Seven economic challenges for Russia

Breaking out of stagnation?

IN-DEPTH ANALYSIS

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This publication describes the current condition of the Russian economy, which has suffered recently from external shocks, such asa collapse in oil prices and Western sanctions. However, it argues that poor economic performance has more to do with long-term internal problems, including a lack of competitive markets, low levels of investment, an absence of innovation and excessive dependence on natural resources. Finally, it discusses President Putin's promises of economic reforms to tackle such issues, and evaluates the probability of major change.

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Executive summary

In 2015, a sharp drop in the price of oil, Russia's main export earner, combined with Western sanctions over Ukraine, pushed the country's economy into recession. Sanctions are still in force, but the oil price has partly recovered, helping economic growth to resume after nearly two years of decline. However, economic recovery has been anaemic, with growth likely to remain below 2 % for the next few years. Forecasts suggest that Russia's share of the global economy will continue to shrink, and that it will lag ever further behind the world's more advanced economies.

External factors such as sanctions certainly weigh on Russia's economy, but the main barriers to growth come from inside the country and are the result of long-standing problems, many originating in the Soviet period or even further back. Despite market-economy reforms in the early 1990s, Russia remains dominated by large and inefficient state-controlled enterprises. Reforms have improved the regulatory environment and cut red tape, but these gains have not been matched by progress in tackling corruption, which remains a major scourge for business. In terms of human capital, a catastrophic shrinkage in the size of the workforce caused by low birthrates is expected to hold back economic growth. Inequality remains high, and economic recovery has not yet benefited the nearly 20 million Russians living in poverty. A low level of competitiveness correlates with a general lack of innovation, low levels of investment and reliance on natural-resource exports.

President Vladimir Putin has made reinvigorating the economy his top priority. For him, stagnation is an existential threat to the country's future. It is of course encouraging that Russia's leaders recognise the importance of structural reforms. However, the ambitious economic targets set by Putin completely lack credibility, and a poor track record of implementing reforms to encourage economic growth in recent years makes it doubtful that Russia is about to turn the economic corner.

Russia's economic policy has important implications for its relations with the European Union, not only because Russia is the EU's fourth-largest trading partner. Western sanctions imposed on Russia for its aggression in Ukraine exacerbate the structural problems mentioned above; if Russia wants to improve its economic performance, getting sanctions lifted is an important part of the way forward. On the other hand, continued stagnation may encourage Vladimir Putin to compensate for his country's economic weakness through continued confronation with the West.

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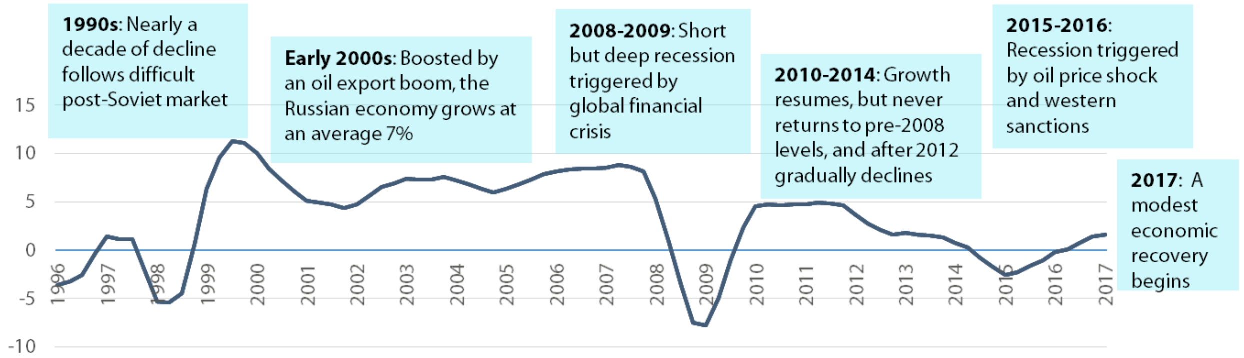
1.1. Snapshot of the Russian economy in 2018

Figure 1: Economic growth in Russia, 1996-2017, % annual growth



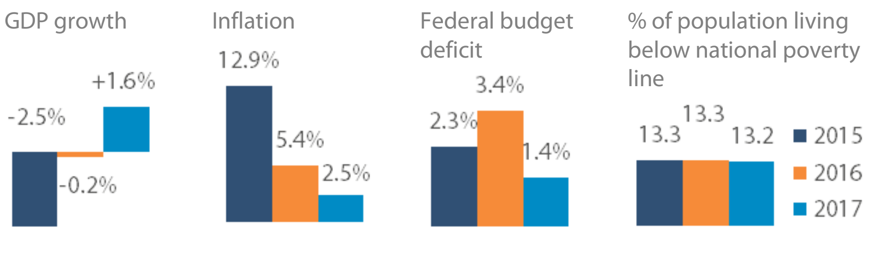
Year-on-year growth compared to previous 12-month period. Data: Federal State Statistics Service.

In 2014, hit with the combined impact of a nearly 75 % drop in the price of oil (Russia's main export) and Western sanctions imposed in mid-2014 after Russian aggression in Ukraine, the economy went into recession. The rouble collapsed, inflation soared, and the government was forced to dig deep into its international reserves to keep the banking sector afloat.[1]

Partly helped by a recovery in the oil price (in April 2018, around US$70 per barrel, up from its January 2016 nadir of under US$30, but still less than its June 2014 peak of US$110), Russia's economy started growing again in late 2016. In 2017, growth reached 1.6 %, and is forecast to remain at a similar level for the next two years.[2] Agriculture was the fastest-growing sector (2.3 %), but manufacturing and services sectors also picked up. Foreign trade grew by 21% and inflation (which went into double digits in 2015 and 2016) fell below 4 %. In 2018 the federal budget came back into surplus.

Eighteen months into economic recovery, ordinary Russians have finally started to feel the benefits of growth. The year 2017 saw a small drop in the poverty rate, and in April 2018 real disposable income (the amount of household income left after essential purchases have been paid for) registered its first improvement after four consecutive years of decline.[3]

Figure 2: Key economic indicators 2015-2017



In 2017, the economy improved: growth resumed, inflation came down, the budget deficit shrank, and the poverty rate showed signs of starting to fall

Sources: Federal State Statistics Service (GDP growth, inflation, poverty rate); Federal Treasury (federal budget deficit).

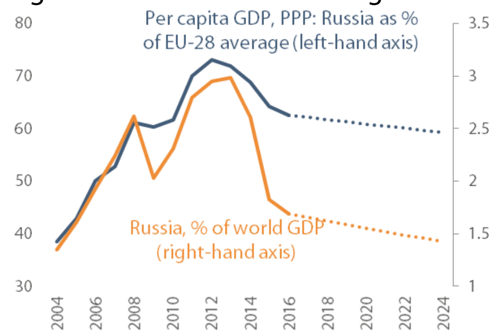
1 Russell M., The Russian economy: Will Russia ever catch up?, European Parliament Research Service, March 2015.

2 Russia's Recovery: How Strong are its Shoots?, World Bank, November 2017.

3 Incomes in Russia Continue 4-Year Plunge, The Moscow Times, 21 November 2017; Federal State Statistics Service.

1.2. Economic recovery masks structural problems in the economy

Figure 3: Russia's economic lag



At current growth rates, Russia's share of the global economy is expected to decline, and it will lag further behind EU economies
Source: World Bank

Russia's current economic growth of under 2 % is not particularly impressive compared to the rates of 2.3 % and 2.7 % registered in the United States and the EU respectively,[4] or the global average of 3.8 %; it is even further below the 7 % averaged during Russia's early 2000s' economic boom. Anaemic growth means that Russia's share of the global economy is gradually declining, and the lag behind the more advanced economies, which had been narrowing till 2014, has started widening again, causing the country to fall further and further behind (Figure 3).

The recession of 2015-2016 and the slowness of the recovery since then, have only partly to do with external factors (Western sanctions, a drop in the price of oil). The fact that economic growth was already starting to run out of steam in 2012, long before either of these two external factors came into play, suggests that Russia has longer-term internal problems holding back the economy.

1.3. Russia's structural economic problems reflect its history

Russia has changed beyond recognition over the past 30 years, but in many ways the economic challenges faced by the country still resemble those of the Soviet era. Abundant natural resources support an adequate standard of living for the population; however, the economy, which is dominated by large and inefficient state-owned enterprises, lacks competitiveness and innovation. Russia has few technologically advanced exports and the standard of living is significantly below that of the more advanced Western economies. Excessive defence spending diverts resources from more economically productive investments, and although Russia is far more integrated into the global economy than the Soviet Union ever was, geopolitical confrontation with the West is encouraging the country to once again look inwards.

Other problems reflect more recent historical developments. The chaotic 1990s created widespread poverty and inequality, which have decreased since but to some extent still persist. The upheavals of the post-Soviet period also led to a dramatic drop in birth rates, the effects of which are now starting to be felt in the form of a demographic crisis.

The following chapter describes structural barriers to Russia's economic growth in seven main areas.

[4] World Economic Outlook (April 2018), International Monetary Fund.

2. Structural barriers to economic growth in Russia

2.1. Competition

2.1.1. The economy is dominated by large state-owned companies

For most of the Soviet period, nearly all businesses were state-owned. During the drastic economic reforms of the 1990s, tens of thousands of companies were privatised, bringing the state's share of the economy down to 38 % of GDP by 2006.[5] However, under Putin's successive presidencies, the trend to privatisation has been reversed with the nationalisation of major companies in strategic sectors such as energy, finance and defence. Oil producer Lukoil is the only privately owned enterprise among the country's top five companies by sales – the Russian state either owns or holds a majority shareholding in Gazprom (gas), Rosneft (oil), Sberbank (banking) and Russian Railways (Figure 4). According to one estimate, in 2012 the public sector accounted for as much as 70 %[6] of the economy, with 4 100 companies in state ownership.

Figure 4: Ownership of Russia's top ten companies

Company name	2016 sales (billion roubles)	Sector	Ownership
Gazprom	5 966	gas	state-controlled
Lukoil	4 744	oil	private
Rosneft	4 134	oil	state-controlled
Sberbank	3 059	finance	state-controlled
Russian Railways	2 133	transport	state-controlled
VTB Bank	1 320	finance	state-controlled
Rostech	1 266	investment	private
Magnit	1 075	retail	private
X5 Retail Group	1 034	retail	private
Surgutneftegaz	1 006	oil/gas	private

Most large Russian companies are state-controlled; Source: RBC.ru.

In a presidential decree[7] signed soon after his election in 2012, President Putin ordered the government to disinvest from non-raw-material sectors by 2016, 'with the exception of natural monopolies and defence-related companies'. There has indeed been some privatisation: in 2016, the state sold off part of its holdings in diamond miner Alrosa and oil company Rosneft (though it retains a controlling interest in the latter company). This was apparently motivated more by the need to plug a large budget deficit than a wish to trim back the state sector. In 2017, Prime Minister Dmitry Medvedev announced further privatisations, with the sale of parts of the government's holdings in bank VTB and shipping company Sovcomflot.[8] However, since then the pressure on government finances has eased, and the timing for the sale of VTB looks poor given that it is targeted by Western sanctions; both these privatisations have therefore been postponed indefinitely,[9] and no plans have been announced for selling off other state-owned companies.

5 Russian Federation Systematic Diagnostic: Pathways to Inclusive Growth, World Bank, 2016.

6 Fiscal Transparency Evaluation, International Monetary Fund, May 2014, p. 8.

7 Presidential Decree No 596 of 7 May 2012 on long-term economic policy (in Russian).

8 Russia approves privatization plan aimed at raising 17 billion roubles, Reuters, 2 February 2017.

9 Russia's improving economy leaves privatization out in the cold, Reuters, 27 October 2017.

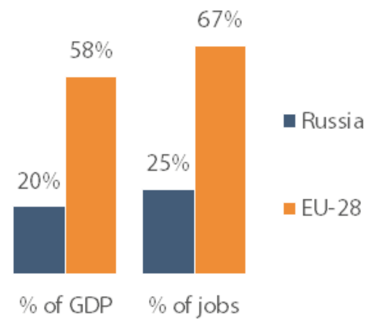
If anything, state control of the economy has become even larger recently, with the government having to bail out three failing private banks in 2017.[10] Further bail-outs of companies targeted by US sanctions in April 2018 are currently being considered.[11]

Data suggest that in Russia, as in many other countries,[12] state-owned companies are less efficient than private-sector counterparts. According to the World Bank, total factor productivity (TFP) – a measure of how efficiently companies convert capital and labour into revenue[13] – is much lower in Russian state-owned companies than in the private sector;[14] a 2012 BNP Paribas report[15] similarly concludes that labour productivity in public companies is over 30 % below the national average, not least because crucial decisions often serve political rather than commercial ends (for example, the discount on gas offered by Gazprom to Armenia after it joined the Eurasian Economic Union[16] or Sberbank's US$2.7 billion sponsorship of the Sochi Olympic Games[17]).

2.1.2. Russia's private sector is also non-competitive

World Bank total factor productivity data[18] suggest that, though more productive than their state-owned counterparts, Russian-owned private companies are considerably less efficient than foreign-owned companies operating in Russia. Moreover, the lag between Russian and foreign-owned companies appears to be growing; productivity increased substantially in the latter between 2005 and 2013, whereas in Russian-owned companies it stagnated or declined. The World Bank also points out that fewer new companies enter Russian markets than in most other former communist countries, and incumbent companies have higher profit margins, pointing to static markets and a general lack of competitiveness. The dominance of large incumbent companies helps to explain why Russian small and medium enterprises account for only one-fifth of the country's GDP and one-quarter of employment[19], far less than in the EU, where the figures are 58 % and 67 % respectively[20] (Figure 5).

Figure 5: Contribution of SMEs to the economy



SMEs play a much smaller role in Russia's economy than in the EU's

Source: World Bank, Eurostat.

10 Russia hit by $3.4 billion Promsvyazbank bailout in latest bank blow, Reuters, 15 December 2017.

11 Viktor Vekselberg's Renova Group says it needs a government bailout (or two), Meduza, 3 May 2018.

12 See Figure 3.2.1, Selected Emerging Market Economies: State-Owned Enterprises, Global Financial Stability Report, IMF, October 2016.

13 The Meaning of Total Factor Productivity, ThoughtCo, 17 March 2017.

14 See Figure 2.8, TFP by Sector and Ownership, Russian Federation Systematic Diagnostic: Pathways to Inclusive Growth, World Bank, 2016.

15 Russia: The land of the bountiful giants, BNP Paribas, 2012.

16 Gazprom cuts wholesale gas price, Economist Intelligence Unit, 7 May 2015.

17 Sochi's costly legacy: A year after Olympics, Russian oligarchs unload toxic assets on state as taxpayers pick up the bill, National Post, 5 February 2015.

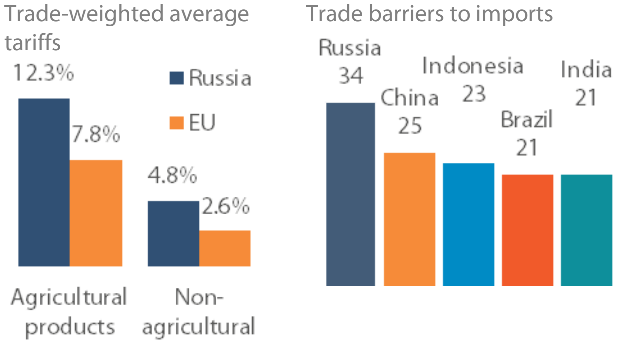
18 See Figure 2.8, TFP by Sector and Ownership, p. 61, Russian Federation Systematic Diagnostic: Pathways to Inclusive Growth, World Bank, 2016.

19 Russian Federation Systematic Diagnostic: Pathways to Inclusive Growth, World Bank, 2016.

20 Statistics on small and medium-sized enterprises, Eurostat (data from September 2015).

2.1.3. Trade barriers protect Russian companies from foreign competition

Figure 6: Trade barriers



Barriers to foreign imports in Russia are high

Source: World Trade Organization, European Commission.

Russia only joined the WTO in 2012. WTO membership has helped to bring formerly high import tariffs down; in 2015, Russia's trade-weighted average tariff[21] was 4.8 % for non-agricultural products, and 12.3 % for agricultural products,[22] somewhat higher than the EU's 2.6 % and 7.8 % (Figure 6). More of a problem for would-be exporters to Russia are the many non-tariff barriers. Apart from differing technical standards, Russia has a long tradition of blocking imports – for example, of Polish meat (between 2005-2012), Moldovan and Georgian fruit and wine, and Belarussian dairy products, mostly over alleged health concerns. Western sanctions over Ukraine have given Russia a pretext to further restrict agrifood imports from the EU and other sanctioning countries. Since then, in the absence of foreign competition, Russian agriculture has grown faster than any other sector.[23] Currently, there are eight trade disputes ongoing against Russia at the WTO; for example, the EU argues that a 'recycling fee' imposed by Russia on motor vehicles discriminates against imports, as domestically produced cars and lorries are largely exempt from this fee.[24] The European Commission lists 34 trade barriers in Russia, restricting imports of products ranging from medicines to agricultural machinery[25] – a higher number than the United States (19) or China (25).

In 2015, Russia, Kazakhstan, Belarus and Kyrgyzstan launched the Eurasian Economic Union (EEU), intended to create an EU-style Eurasian internal market, with free movement of goods, services, persons and capital.[26] However, the removal of intra-EEU trade barriers is unlikely to mean much extra competition for Russian businesses, firstly because the other EEU member states account for just 10 % of total Russian foreign trade, and secondly because most of them have economies which are even less competitive than Russia's.

2.1.4. Russia launches an import-substitution programme

Partly in response to Western sanctions, in 2015 Russia launched an import substitution programme.[27] The programme covers 19 sectors including defence, car manufacture and electronics, with measures including low-interest loans, tax breaks and mandatory preference for services and equipment from Russia and other EEU countries in government tenders. Between 2014

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21 i.e. average tariffs, weighted by value of imports.

22 Tariff profile, Russian Federation, World Trade Organization.

23 Russian agriculture thrives as sanctions close off imports, Financial Times, 3 September 2017.

24 Russian Federation — Recycling Fee on Motor Vehicles, World Trade Organization; see the WTO dispute portal for further examples of trade disputes with Russia.

25 Market access database, European Commission.

26 Russell M., Eurasian Economic Union: the rocky road to integration, European Parliament Research Service, April 2017.

27 Connolly R. and Hanson P., Import Substitution and Economic Sovereignty in Russia, Chatham House, June 2016.

and April 2018, the government invested 600 billion roubles (US$10 billion)[28] in import substitution; as of January 2018, 350 projects had been completed, and a further 780 are due by 2020.[29]

Import substitution is a necessity in the defence sector, where sanctions have cut off supplies of technology used by Russian arms manufacturers. However, its efficacy in sectors not targeted by sanctions has been questioned. It is true that from 2013 to 2017, the share of imports in food products fell from 36 % to 22 %, and in non-food products from 44 % to 35 %.[30] However, a large part of this decrease has undoubtedly to do not with substitution efforts, but with a 40 % drop in the value of the rouble, which has made imports too expensive for most Russians, as well as a ban (since August 2014) of numerous agrifood products from Western countries. Most likely, an end to Russian counter-sanctions and a recovery in the value of the rouble would see Russians returning to imports.

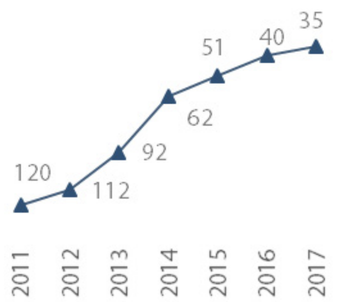
Besides, even when they boost domestic production, import-substitution policies often fail to deliver lasting economic benefits, as the example of Latin American countries in the 1950s and 1960s shows.[31] In 2015, Dmitry Medvedev warned that Russia will not achieve competitiveness if import subsitution means promoting inferior and more expensive domestic products.[32] But in some sectors at least, this is precisely what appears to be happening: in 2016, mandatory preference for Russian-made vehicles in government contracts was reported to have raised prices by up to 82 %.[33]

2.2. Governance

2.2.1. Progress has been made in cutting red tape

The World Bank's Ease of Doing Business Index measures the regulatory environment for business. Until quite recently, Russia was in the bottom half of this ranking (120th out of 183 countries in 2011[34]), with companies facing complex and drawn-out bureaucratic procedures for such basic operations as exporting products, paying taxes and getting construction permits.

Figure 7: Ease of Doing Business ranking



Doing business has become much easier in Russia

Source: World Bank.

In 2012, Vladimir Putin set the ambitious target of getting the country into the top 20 of the ranking. That target has not yet been met; nevertheless, Russia's performance in the index has improved dramatically, to 35th place,[35] putting it ahead of several EU countries, including Italy and Belgium (Figure 7). For example, starting a business now involves four procedures and takes 11 days (in Moscow), compared to nine procedures and 30 days in 2010. Meanwhile, the time needed by the average company to file its tax returns has been slashed by half. Applying for construction permits is still a lengthy procedure, requiring an average 230 days – a big improvement compared to 2010 (two years), but much longer

28 MacLeod J., Technology import substitution fits wider Russian aims, Oxford Analytica, 12 July 2018.

29 Russia expects to complete 780 import substitution projects in two years, TASS, 20 January 2018.

30 Federal State Statistics Service.

31 Pouget-Abadie T., How successful was the policy of import substituting industrialisation in Latin America?, January 2017.

32 Medvedev D., The new reality: Russia and global challenges (in Russian), 2015.

33 Import Substitution and Economic Sovereignty in Russia, Chatham House, June 2016.

34 Doing Business 2010, World Bank, September 2009.

35 Doing Business 2018, Economy Profile, Russian Federation, World Bank, 2017.

than in most of the other countries compared. The other main problem area is trading across borders, with exports requiring three days to clear customs and other border checks.

As well as cutting red tape, Russia has also facilitated procedures by putting some of them online. A 2016 United Nations survey[36] puts Russia 35th out of 193 countries in terms of e-government, ahead of several European countries including the Czech Republic, Portugal and Croatia.

Unfortunately, given the many other structural problems in Russia's economy, such improvements have not sufficed to encourage additional investment (see section 2.6 below on Investment).

2.2.2. Corruption is a major handicap for businesses

It is one thing to streamline bureaucratic procedures, and another to reform the government departments that implement them. According to Transparency International's Corruption Perceptions Index, in 2017 Russia was the most corrupt country in Europe, and 46th most corrupt in the world,[37] on a par with Bangladesh and Guatemala. In 2018, the country's Business Ombudsman Boris Titov stated that corruption was the biggest problem facing Russian entrepreneurs.[38]

In December 2017, Prosecutor-General Yuri Chaika estimated the costs of corruption to the Russian economy at US$2.5 billion over three years, but this figure is probably only the tip of the iceberg. Corruption means additional costs for companies: according to a 2011 survey,[39] entrepreneurs were forced to pay bribes averaging 0.9 % of sales revenue – typically extorted when dealing with tax and customs authorities, but also in court cases and government tenders. Furthermore, corruption plays a part in incidents such as the deadly March 2018 Kemorovo mall fire, where it may have helped mall owners to evade strict fire-safety rules. Russia's image as a corrupt country deters foreign investment.[40] On top of this, huge sums of often corruptly accumulated wealth are hidden away in offshore accounts, instead of being invested in the domestic economy; the Panama and Paradise Papers scandals have highlighted the issue, but have not revealed the full extent of Russia's offshore wealth, which one estimate puts at 75 % of the country's GDP.[41]

Corruption is a perennial Russian problem that goes back to Soviet and even Tsarist times — for example, in 1826, Nicholas I called for the 'eradication of this ulcer'.[42] Efforts have been made to address the problem. A national anti-corruption plan[43] and law were adopted in 2008,[44] and have been updated several times since then; measures include requirements for civil servants and parliamentarians to declare incomes and assets, closer scrutiny of large infrastructure projects, and enhanced protection for whistleblowers. By limiting face-to-face contacts with officials, online procedures should also mean fewer opportunities to extort bribes.

In spite of these measures, there is no evidence that Russia is progressing much in its fight against corruption. Since 1996, when it featured in the Corruption Perceptions Index for the first time, Russia has remained within the group of 60 countries seen as the most corrupt in the world. Similar

.[36] UN E-Government Survey 2016.

[37] Russia Corruption Report, GAN Business Anti-Corruption Portal.

[38] Titov: Russian businesses face 'corruption' challenges, BBC News, 8 March 2018.

[39] 2011 Business Environment and Enterprise Performance Survey, World Bank/EBRD, January 2013.

[40] German Firms Put Off by Russian Corruption, Spiegel Online, April 2013.

[41] Novkmet F, Piketty T., Zucman G., From Soviets to Oligarchs: Inequality and Property in Russia 1905-2016, World Wealth and Income Database, July 2017.

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

[43] National Anti-Corruption Plan, 22 September 2008.

[44] Federal Law of 25 December 2008 on Countering Corruption (in Russian).

conclusions are suggested by a March 2017 survey,[45] according to which just 15 % of Russians believe that the situation has improved since the early 2000s.

Indeed, the capacity of the Russian authorities to change the situation is doubtful, given that corruption has spread to all levels of government, including the very officials responsible for tackling the problem. Former Economy Minister Aleksey Ulyukayev, senior anti-corruption officer Dmitry Zakharchenko, and at least three regional governors all featured in high-profile corruption cases in 2017. Anti-corruption activist Alexey Navalny claims the problem goes even higher; in March 2017 he posted a widely viewed YouTube video[46] accusing Dmitry Medvedev of corruptly accumulating wealth; in 2015 Navalny made similar allegations about properties owned by the family of Russian Prosecutor-General Yuri Chaika.[47]

Many of Russia's recent corruption trials seem to reflect a politically motivated drive to eliminate rivals, rather than a genuine wish for clean governance. For example, Navalny's fraud conviction was used to exclude him from the 2018 presidential election, while the charges against economy minister Aleksey Ulyukayev[48] and regional governor Nikita Belykh[49] have been linked by some observers to in-fighting within the political elite.

2.3. Human capital

2.3.1. A shrinking and ageing population weighs heavily on the economy[50]

In 2017, Economic Development Minister Maksim Oreshkin described Russia's demographic situation as 'one of the most difficult in the world'.[51] That situation is largely due to the after-effects of the chaotic 1990s, a period when economic instability discouraged families from having children. As a result, there are now far fewer young people entering the workforce or opting to have families of their own. Total population is stagnating, but the working-age population has already declined from 90 million in 2005 to its current level of 83 million. As the effects of the 1990s demographic dip continue to feed through, forecasts suggest that total population could, in the worst case, shrink by 10 million over the next 20 years, while the workforce sheds up to 8 million (-10 %; see Figure 8).

45 Institutional corruption and personal experience, Levada Center, 28 March 2017 (in Russian).

46 Alexey Navalny, Don't call him Dimon, 2 March 2017.

47 The luxury hotel, the family of the top Moscow prosecutor and Russia's most notorious gang, The Guardian, 13 December 2015.

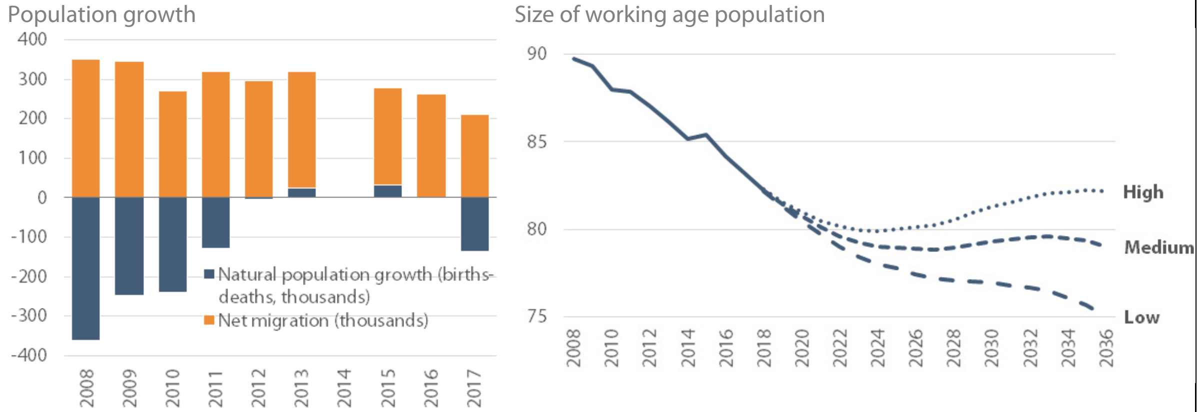
48 Russian ex-minister Ulyukayev jailed for eight years over $2 million bribe, Reuters, 15 December 2017.

49 The Non-Political Political Arrest of Nikita Belykh in Russia, The New Yorker, 1 July 2016.

50 Unless otherwise stated, data and forecasts in this section come from Russia's Federal State Statistics Service (in Russian).

51 Another Worrying Sign For Russia's Dire Demographics, RFE/RL, 27 September 2017.

Figure 8: Demographic change in Russia, 2008-2017



In recent years, the number of deaths has mostly exceeded the number of births. However, this natural decline has been offset by migration. Although total population has remained stable, the working-age population is shrinking fast

Source: Federal State Statistics Service; Population growth data not available for 2014.

To encourage more Russians to have children, in 2007 the government introduced a maternity capital programme, under which parents receive a voucher worth around €6 000 per child for second and subsequent children, which among other things can be used to help buy or renovate an apartment. In November 2018, Vladimir Putin announced additional support, in the form of an allowance to be paid to less well-off families during the first 18 months of their first child. However, such measures are not expected to significantly offset the underlying negative demographic trends mentioned above (a surge in birth rates after the introduction of the maternity capital programme was in fact largely the result of parents from a 1980s baby boom entering reproductive age; since 2014, birth rates have started declining again[52]).

Apart from falling birth rates, there are several other reasons why the workforce is smaller than it could be. Retirement ages (60 for men, 55 for women) are among the lowest in the world. Many Russians are in poor health (life expectancy at birth is nine years less than the EU-28 average); in the 2010-2015 period, 37 % of Russian employees died before reaching retirement – twice the percentage in France.[53] Apart from unhealthy lifestyles (alcoholism, smoking and drugs are estimated to cause nearly two-fifths of deaths[54]), Russia simply does not spend enough money: in 2016, government healthcare expenditure was a mere 3.8 % of GDP,[55] only half as much as in advanced OECD economies; including private spending, that figure rises to 5.6 % of GDP, again much less than the OECD average of 9 %.[56] In 2018, the government envisages a modest increase in healthcare spending to 4.1 % of GDP; however, Vladimir Putin argues that in the longer term, the country needs to spend twice as much on health as it does now.[57]

On top of this, there is a persistent brain drain: since 2012, the number of Russians leaving the country has tripled, reaching 250 000 in 2016.[58] More worrying than the actual number of emigrants is the fact that many of them are researchers, entrepreneurs and people with IT skills looking for

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52 Chawryło K., Putin's pro-family support programme, Centre for Eastern Studies, 6 December 2017.

53 Russian Federation Systematic Diagnostic: Pathways to Inclusive Growth, World Bank, 2016, p. 108.

54 Lack of people may be Russia's greatest challenge, Oxford Analytica, 31 May 2018.

55 ibid.

56 Health at a Glance 2017 – OECD Indicators, OECD, 10 November 2017.

57 Presidential Address to the Federal Assembly, 1 March 2018.

58 Federal State Statistics Service (in Russian)

more attractive economic opportunies abroad – the very people that Russia's economy can least afford to lose.[59]

This is at least good news for jobseekers. Even during the recent recession, unemployment remained close to 5 %, except in impoverished regions such as Ingushetia, which has the country's highest jobless rate (26 %).[60] However, it is much more worrying for employers, who are already struggling to find specialists, for example in the technology sector.[61] The resulting skills shortage seriously constrains the Russian economy, costing it 0.4 % of growth a year, according to one estimate.[62]

Apart from exacerbating the skills shortage, demographic change will make it harder to finance pensions, as fewer employees are paying social security contributions. Rural depopulation is another impact; thousands of villages have already been abandoned, and those that remain lack basic facilities, making it even harder to retain young people.[63]

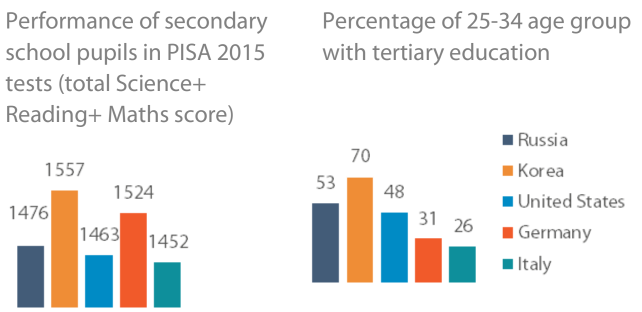
Migration (mostly from the ex-Soviet central Asian republics of Uzbekistan, Tajikistan and Kyrgyzstan) is helping to offset the effects of low birth rates, but does little to address the skills shortage, as most migrants are unskilled labourers. Moreover, hostility towards central Asian migrants is widespread (in a February 2017 survey, 38 % of respondents admitted negative feelings towards them[64]), a factor that limits Russia's capacity to integrate large numbers of migrants.

2.3.2. Russia's education system fails to prepare workers for the labour market

Russia's skills shortage reflects not only the quantity, but also the quality of the workforce. It is true that Russia has one of the world's highest percentages of university graduates (in 2011, 53 % of the population, far higher than in most economically advanced countries (see Figure 9; the OECD average is 32 %[65]), and an adult literacy rate close to 100 %. Russian pupils do well in international tests comparing Maths, Science and Reading skills in schools from different countries– close to the top in TIMMS/PIRLS, average or just below the international average in PISA.[66] Unfortunately, this high level of formal education does not mean that Russian schoolleavers and university graduates are well-prepared for the workplace.

Russian employers report considerable difficulties in recruiting suitably skilled

Figure 9: Russia's education system



In secondary school, Russian pupils perform similarly to their peers in other advanced economies. However, Russia has a very high percentage of university graduates.
Source: OECD PISA 2015; tertiary education figures for 2016, except Russia in 2013.

59 A New Emigration: The Best Are Leaving, Institute of Modern Russia, April 2015.

60 Federal State Statistics Service (in Russian)

61 'No miracles': labor shortage set to hit Russia's GDP, Reuters, 3 October 2017.

62 Another Worrying Sign For Russia's Dire Demographics, RFE/RL, 27 September 2017.

63 Russia, a land of dying villages, Centre for Economic and Political Reforms, 17 May 2017.

64 Attitudes towards migrants, Levada Center, 29 May 2017.

65 Education at a Glance, Russian Federation, OECD, 2013.

66 Russell M., Russia's education system, European Parliament Research Service, January 2017.

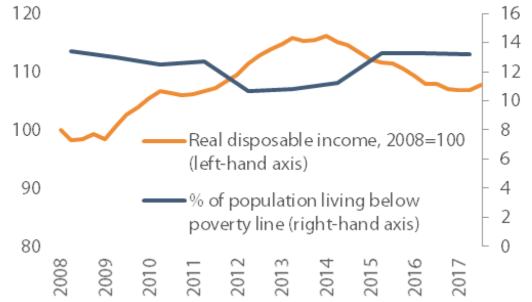
staff. According to a 2017 survey,[67] Russian entrepreneurs feel that an inadequately educated workforce is the sixth main obstacle they face. A 2012 survey of employers provides further insight into the nature of the skills that they feel are lacking; these include problem-solving skills, the capacity to think outside the box (both skills are particularly important in innovative companies), and an ability to work with people.[68] The results of this latter survey suggest that Russian schools and universities, with their emphasis on traditional teaching methods, knowledge rather than skills, memorisation rather than creativity, frontal teaching rather than group work, are out of touch with the world of work.

Such shortcomings are unlikely to be remedied after Russians leave the education system. OECD data suggest that compared to their counterparts in Western Europe, few Russian employees take part in adult education, and on-the-job training is limited.[69]

2.4. Poverty

2.4.1. 20 million Russians live below the national poverty line

Figure 10: Income and poverty



Although the economy started growing in late 2016, household incomes have only just begun to recover
Source: Federal State Statistics Service.

In 2000, 30 % of Russians were living below the national poverty line (which in 2017 was set at 10 181 roubles, around €130, per person per month).[70] Over the next 13 years, rapid economic growth lifted nearly 27 million out of poverty, bringing the poverty rate under 11 %. Unfortunately, the economic recession of 2015-2016 reversed some of that progress, as four million Russians fell below the poverty line, bringing the poverty rate back up to 13.4% (20 million people;[71] see Figure 10). Perceived poverty is even higher – according to one survey, 20-23 % of the population considered itself poor in 2017, up from 15 % in 2014.[72] The increase in poverty had less to do with unemployment, which remained constant at around 5 % throughout the recession, than falling wages, which did not keep pace with inflation; in 2016, the average salary was worth 8 % less than two years earlier.[73] Although the economy started growing again in late 2016, it has taken much longer for the benefits to trickle down to ordinary Russians. It is true that real wages grew by 3.4 % in 2017,[74] but real disposable income did not start rising until early 2018, after four consecutive years of decline. Real disposable income is arguably a better indicator of economic well-being than real wages, as it includes informal earnings and non-wage income.[75]

67 World Economic Forum, Executive Opinion Survey 2017, cited in The Global Competitiveness Report 2017–2018, World Economic Forum, 2017.

68 Developing Skills for Innovative Growth in the Russian Federation, World Bank, June 2013.

69 Russian Federation Systematic Diagnostic: Pathways to Inclusive Growth, World Bank, 2016, pp. 108-109.

70 Federal State Statistics Service (in Russian).

71 Federal State Statistics Service (in Russian).

72 The mystery of 2017: higher wages, but no money, gazeta.ru, 18 December 2017 (in Russian).

73 Federal State Statistics Service (in Russian).

74 Russians' incomes: four years of unbroken decline gazeta.ru, 25 January 2018 (in Russian).

75 See Box 2: Is there a wage-income paradox? in Russia's Recovery: How Strong Are Its Shoots?, World Bank, November 2017, p. 13.

Poverty and inequality have become major political issues. In an April 2018 survey,[76] continuing income inequality was seen as Vladimir Putin's greatest failure (by 45 % of respondents), while 32 % complained that wages and pensions were not rising. Responding to such concerns, in his March 2018 speech Vladimir Putin set a target of cutting poverty by half. Wage growth at its current level will not be enough to achieve this drastic reduction in the near future: between 2010 and 2013, when the Russian economy was growing much faster than it is now, and real wages substantially increased by 22 %, the poverty rate fell by 1.7 % – far less than the 6 % drop that Putin's target requires. Poverty reduction will therefore require additional measures. On 1 May 2018, the minimum wage was raised to the poverty threshold.[77] Reforms to the welfare system could also help tackle poverty: although the 2018-2020 federal budget adopted in late 2017 does not envisage substantial extra spending in this area,[78] benefits could be targeted more effectively by linking them to income (at present, just 15 % of welfare spending is means-tested, i.e. paid only to low-income recipients[79]).

2.5. Innovation

2.5.1. Russian research has little impact

The Soviet Union invested heavily in research and development – in 1990, around 5% of GDP[80] – and achieved outstanding results in fields such as space exploration and theoretical physics (seven Nobel Prizes). Research spending has declined since then to 1.1 % of GDP in 2015[81] – well below the EU-28 average of 2 %, but at a similar level to many other countries with a comparable level of economic development.

Perhaps of greater concern than the amount of expenditure are the limited results achieved by Russian research. In 2016, Russia had over 370 000 researchers, roughly in line with other large developed countries;[82] however, it has fewer scientific journals and publications than several other countries (such as Canada and the Netherlands) with far smaller researcher populations.[83] Quality is a problem, as well as quantity – of the researchers from 40 countries analysed in an OECD report,[84] Russian scientists are the least likely to be cited by their international peers.

In his March 2018 speech, Vladimir Putin mentions several large investments in research facilities, including new colliders for particle research. However, not all the problems in the country's research sector can be solved by additional spending. Critics point to poorly managed state research institutes, excessive bureaucratic control, a lack of competition among researchers and failure to allocate funding to the most promising projects.[85]

76 Vladimir Putin, Levada Center, 7 May 2018 (survey carried out in April 2018).

77 The minimum wage: issues, TASS, 30 April 2018 (in Russian).

78 Two Lean Years: Russia's Budget for 2018-20, Zhavoronkov S., 6 December 2017.

79 Russian Federation Systematic Diagnostic: Pathways to Inclusive Growth, World Bank, 2016.

80 According to UNESCO figures, cited in 'Productivity', M. Schaffer and B. Kuznetsov, in *Can Russia Compete*? Desai R., Goldberg I. Eds., 2008.

81 Research and development expenditure (% of GDP), World Bank data.

82 Researchers, OECD data.

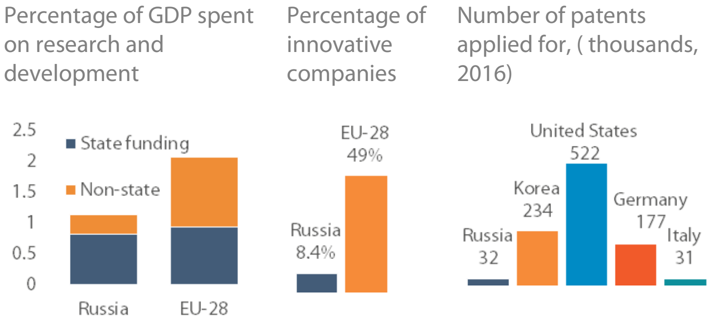
83 Figure 1.16. Scientific publication output and number of active journals, top 20 countries, in Compendium of Bibliometric Science Indicators, OECD/CSIS, 2016.

84 ibid.

85 How Putin can restore Russian research, Nature, 13 March 2018.

2.5.2. Russian companies are failing to innovate

Figure 11: Research and innovation



Russian businesses spend much less on R&D than their EU counterparts. Few Russian companies innovate, and the number of patents also reflects the low level of innovation.

Source: World Bank, Federal State Statistics Service, Eurostat, World Intellectual Property Organization.

Russia has several important innovative sectors – for example, IT services, defence and space. However, overall the economy is characterised by a low level of innovation. In 2016, just 8.4 % of Russian companies reported engaging in technological, organisational and marketing innovation,[86] the lowest level in several years, and far below the 49 % recorded in the European Union[87] (Figure 11). One of the ways in which Russian businesses lag behind international competitors is in their relatively low take-up of IT. In 2016, fewer than half of Russian companies (46 %) had their own websites,[88] compared to 77 % of their EU counterparts.[89] The lack of innovation is particularly striking in the energy sector, which generates the bulk of Russia's exports. In 2016, oil and gas producers Gazprom and Rosneft spent just 0.095 % and 0.02 % respectively of their turnover on research and development, a mere fraction of the 0.43 % and 0.47 % spent by Shell and ExxonMobil.[90] Instead of pursuing their own innovation, Russian energy companies rely on Western partners to provide the technology they need to develop hard to access reserves.[91] The lack of domestic innovation in this field has become a major problem now that EU and US sanctions have restricted access to such technology, forcing Russia's energy sector to abandon several promising projects.[92]

The general lack of innovation is partly due to the situation of the Russian research sector, which is failing to produce ideas that can be transformed into new products and processes. In 2016, Russian inventors applied for 32 000 patents,[93] a mediocre result compared to the size of the Russian economy. The relatively small number of patents reflects not only the poor quality of Russian research, as described in the preceding section, but also the lack of involvement of the private sector, which provided just 28 % of the country's total research and development expenditure in 2016, compared to 55 % in the EU;[94] this dominance of state research funding may help to explain the lack of commercial results.

Innovation is also held back by poor intellectual property protection. Counterfeit goods are common, and there is widespread online piracy of content including video games and software – a

[86] Federal State Statistics Service

[87] Innovation Statistics, Eurostat, March 2017.

[88] Federal State Statistics Service

[89] Digital economy and society statistics - enterprises, Eurostat, March 2018.

[90] 2016 financial reports for Gazprom; Rosneft; Shell; ExxonMobil.

[91] Negative outlook for Russian economy as sanctions bite, International Institute for Strategic Studies, March 2015.

[92] Russell M., Sanctions over Ukraine: Impact on Russia, European Parliament Research Service, March 2015.

[93] Statistical country profile: Russian Federation, World Intellectual Property Organization, 2007-2016.

[94] Table 3.8, Internal research and development expenditure by funding source, p. 85, Research Indicators: 2018, Federal State Statistics Service et al. (in Russian), and R & D expenditure, Eurostat, March 2018.

serious problem for Russia's growing ICT sector.[95] Red tape hinders rights holders from taking intellectual property violators to court, and the authorities are not allocating enough resources to tackle the problem. Due to these problems, in 2017 the Office of the US Trade Representative identified Russia as one of 11 countries where intellectual property is particularly at risk.[96]

A third important factor is the lack of competitive pressure on Russian markets described above; Russian businesses do not have to keep ahead of competitors, and therefore have little incentive to invest in innovation. For example, minimal research and development activity does not prevent large Russian energy companies from thriving.

The general lack of innovation makes it harder for Russian businesses to become more productive, and therefore limits economic growth. The Russian government has taken several initiatives to tackle the problem. Companies developing new products and services can write off certain types of research and development expenditure at a higher rate in order to pay less tax on their profits.[97] Companies engaged in technological innovation and located in one of four special economic zones enjoy additional tax breaks.[98] Special tax exemptions also apply to technology parks, of which the largest is Skolkovo, just outside Moscow, dubbed 'Russia's Silicon Valley'. Set up in 2010, Skolkovo has over 1000 participating startups,[99] and its international partners include Boeing, IBM and Microsoft. In 2016, it claimed to have attracted 19 billion roubles of investment (€250 million).[100]

However, such isolated top-down initiatives have their limitations, given the lack of a favourable environment for innovation. In 2016, Kremlin spokesman Dmitry Peskov admitted that the results of the country's special economic zones were disappointing compared to the resources invested in them.[101] Many of the several hundred technology parks only exist on paper.[102] Although relatively successful, Skolkovo is not immune to the wider problems that affect the Russian economy: the park was hit by a corruption scandal in 2013,[103] much of its labour force has been depleted by the brain drain,[104] and its president Viktor Vekselberg was recently added to the US sanctions list.

While government initiatives such as Skolkovo aim to promote innovation, political repression can have the opposite effect. Although Vladimir Putin in his March 2018 speech envisaged rolling out high-speed internet to the entire country by 2024, the Kremlin often sees the internet – which is still relatively free in Russia[105] – as a potential source of subversion. In an effort to assert greater control online, a 2014 law requires websites to store Russian users' personal data on Russian servers; social network LinkedIn has since been blocked for failure to comply.[106] In April 2018, Telegram (a popular messaging service founded by Russian entrepreneur Pavel Durov) was banned in its turn, for failure to hand over information to the Russian authorities that would enable them to decode private messages – a requirement under the repressive 'Yarovaya' package of laws adopted in 2016.[107]

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95 Russian Federation Systematic Diagnostic: Pathways to Inclusive Growth, World Bank, 2016, p. 83.

96 2017 Special 301 Report, Office of the United States Trade Representative.

97 Tax incentives in Russia, Deloitte, 2016.

98 Technology Innovative SEZ, Russian Ministry of Economic Development.

99 What is Skolkovo?, Skolkovo Foundation.

100 2017 Annual Report, Skolkovo Foundation.

101 Kremlin calls special economic zones inefficient, Russia Beyond the Headlines, June 2016.

102 Science parks: Russia's secret weapon, or Potemkin village?, Russia Beyond the Headlines, March 2016.

103 Political backlash blamed for woes at Russia's 'Silicon Valley', Financial Times, May 2013.

104 The Short Life and Speedy Death of Russia's Silicon Valley, Foreign Policy, May 2015.

105 Russell M., Media freedom trends 2017: Russia, European Parliament Research Service, May 2017.

106 LinkedIn blocked by Russian authorities, BBC News, November 2016.

107 Russia Seeks To Block Telegram In Showdown Over Internet Freedom, RFE/RL, 6 April 2018.

Although Russia is still far from a Chinese-style firewall, such measures are tending to isolate the country from the global internet. There are also direct economic consequences: according to one estimate, the ban on Telegram could cost Russian businesses (many of which use the service) up to US$1 billion,[108] while former Finance Minister Alexey Kudrin is concerned that it will hold back the process of digitalisation needed by Russia to boost economic growth.[109]

Geopolitical tensions are yet another barrier to innovation. Antivirus company Kaspersky Lab, one of Russia's most successful internet companies, has been banned from US government departments over fears that its software could be used by Kremlin-linked hackers to access sensitive information.[110] Meanwhile in the energy sector, Western sanctions restrict Russian energy companies' access to innovative technology and services.

2.6. Investment

2.6.1. Businesses – domestic and foreign – are reluctant to invest in Russia

In 2017, investment in fixed assets represented 21 % of GDP[111] – in line with the 20 % averaged by EU countries, but well below levels recorded in dynamic emerging economies such as China (43 %) and Korea (30 %).[112] In his March 2018 speech, Vladimir Putin identified increased investment as the second driver of economic growth after innovation, and called for it to increase to 27 % of GDP. Low investment reflects numerous factors, several of which have already been identified: in non-competitive markets, companies do not need to invest in order to stay ahead; although businesses now have to deal with much less red tape, corruption and difficulties in recruiting skilled staff are still discouraging both foreign and domestic investors.

Geopolitical tensions weigh heavily on foreign investment, which has slumped since 2014 (Figure 12). Ukraine-related sanctions imposed by the EU and US have affected foreign involvement in the energy sector, the main destination for foreign direct investment in Russia: as well as directly banning involvement in innovative energy projects, sanctions also discourage other types of investment, which are not directly banned but where the complexity of sanctions creates a risk of inadvertent non-compliance. For example, German conglomerate Siemens pulled out of a joint venture after the Russian recipient of four of its turbines transferred them to Crimea, in breach of EU sanctions.[113] On top of this, an atmosphere of uncertainty has been created by the prospect of new sanctions; the United States is continuing to introduce sweeping measures envisaged under an August 2017 law,[114] there is talk of new sanctions in the United Kingdom,[115] while Moscow has retaliated with a new law on counter-measures that could potentially hurt Western businesses operating in Russia.[116]

108 High estimate of the cost of the Telegram ban (in Russian), Kommersant, 26 April 2018.

109 Kudrin sees the Telegram ban as an obstacle to digitalisation of the Russian economy, 26 April 2018 (in Russian).

110 Trump signs into law U.S. government ban on Kaspersky Lab software, Reuters, 12 December 2017.

111 Federal State Statistics Service (in Russian)

112 Figures for 2016, Gross fixed capital formation (% of GDP), World Bank data.

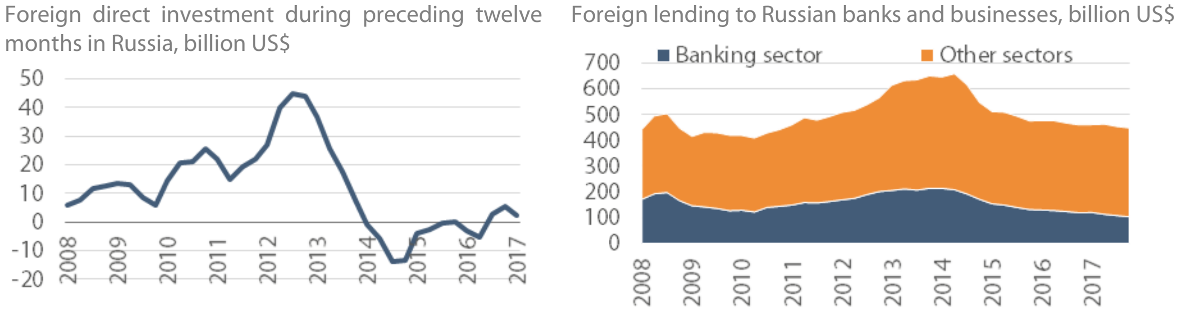
113 Siemens to exit Russian power joint venture, BBC News, 21 July 2017.

114 Countering America's Adversaries Through Sanctions Act, US Department of the Treasury.

115 Russian 'dirty money' is damaging UK security, MPs say, The Guardian, 21 May 2018.

116 Putin signs Russian 'counter-sanctions' into law, Reuters, 4 June 2018.

Figure 12: Foreign investment/lending in Russia



Since 2014, the flow of foreign direct investment and foreign finance into Russia has slumped dramatically
Source: Central Bank of Russia.

2.6.2. Getting finance is difficult

According to the World Economic Forum's 2017 Global Competitiveness Report, Russian managers identify access to finance as the third biggest problem they face.[117] The same report singles out poorly developed financial markets as the area where Russia does worst compared to other countries, coming 107th out of 137 countries. Among the reasons for this low ranking are the difficulty of getting loans, the lack of affordable financial services, and the limited options for finding Russian investors. The weakness of the banking sector is a major problem: the worst recent crisis was in December 2014 at the height of the recession, when savers withdrew US$21 billion from Sberbank, Russia's biggest bank;[118] soon afterwards, the government announced a US$24 billion bailout plan for the sector.[119]

Apart from the general economic downturn, one of the main causes of the 2014-2015 banking crisis was Ukraine-related sanctions. Russian banks and businesses are heavily reliant on foreign loans. This has become a problem, as sanctions severely restrict lending by EU and US banks to Russia. Unable to get loans extended, Russian borrowers have had to pay back US$210 billion since mid-2014.[120] Domestic lenders have not been able to make up for this shortfall in foreign finance: between April 2017 and March 2018, Russian banks issued 215 trillion roubles in business loans, compared to 192 trillion during the corresponding period four years earlier[121] – in dollar terms, a 47 % drop taking into account the steep devaluation of the rouble since 2014. Small businesses were even harder hit, with loans dropping by 54 % in dollar terms during the same period.[122]

However, the problems of the banking sector, and more generally, the difficulties faced by Russian businesses in accessing finance, pre-date 2014. In the 2013 Global Competitiveness Report,[123] Russia already scored very badly in terms of financial market development (121st out of 148 countries), while access to finance was rated by Russian entrepreneurs as their fifth-biggest problem.

117 World Economic Forum, Executive Opinion Survey 2017, cited in The Global Competitiveness Report 2017–2018, World Economic Forum, 2017.

118 Russian Banks Face More Pain, Bloomberg, November 2015.

119 Russia unveils $35 billion anti-crisis plan, silent on cuts to pay for it, Reuters, January 2015.

120 Central Bank of Russia

121 Volume of Loans in Rubles Granted to Resident Legal Entities and Individual Entrepreneurs, by Economic Activity and Use of Funds, Central Bank of Russia.

122 Volume of Loans in Rubles, Foreign Currency and Precious Metals Granted to Small, Medium-Sized Businesses, Central Bank of Russia.

123 The Global Competitiveness Report 2013–2014, World Economic Forum, 2014.

Long-standing structural weaknesses in the Russian banking sector have been blamed both on excessive regulation and irresponsible lending by banks.[124] In an effort to address such problems, the Central Bank of Russia has closed down over one-third of the country's banks since 2014.[125] However, Russian banks (particularly privately owned ones) are still fragile, and in 2017 three major banks had to be bailed out.[126]

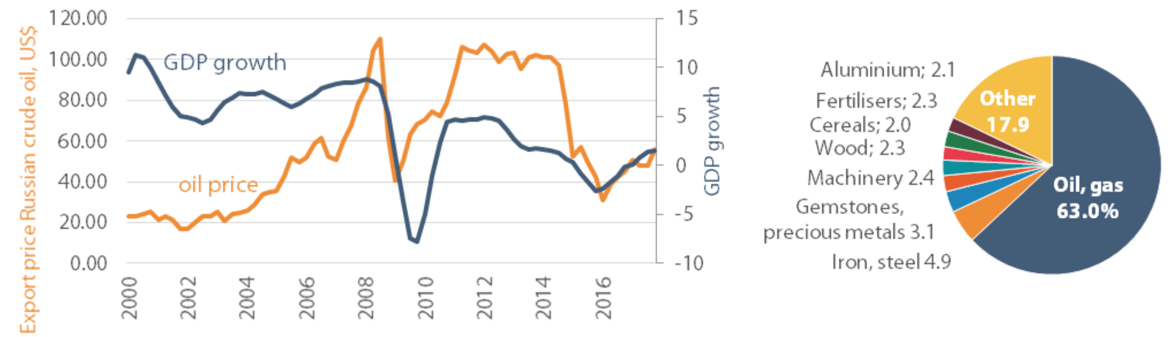
2.7. Natural resources

2.7.1. Russia's natural resource wealth is both a blessing and a curse

Figure 13: Economic contribution of oil and gas

GDP growth and oil price

Main Russian exports (2016)



The close correlation between economic growth and high oil prices, and the overwhelming share of oil and gas in exports, show Russia's dependence on fossil fuel production

Source: Central Bank of Russia, ITC Trade Map.

According to some estimates,[127] Russia has more mineral wealth than any other country. As of 2015, it had the world's largest reserves of natural gas and the sixth-largest oil reserves,[128] and it is also in the world's top ten for a wide range of minerals, including iron, nickel, platinum, gold and diamonds. In 2016, natural resources contributed 11.5 % of Russia's GDP[129] and over three-quarters of its exports. Between 2000 and 2008, the average price of oil, Russia's main export, grew nearly fivefold to over US$100 per barrel of crude oil,[130] fuelling a boom period that saw average GDP growth of 7 %.

As well as driving economic growth, oil and gas are a major source of income for the federal government (hydrocarbon taxes provided 37 % of budget revenue in 2017[131]), enabling Russia to run a healthy budget surplus most years and keep government borrowing down. In 2008, central government debt was a mere 6.5 % of GDP;[132] since then, it has more than doubled to 14 %, but this

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124 How to fix Russia's broken banking system, Financial Times, 14 January 2018.

125 Russia pushes to rid itself of 'Potemkin' banks by 2019, Reuters, 6 March 2017.

126 Russia Is Bailing out Another One of its Biggest Banks, Fortune, 15 December 2017.

127 For example, The World's Most Resource-Rich Countries, 24/7 Wall Street, April 2012.

128 BP Statistical Review of World Energy, June 2017.

129 Total natural resources rents (% of GDP), World Bank. However, this may be understated; according to one estimate, oil and gas could account for as much as one-quarter of Russia's GDP.

130 External Sector Statistics, Russian Federation: Crude Oil Exports, 2000-2017, Central Bank of Russia.

131 Russian federal budget for 2017, infographic, Argumenty i Fakty, 10 January 2017 (in Russian).

132 Central government debt, total (% of GDP), World Bank.

is still enviably low compared to the 62% average for EU countries.[133] Moreover, oil and gas revenue has enabled Russia to build up US$460 billion of international reserves, as of April 2018.[134]

However, natural resource wealth is a curse as well as a blessing for the economy. Between 2000 and 2008, Russia prospered thanks to rising commodity prices. Unfortunately, the country's dependence on hydrocarbon exports means that the economy suffers the moment oil prices start falling, as they did in 2008 and again in 2014. The volatility of global oil markets threatens the stability of Russia's economic growth – it has been estimated that a drop of US$10 in the price of a barrel of crude oil shaves 0.8 % off Russian GDP.[135]

Moreover, while Russia remains vulnerable to dips in the oil price, the upside benefits of rising prices appear to be diminishing. Between 2010 and 2013, oil remained at well over US$100, but growth decelerated, suggesting that the structural problems discussed in the earlier sections of this chapter are holding back the economy even when Russia's commodity exports are booming. The same applies to the current economic recovery – uncertainties over Iranian and Venezualian supplies are currently pushing oil prices up;[136] nevertheless, even with significantly higher prices, the World Bank does not expect economic growth in 2018 and 2019 to exceed 2 %.[137]

With the vast majority of Russia's export earnings coming either from hydrocarbons or other natural resources, the country has limited incentives to carry out difficult structural reforms. The reliance on exports that only require a limited technological input helps to explain the low levels of innovation and competitiveness.

Eventually, of course, the flow of petrodollars will dry up. Oil fields in western Siberia, where most of Russia's oil currently comes from, are slowly running out; the country still has huge untapped reserves, but most of these are difficult to access, and therefore within the scope of Western sanctions restricting cooperation with Russian oil companies on Arctic and deepwater oil projects.[138] Recently, oil producer Rosneft succeeded in sinking a new well deep in the Arctic without Western finance or technology,[139] a sign of the company's increasing technological capacity. There has also been progress in reducing dependence on western oil and gas equipment; by 2017, the share of imported equipment had fallen from 60 % (in 2014) to 52 %[140]. However, without Western help, wider development of Arctic resources will be difficult.

133 At the end of 2017, general government debt in the 28 EU Member States stood at 82 % of GDP; around 75 % of this was central government debt (Eurostat).

134 International Reserves of the Russian Federation, Central Bank of Russia.

135 Chakarov I., Oil, not sanctions, caused Russian GDP to fall, Vedomosti, October 2015 (in Russian).

136 Citi raises oil price forecast due to concern about possible loss of Iran, Venezuela supply, CNBC, 16 April 2018.

137 From Recession to Recovery: Russia Economic Report, World Bank, May 2017.

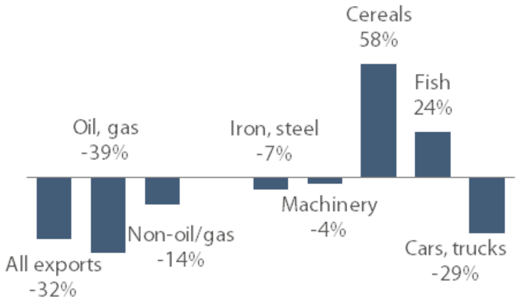
138 Katona V., When Will Russia Run Out Of Oil?, 4 April 2017.

139 Rosneft spuds northernmost Arctic well, The Independent Barents Observer, 3 April 2017.

140 MacLeod J., Technology import substitution fits wider Russian aims, Oxford Analytica, 12 July 2018.

2.7.2. There is little progress towards diversifying exports

Figure 14: Change in exports, %, 2013-2017



Only a few categories of exports have performed well
Source: ITC Trade Map.

Since 2013, the share of fossil fuels in Russia's exports has decreased from 71 % to 63 %.[141] However, this shift reflects a drop in oil and gas exports (-39 %, due to lower oil prices), rather than an improvement in non-hydrocarbon exports. Most of the latter actually decreased during the same period, though by a smaller percentage than oil and gas. Among the few bright spots were cereals (+58 %), benefiting from favourable weather conditions;[142] meanwhile, most other categories declined (Figure 14). The performance of Russia's non-hydrocarbon exports is particularly disappointing, given that during the same period, they became considerably cheaper due to the rouble losing about half of its value. The failure of these products to compete either on price or (given the poor reputation of many Russian manufactured goods) quality,[143] casts serious doubts on efforts to diversify exports.

2.7.3. New fiscal rule reduces budget dependence on oil price

While exports remain dominated by hydrocarbons, some efforts have been made to diminish the effects on government finances of oil price volatility, which in 2015 and 2016 pushed the federal budget into deficit and drained international reserves. For the first time, the 2018 budget applies a new fiscal rule, under which additional revenue from taxes on oil and gas production (currently generating 37 % of federal budget revenue), arising from oil prices in excess of US$40 per barrel, will be put aside. This will give the government more reserves to draw on when the oil price falls below the US$40 threshold. The rule has been welcomed by the IMF,[144] and assuming that it sticks, it could be a useful first step towards weaning the economy off fossil fuel exports.[145]

3. Prospects for reform during Putin's fourth presidency

3.1. Vladimir Putin makes economic reform the top priority

On 1 March 2018, Vladimir Putin delivered his annual state-of-the-nation address,[146] widely seen as setting out the priorities for the next six years following his expected re-election on 18 March. Despite dwelling at length on the country's new generation of allegedly invincible nuclear weapons, the main focus of Putin's speech was not on external security threats, but on the urgent need for domestic reform. According to him, *'our main enemy is the fact that we are falling behind'*. Stagnation, in his view, *'is like a serious chronic disease that steadily saps the energy from the body and destroys it from within step by step'*. Putin therefore called for a decisive breakthrough, and set a series of

141 ITC Trade Map

142 Russia to harvest record grain crop, world-grain.com, 6 November 2017.

143 p.89, Table A2.1.1. Russia's Exports with Potential to Become Competitive, Russian Federation Systematic Diagnostic: Pathways to Inclusive Growth, World Bank, 2016.

144 Russian Federation: Staff Concluding Statement of the 2018 Article IV Mission, IMF, 23 May 2018.

145 Sanghi A, Kojo N., Will Russia's new fiscal rule end its oil and gas dependence? Brookings, 6 December 2017.

146 Presidential Address to the Federal Assembly, 1 March 2018.

ambitious economic targets, which were further elaborated on in a presidential decree of 7 May 2018.[147]

3.2. Competing options for economic reforms are on the table

In Russia, there has long been consensus on the need to reinvigorate the economy, but disagreement on the nature of reforms to achieve that goal. Some of the options were presented at the St Petersburg International Economic Forum in June 2017.[148] Among the main advocates of economic liberalisation is former Finance Minister Alexey Kudrin, who left the government in 2011, but remains close to Putin. Overall, Kudrin is in favour of more innovation, a greater role for the private sector, as well as a more globally integrated economy.[149] He advocates halving the share of the state in the economy by privatising state-controlled energy and finance companies.[150] He wants to see more productive government spending, which he believes will boost economic growth, for example by investing in human capital (education and health) and infrastructure.[151] Kudrin believes this can be done without increasing overall government spending, by cutting back excessive defence and security spending, raising the retirement age, and downsizing the civil service staffing with the help of digitalisation.[152] He is in favour of improving the rule of law through judicial reforms making courts more independent of the government. Kudrin believes that reforms on these lines could more than double Russia's long-term growth potential, from 1.7 % under a 'business as usual' scenario to 3.8 %.

Competing for Vladimir Putin's attention[153] are the proposals[154] of the Stolypin Club, a group of experts led by business ombudsman Boris Titov and presidential adviser Sergey Glazyev. While agreeing with Kudrin on the need for deep reforms to boost growth, these envisage a more state-led approach, with targeted programmes in support of key industries, including through import-substitution projects. The Stolypin Club is in favour of keeping interest rates low to stimulate more lending and, in a break from the current policy of allowing the rouble to find its own level,[155] advocates an artificially weak rouble to make Russian exporters more competitive.

Putin's economic targets for 2018-2024
(1 March presidential address and 7 May decree)

- Russia to become one of the world's top five economies *(currently in 12th place)*
- GDP per capita to grow by 50 %
- Labour productivity to grow by 5 % per year *(currently 0.8 % per year)*
- Investment to reach 25 % of GDP *(currently 21 %)*
- Small and medium-sized enterprises to generate 40 % of GDP *(currently 20 %)*
- 50 % of companies to engage in innovation *(currently 8 %)*
- Non-hydrocarbon exports to reach US$250 billion per year *(currently US$133 billion)*
- State share of economy to decrease
- High-speed internet throughout the country

147 Decree No 204 of the President of the Russian Federation on National Goals and Strategic Tasks for the Development of the Russian Federation up to 2024 (in Russian), 7 May 2018.

148 Kremlin gathers experts to tackle Russia's anaemic growth, Financial Times, 31 May 2017.

149 Sustainable Economic Growth: a Model for Russia, presentation delivered at the Gaidar Forum, January 2017 (in Russian).

150 Kudrin's Center Publishes 'Seven Priorities' for Putin, RBC, 11 April 2018 (in Russian); Senior Putin adviser proposes Russia oil industry privatisation, Financial Times, 1 June 2017.

151 Kudrin A., Sokolov I., Fiscal maneuver and restructuring of the Russian economy, *Russian Journal of Economics*, September 2017.

152 Kudrin explains how the civil service can be cut by a third, Vedomosti, 10 November 2017.

153 Kremlin gathers experts to tackle Russia's anaemic growth, Financial Times, 31 May 2017.

154 Strategy of Growth, P.A. Stolypin Institute of Economic Growth, 28 February 2017 (in Russian).

155 Bank of Russia exchange rate policy, Central Bank of Russia.

In his March 2018 address and subsequently, Putin has had plenty to say about economic targets, but has provided little detail of reforms, making it difficult to assess the extent to which he is considering radically overhauling current policies, and if so, whether he will be more influenced by Kudrin's liberalisation agenda or the state-led approach advocated by the Stolypin Club. It is true that at several points (for example, his analysis of the threat posed by Russia's technological backwardness), the rhetoric of his address repeats almost word-for-word Kudrin's proposals.[156] On the other hand, many elements of Kudrin's programme (in particular, judicial reforms) are lacking, and although in March Putin called for the state to 'gradually reduce its share in the economy', the 7 May presidential decree said nothing about privatisation. Indeed, several of Putin's ideas imply an emphasis on state intervention, with calls for major infrastructure projects, sectoral support programmes and a ceiling of 8 % on mortgage interest in support of the housing market. All in all, it seems that, rather than following a consistent direction, future economic policies are likely to mix different approaches.

3.3. Some conditions for reforms are favourable

Political and economic conditions provide a window of opportunity for reform. Improving government finances (the federal budget is expected to be in surplus in 2018[157]) give more scope for additional investments in support of economic growth. Putin has a six-year presidency in front of him, and the State Duma, where Putin's United Russia party has a commanding majority, is not due for elections for another three years – plenty of time to push through potentially unpopular reforms. Some steps have already been taken, others are being considered. In 2017, defence spending fell by 20 % in dollar terms compared to the previous year;[158] in June 2018, Dmitry Medvedev anounced a proposal to raise the retirement age[159]. The Ministry of Economic Development claims that, if implemented, this reform could add 1.8 million people to the workforce and boost the economy by 1.3 % over the next six years[160]. It is also planned to increase the VAT rate from 18 % to 20 %, generating revenue that could be used to boost economic growth (for example, through increased spending on infrastructure and education). All of these changes are in line with the reform programme advocated by Kudrin.

[156] Sustainable Economic Growth: a Model for Russia, January 2017, p. 13 (in Russian).

[157] Siluanov forecasts Russian budget surplus of 0.5 % GDP in 2018, Interfax, 20 April 2018 (in Russian).

[158] SIPRI Military Expenditure Database. However, this figure may not be accurate, given that not all defence expenditure is listed as such in the federal budget.

[159] Russia, on quest for budget savings, to raise retirement age, Reuters, 14 June 2018.

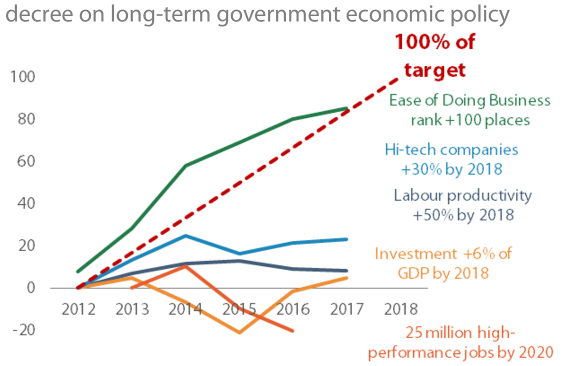
[160] Ministry of Economic Development estimates economic impact of higher retirement age (in Russian), Rossiyskaya Gazeta, 4 July 2018.

3.4. A poor track record casts doubt on the success of economic reforms

There is nothing especially new about Vladimir Putin's professed determination to overhaul the economy. In 2009, then-President Dmitry Medvedev presented a catalogue of economic woes: a 'humiliating dependence on raw materials', endemic corruption, reliance on government intervention, and a general lack of competitiveness.[161] In response to those problems, Skolkovo technology park was part of Medvedev's effort to launch a technological revolution – but as mentioned above, it was an initiative that failed to create a broader culture of innovation in Russia. In his turn, soon after returning to the presidency in 2012, Vladimir Putin set out his vision of a technologically advanced, innovative Russia in a presidential decree on long-term government economic policy.[162] Some of the measures outlined in that decree have since been implemented, for example, the creation of a business ombudsman, and the country has spectacularly improved its place in the World Bank's Ease of Doing Business ranking, even though it missed its target of getting into the top 20 by 2018. However, progress in other areas has been much more disappointing. In 2012, Putin called for the state to disinvest from non-raw materials companies by 2016, but as mentioned above, there has been very little privatisation. The economy has not come close to meeting any of the other main targets set in 2012 (Figure 15). The economic recession of 2015-2016 takes some of the blame for these failures, but it is also true that progress had been very slow even before the economy started going into decline around mid-2014.

Figure 15: May 2012 economic targets

% achievement of targets set in May 2012 presidential decree on long-term government economic policy



With the exception of the Ease of Doing Business rank, Russia has made little or no progress towards the economic targets set in May 2012

Source: [Federal State Statistics Service](#).

The latest set of targets looks even less realistic. Vladimir Putin wants a 50 % increase in per capita GDP by the mid-2020s, and he also wants Russia to become one of the world's five largest economies. Both objectives imply average annual growth of well over 5 % – far in excess of its current level of 1.6 %, or even the 3.8 % envisaged by Kudrin's most optimistic scenario.

3.5. Geopolitical tensions will continue to hold back the economy

Since 2014, Russia's economy has paid a heavy price for the country's confrontational stance on Ukraine, leading to Western sanctions. As already mentioned, these exacerbate structural problems, for example by encouraging more state intervention, limiting foreign investment together with the innovation that it brings, and generally isolating Russia from the global economy. Kudrin, who has

[161] Medvedev D., Go Russia!, 10 September 2009.

[162] Decree of the President of the Russian Federation on long-term government economic policy, (in Russian), 7 May 2012 (in Russian).

put the annual economic cost of sanctions at around 0.5 % of Russia's GDP,[163] argues that improving relations with the West will help to kick-start economic growth.[164]

However, here too there is no sign of a change of approach. Of the multiple sanctions regimes in place against Russia, the heaviest economic cost comes from the EU and US measures targeting the Russian defence, energy and financial sectors;[165] the EU has tied these to implementation of the Minsk Agreements on eastern Ukraine. That process is now deadlocked, as fighting between pro-Russian separatists and Ukrainian troops continues; in June 2018, EU leaders agreed to extend sanctions for another six months. Meanwhile, the United States continues to pile on its sanctions against Russia, bringing further economic costs,[166] and relations are tenser than ever. Putin's March 2018 presidential address took a defiant tone, with a warning to countries that have introduced sanctions that 'no one has managed to restrain Russia'; nothing in his statements since then suggests that he is considering initiatives to ease tensions.

3.6. The new government line-up suggests there will be few changes

Hopes among economic liberals that reforms could be spearheaded by Kudrin in a ministerial or even prime ministerial role have been disappointed; in the end, he was nominated chairman of the Accounts Chamber, a post in which he hopes to counter corruption,[167] but will have little say on economic policy-making. Reformers can at least take heart from the fact that Kudrin protegé Anton Siluanov not only held onto the Finance Ministry but was promoted to first deputy-prime minister; at the same time, Maxim Oreshkin – also seen as an economic liberal[168] – stays as economic development minister. The economic policy team in Medvedev's previous government proved relatively competent, keeping tight control of government finances and steering the country through a recession in the face of highly unfavourable external conditions. However, little was done to boost economic growth, and with virtually the same-line up in charge, it is doubtful whether the next six years will bring major changes.

3.7. Political will to carry out difficult reforms may be lacking

Economic problems have never affected Vladimir Putin's popularity ratings much – these remained at over 80 % throughout the 2015-2016 economic recession – and now, with the economy growing, albeit slowly, oil prices rising and the federal budget back in surplus, there is no real pressure on him to carry out reforms. Indeed, necessary but painful reforms are unlikely to be well received. In July 2018, the government's proposal to raise the retirement age brought thousands of protestors onto the streets, and saw a massive drop in Vladimir Putin's popularity rating.[169] An August 2017 survey[170]

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163 Russia risks decades of low growth under U.S. sanctions: Putin adviser, Reuters, 27 July 2017.

164 Liik K., Winning the normative war with Russia: An EU-Russia Power Audit, European Council on Foreign Relations, 21 May 2018.

165 Russell M., Sanctions over Ukraine: Impact on Russia, European Parliament Research Service, January 2018.

166 HSE Experts have estimated damage to Russian economy caused by sanctions, Vedomosti, 16 April 2018 (in Russian).

167 Russia's Kudrin May Get Top Audit Chamber Post, RFE/RL, 14 May 2018.

168 A herald of change: what Oreshkin's appointment as economic development minister means for Russia's economy, lenta.ru, 2 December 2016 (in Russian).

169 Russia pension: Protests over retirement age hikes, BBC News, 1 July 2018.

170 Kolesnikov A., Volkov D., The Perils of Change: Russians' Mixed Attitudes Toward Reform, Carnegie Moscow Center, 6 February 2018.

suggests that, while most Russians would generally like to see changes, economic reforms are low on their list of priorities, and only a minority would be willing to make personal sacrifices in the interest of a stronger economy.

Thus, failure to achieve an economic breakthrough does not threaten the survival of Putin's regime. However, the long-term repercussions are potentially serious. Putin himself seems well aware of the dangers. Mindful perhaps of the role that stagnation played in the downfall of the Soviet Union,[171] in his March address he warned against it as 'a serious chronic disease that steadily saps the energy from the body and destroys it from within step by step'. Failure to keep up with global progress will, he fears, ultimately compromise the country's security and sovereignty. It is certainly true that, with Russia's economic growth rate well below the global average, its share of the global economy, which is already below 2 %, will gradually decline, undermining the country's great power ambitions. However, there is no certainty that Putin's understanding of that threat will translate into economic reforms. It is more probable that he will seek to compensate for Russia's economic weakness by continuing a confrontational foreign policy towards the West.

171 The mood of Russia: Time to shove off, The Economist, 10 September 2011.

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This publication describes the current condition of the Russian economy, which has suffered recently from external shocks, such as a collapse in oil prices and Western sanctions. However, it argues that poor economic performance has more to do with long-term internal problems, including a lack of competitive markets, low levels of investment, an absence of innovation and excessive dependence on natural resources. Finally, it discusses President Putin's promises of economic reforms to tackle such issues, and evaluates the prospects for major change.

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