for example, in 1826, Nicholas I called for the 'eradication of this ulcer'.⁷⁵ According to a poll⁷⁶ by the Levada Centre, Russia's leading independent, non-governmental pollsters, 38% of Russians believe that the country's

⁶⁷ [The Business Environment and Enterprise Performance Survey](#), EBRD, 2013.

⁶⁸ [Corruption process in Russia: level, structure, trends](#), INDEM Foundation, 2005.

⁶⁹ A Kalanina, [Corruption in Russia as a Business](#), Institute of Modern Russia, 2013.

⁷⁰ ['Promising but Perilous: German Firms Put Off by Russian Corruption'](#), *Spiegel*, 2013.

⁷¹ ['Dmitry Medvedev signed an executive order approving the National Strategy for Countering Corruption'](#), President of Russia website, 2010.

⁷² ['Measures taken to strengthen Russian anti-corruption laws'](#), Lexology, 2013.

⁷³ ['Aleksei Navalny, Putin Critic, is Spared Prison in a Fraud Case'](#), *New York Times*, 2014.

⁷⁴ [Judicial Statistics on corruption cases](#), Russian Supreme Court (in Russian only).

⁷⁵ [Corruption in Tsarist Russia: A history of the problem](#), Romanov B., proza.ru, 2010 (in Russian only).

⁷⁶ [Russians tend to call corruption indestructible – poll](#), Johnson's Russia List, 2014.

corruption is 'indestructible', all of which suggests that this problem will continue to weigh on the economy for many years to come.

4. The current economic situation

4.1. External factors

Apart from the structural factors mentioned in the previous section, the current economic situation is influenced by a combination of two mutually aggravating external developments:

4.1.1. *Falling oil and gas prices*

In 2014 crude oil prices collapsed from over US\$100 per barrel to around US\$55, due to higher production levels — in the United States, for example — and weak demand.⁷⁷ Natural gas prices, which are tied to oil prices in some Gazprom supply contracts, have also fallen. As mentioned above, oil and gas account for around 70% of Russia's exports, and half of the federal budget. The impact on the wider economy is severe given that numerous other sectors are dependent on the oil and gas industry (for example, as a purchaser of goods and services and provider of investment).

4.1.2. *Economic sanctions*

The first economic sanctions against Russia were introduced in March 2014 after its annexation of the Crimea and were gradually stepped up over the year. Participants include the EU and EFTA countries, the US, Canada, Australia, New Zealand and Japan. Restrictive measures include:

- freezing the assets of persons and companies close to the Russian leadership;
- severely limiting access by the main Russian banks and companies in the energy and defence sectors to EU and US financial markets;
- banning exports of technology and equipment useful to the defence and energy sectors.

Russia retaliated in August 2014 by banning imports of agricultural and processed food products from western countries.

In the short and medium term, restricted access to western financial markets hurts Russian business, which not only needs to service corporate debt, but also to fund new investments. At the same time, restricted access to innovative extractive technology has resulted in several joint ventures (e.g. Gazprom Neft/Shell, Rosneft/ExxonMobil, Lukoil/Total) being suspended,⁷⁸ which in the longer term will impair the capacity of the Russian oil industry to tap into non-conventional resources as current reserves run out.

In November 2014, the total impact of lower oil prices and economic sanctions was estimated by Finance Minister Anton Siluanov at US\$130-140 billion a year (around 7% of GDP): US\$90-100 billion from reduced oil revenue (based on oil prices of US\$80 per barrel) and US\$40 billion from sanctions.⁷⁹

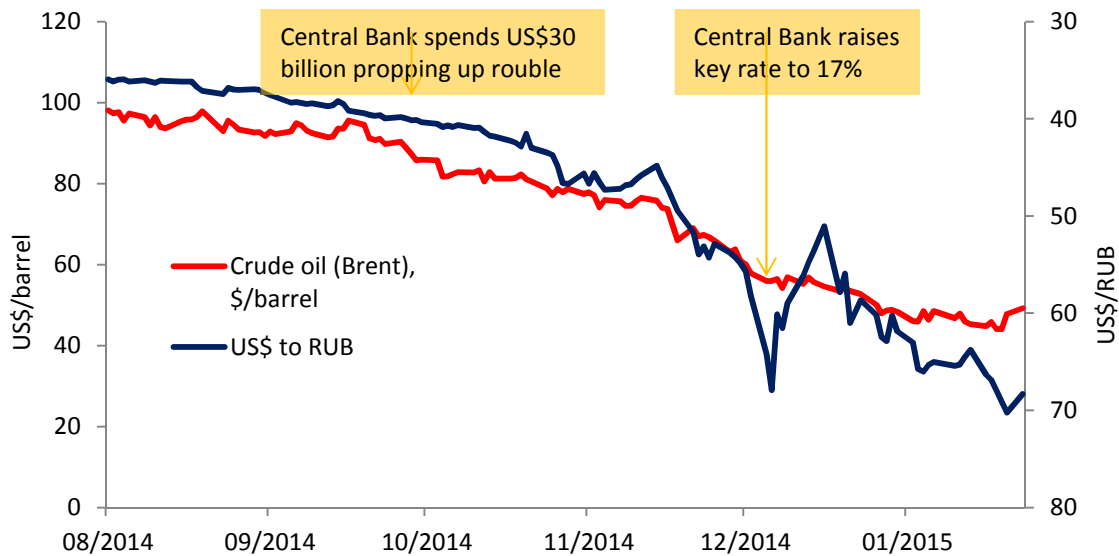
⁷⁷ ['Why the oil price is falling'](#), *The Economist*, 2014.

⁷⁸ ['Shell suspends Russian shale oil venture'](#), *Financial Times*, 2014.

⁷⁹ ['Russia puts losses from sanctions, cheaper oil at up to \\$140 billion per year'](#), Reuters, 2014.

4.2. The rouble

Figure 9: the rouble and oil prices



Data: US Energy Information Administration/Exchange-Rates.org.

In the second half of 2014, the rouble fell in tandem with oil prices, losing over half of its value. Interventions by the Russian Central Bank (US\$30 billion spent on propping up the rouble in October; an interest rate hike of 6.5% to 17% in December, later eased to 15%) failed to halt the currency's downward slide for more than a few days.

A weaker rouble is particularly difficult for Russian businesses with US dollar-denominated debt, of which \$106 billion must be paid back or re-financed in 2015.⁸⁰ It also affects consumers, as more expensive imports (accounting for over half⁸¹ the products on which the consumer price basket is based) have pushed inflation into double digits — 11% for 2014 as a whole, with consumer prices rising by 4.8% in the final quarter of the year.⁸²

On the other hand, a weaker rouble can benefit Russian companies by making their products more competitive; for example, severe rouble depreciation caused by the 1998 currency crisis helped to kick-start growth after several years of contraction. In 2014, there was some evidence of import substitution: at the end of the third quarter, economic activity in the agricultural sector (also boosted by the ban on imports of EU agricultural products) was up by 7%, compared to the equivalent period in 2013, while manufacturing output grew by 1%, in contrast to non-tradable sectors such as construction (-1%).⁸³ Overall, Russia's trade balance for the first 11 months of 2014 was up US\$11 billion compared to the equivalent period last year.

⁸⁰ Iana Dreyer and Nicu Popescu, [Do sanctions against Russia work?](#), European Union Institute for Security Studies, December 2014.

⁸¹ ['Moscow's Migraine: Ruble Pains to Ease in 2015'](#), Roubini Global Economics, 2014.

⁸² Russian [Federal State Statistics Service](#).

⁸³ Russian [Federal State Statistics Service](#).

However, the competitiveness boost provided by a weaker rouble is likely to be more limited than in 1998: then, Russian manufacturing had plenty of spare capacity after years of contraction; now, capacity utilisation rates are relatively high,⁸⁴ which means that in order to significantly increase output, manufacturers will have to make capital investments — difficult in the current context of scarce financing — as well as taking on more human resources — also in short supply given tight labour markets (see section 3.2.5 on the labour market, above). Moreover, satisfactory domestic alternatives do not always exist for Russia's main imports (machinery, cars and trucks, electrical and electronic equipment, pharmaceutical products).⁸⁵

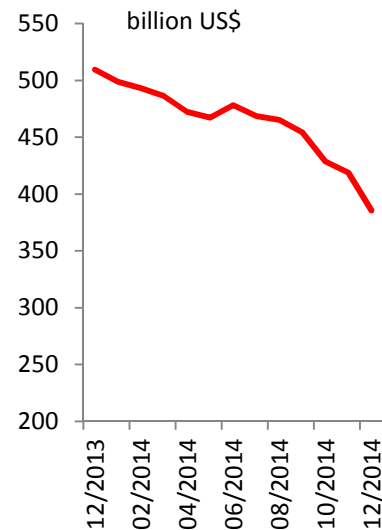
4.3. Public finances

As mentioned above, the federal budget gets 50% of its revenue from oil and gas production. The 2015 budget was drawn up assuming crude oil price levels of US\$100 per barrel;⁸⁶ Russian Finance Minister Anton Siluanov recently estimated that current levels of around US\$50 will mean around US\$45 billion less in revenue for the government.⁸⁷ To compensate for this, he is proposing to cut non-defence spending by 10%,⁸⁸ twice the level demanded by President Putin in December. Civil servants' salaries have already been frozen for 2015.⁸⁹ However, Siluanov admits that even these cuts will not be enough to balance the budget, which he expects to run a deficit of over 3% GDP in 2015⁹⁰ (compared to 1.3% in 2013, and a small surplus in 2012).

Admittedly, Russia starts from a relatively strong position, with total central government debt of just 9.4% of GDP in 2013.⁹¹ The country also has substantial reserves, totalling US\$379 billion (as of 16 January 2015),⁹² which are, however, shrinking rapidly, down from US\$510 billion at the beginning of 2014. Large sums have already been spent on propping up the rouble (US\$30 billion in October 2014 alone), and claims on reserves are continuing to grow — for example, a US\$35 billion package of measures in support of the banking sector, announced in January 2015,⁹³ and the expected budget deficit in 2015, which may have to be funded from reserves. It should also be borne in mind that not all of the reserves, which include US\$46 billion in gold

Figure 10: Russian international reserves

Russia's international reserves are shrinking fast



Data: [Central Bank of Russia](#)

⁸⁴ According to figures from Haver Analytics, cited by the World Bank in [Russia Economic Report](#), 2014.

⁸⁵ [Trade Map](#), International Trade Centre.

⁸⁶ [Main Budget Policy Guidelines for 2015](#) (in Russian only), Russian Ministry of Finance, 2014.

⁸⁷ ['Russian Finance Minister: We'll Lose \\$45 Billion If Oil Is At \\$50 In 2015'](#), *Business Insider*, January 2015.

⁸⁸ ['Russian official calls for 10% cut in government spending'](#), CNN, 2014.

⁸⁹ ['Putin: No pay rise for Russian civil servants in 2015'](#), *Russia Today*, 2014.

⁹⁰ ['Russia Rating in Balance as Kudrin Sees No Will for Overhaul'](#), *Bloomberg Business*, 2014.

⁹¹ World Development Indicators, World Bank.

⁹² [International Reserves of the Russian Federation](#), Central Bank of the Russian Federation.

⁹³ ['Russia considers creation of 'bad bank' to aid financial sector'](#), *Financial Times*, 2015.

and US\$80 billion in the National Welfare Fund⁹⁴ to meet future pension commitments, are easily accessible.

In response to the rapid deterioration in Russia's financial position, the country's sovereign debt has been downgraded by all 'Big Three' rating agencies, most recently to junk bond status by Standard and Poor's in January 2014, which cited the weak rouble, restricted access to international capital markets, and recession. While the direct impact of this downgrading on public finances will be limited given low levels of government borrowing, it is a further blow to Russia's international reputation which could make it even harder for Russian businesses and banks to finance themselves.

4.4. Employment

Despite the economic slowdown, unemployment remains at a very low level of around 5% (albeit with very substantial regional variations, from 1.7% in Moscow to over 40% in the northern Caucasus region of Ingushetia), reflecting a tight labour market due to demographic constraints (see section 3.2.5 above). However, some companies are already laying off workers — automotive companies have begun downsizing,⁹⁵ and former Finance Minister Alexei Kudrin recently referred to 100 000 people being laid off in Moscow's construction sector.⁹⁶

Inevitably, illegal migrants⁹⁷ working in sectors such as construction are the first to be laid off, and as they are not included in official statistics, the impact on the unemployment rate may be limited. On the other hand, remittances from migrant workers to their home countries⁹⁸ have fallen substantially.

4.5. GDP growth

Even before the current crisis, economic growth was already on a downward trajectory, from 4.3% in 2011 to 1.3% in 2013. For the first three quarters of 2014, this fell to an annualised rate of 0.8%, and appears to have gone negative in the final quarter, with an estimated rate of 0.6% for the year as a whole.⁹⁹

The reasons for this decline are clear. As already explained, external factors (falling oil prices and economic sanctions) have meant lower export earnings, lower government revenue, higher interest rates, higher inflation rates, and limited access to financing. At the same time, continued geopolitical uncertainty over the Ukraine crisis undermines business and consumer confidence. This crisis of confidence is reflected in and exacerbated by capital flight, estimated by the Central Bank of Russia at US\$128 billion.¹⁰⁰

⁹⁴ Central Bank of Russia, data for December 2014.

⁹⁵ ['Russia's automobile manufacturers begin layoffs campaign'](#), TASS, 2014.

⁹⁶ ['Russia's Kudrin says mass layoffs show crisis deepening'](#), Reuters, 2015.

⁹⁷ Estimates vary, for example Mohammad Majumder, President of the Russian Federation of Migrants, cited by [Radio Free Europe](#), claims that as many as 90% of the estimated 10 million migrant workers in Russia are in the country illegally.

⁹⁸ Statistics from the Central Bank of Russia show that remittances to Uzbekistan (the main country of origin) fell by 9% in the third quarter of 2014 compared to one year earlier. Similarly, the Federal Migration Service records 365 000 Uzbek migrants leaving the country in the second half of the year.

⁹⁹ Data from OECD (2014, 2015), Central Bank of Russia.

¹⁰⁰ ['Russian Central Bank Increases Capital Flight Estimate by \\$38 Billion'](#), *Moscow Times*, 2014.

All of this creates an extremely unfavourable environment for growth. Analysing GDP growth according to its main components, based on the most recent available official statistics¹⁰¹ comparing GDP in the third quarter of 2014 with the same period a year earlier:

- **household spending:** in the third quarter of 2014, annual growth in household spending slowed to 0.8% per year;
- **government spending:** over the same period, this declined by 0.3%;
- **business investment:** down by 2%;
- **trade balance:** the only positive area, up by 7%.

Since then, this already difficult situation has deteriorated further — households and businesses are suffering from higher interest rates (and, for those with loans denominated in foreign currencies, a dramatically weakened rouble), while significant government spending cuts are planned, including a freeze on civil service salaries, all of which will continue to depress growth further.

5. Future prospects

5.1. For the coming year

For 2015, the OECD's most recent forecast¹⁰² is for GDP growth of -4.6%, based on oil prices averaging US\$58/barrel over the year and sanctions continuing, a figure which ties in with a December 2014 forecast by ex-Finance Minister Kudrin of -4% assuming oil at US\$60.¹⁰³ For its part, the IMF¹⁰⁴ expects to see the economy contract by 3%.

Given the volatility of crude oil prices and the uncertainties over the situation in Ukraine, these are not reliable forecasts. Just three months earlier, in October 2014, the IMF forecast 0.5% growth for Russia, while in September the World Bank predicted 0.3% growth under a 'pessimistic scenario' predicated on oil at US\$100 a barrel,¹⁰⁵ (whereas just three months later oil prices were half that level). Whether or not the current forecasts are equally mistaken will depend on how the two main external factors currently weighing on the Russian economy evolve.

Oil prices: a clear trend has yet to emerge. Having fallen below US\$50 per barrel at one point, in February 2015 crude oil was at US\$55. With global oil stocks still rising, volatility is likely to continue in the short term.¹⁰⁶ The IMF¹⁰⁷ believes that oil futures prices point to a partial recovery.

Sanctions: NATO claims that Russia is directly involved in the recent escalation of violence in Eastern Ukraine. US President Barack Obama has called for additional sanctions, although it is unclear what form these could take. One option that would hurt Russian banks and companies involved in foreign trade might be to exclude the country from the SWIFT international payments system. On the other hand, it might be

¹⁰¹ Russian [Federal State Statistics Service](#).

¹⁰² [Regional Economic Prospects in EBRD Countries of Operations, OECD, January 2015](#).

¹⁰³ 'Russia faces full-blown crisis, says Kudrin', *Financial Times*, 2014.

¹⁰⁴ [World Economic Outlook](#), IMF, January 2015.

¹⁰⁵ [Russia Economic Report](#), World Bank, September 2014.

¹⁰⁶ 'Global oil prices will stay volatile for now', Oxford Analytica, 2014.

¹⁰⁷ World Economic Outlook, op. cit.

difficult for the EU to agree to this kind of measure, with both the Greek and Hungarian governments having expressed reservations on further sanctions.

5.2. Longer term prospects

It is impossible to reliably predict the long term outcome of the rapidly unfolding Ukraine crisis. As for oil prices, they seem likely to revert to long-term trends over the next few years: oil company investment cutbacks will mean lower future production capacity and lower supply. For example, Italian oil executive Claudio Descalzi has predicted oil prices of up to US\$200 a barrel unless the sector invests more.¹⁰⁸ In view of this, Russia's economic situation should eventually improve, with a resumption of growth, though not at the levels seen during the 1999-2008 boom.

Of course, this will not address the fundamental problem of Russia's dependence on oil. Oil-driven growth is limited by the fact that production capacity cannot be expanded indefinitely, especially in view of the current lack of investment; moreover, it is vulnerable to volatile oil prices, as the present crisis so clearly demonstrates.

In order to achieve the sustained high growth Russia needs in order to modernise its economy, the structural issues mentioned above will have to be tackled. Unfortunately, even under Dmitri Medvedev's presidency with its declared reform agenda, the Russian government did not have a good track record in this field: the measures taken were half-hearted and incoherent. At that time, there were already tensions between, on the one hand, liberal reformers, and on the other, Russia's *siloviki* — hardliners who, like Vladimir Putin, have a background in the military or security forces, such as Sergei Ivanov, Head of Presidential Administration. These tensions were reflected in the resignation of the highly respected former Finance Minister Alexei Kudrin, among other things over his opposition to a planned increase in defence expenditure.¹⁰⁹

These tensions continue. For example, it has been claimed that corruption charges in connection with the Skolkovo Innovation Centre were the result of *siloviki* efforts to discredit reform projects.¹¹⁰ At the moment, the geopolitical situation seems likely to play into the hands of the hardliners, as the country pursues an aggressive foreign policy regardless of the economic cost. Against this backdrop, economic reforms will be even less of a priority.

Russia has always lagged far behind the rest of Europe — figures from studies¹¹¹ such as the Maddison Project, which looks at historical GDP data, show that this gap already existed in the Tsarist period, and has remained fairly constant ever since, with per capita GDP stuck at around half that of the advanced Western economies. This confirms the thesis¹¹² advanced by former Prime Minister Yegor Gaidar of a stable 50-year time lag between Russia and Western Europe. With no prospect of the radical structural reforms needed for Russia to catch up, that development gap will continue for the foreseeable future.

¹⁰⁸ ['Oil price could spike to US\\$200 a barrel as investment slump incubates future crunch, experts warn'](#), *Financial Post*, 2015.

¹⁰⁹ [No pain, no gain: Big defense spending to continue, says Medvedev](#), *Russia Today*, 2011.

¹¹⁰ [Political backlash blamed for woes at Russia's 'Silicon Valley'](#), *Financial Times*, 2013.

¹¹¹ See the [Maddison Project](#) database.

¹¹² In Gaidar, Yegor, *Dolgoe vremya. Rossiya v mire* (The Long Term. Russia in the World), 2005.

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The Russian economy is reeling from the impact of lower oil prices and economic sanctions. However, many of the problems go back much further, to Soviet and even Tsarist times: an unhealthy dependence on the country's bountiful natural resources; continuing state control of companies in many economic sectors; barriers to domestic and international competition; red tape and endemic corruption; and a lack of innovative activity. Economic reforms undertaken by the government have brought measurable improvements in only a few areas.

Higher oil prices and the easing of economic sanctions could help Russia to recover from its current difficulties. In the longer term though, the country will have to address its structural problems in order to achieve stable growth and build a modern economy.

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