Russia's Recent Economic and Reform Performance and Remaining Reform Challenges[1]

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This brief paper presents a comparative discussion of the economic growth and reform process in Russia during the 2000s. It also discusses the remaining reform priorities for Russia.

Key words: Russian economy, transition countries, structural reforms
JEL classification: P2, P5

1. Macroeconomic performance in Russia

The ultimate aim of macroeconomic and structural reforms are not the reforms per se, but to generate higher long-term sustainable growth. Therefore, I will start by making a brief description of Russia's recent growth performance. Equally, as pointed out throughout in Vinhas de Souza, 2008b, any meaningful discussion of performance (economic or otherwise) must be made in *relative terms*, in which a given country is compared to *relevant* benchmarks. This will be done throughout this paper.

GDP performance

One thing that should be stated from the start is that the common perception of Russia as under-performing in terms of economic growth is largely a myth: as one can se in Figure 1[3], since 1999 Russia's growth performance has been quite close to the CIS-11[4] and BRIC[5] averages, and has actually surpassed the performance of the European Union's (EU) New Member States (NMS-10[6] in Figure 1).

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[1] The views expressed in this paper are those of the author writing in a personal capacity and do not necessarily reflect the official views of the European Commission or any other institution with which he is associated. All the usual disclaimers apply. This paper is largely based on my book "Russia: A Different Country", Vinhas de Souza, 2008b (http://shop.ceps.eu/BookDetail.php?item_id=1652).

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[3]The groupings' GDP growth rates in Figure 1 are weighted by the GDPs of groupings' individual countries.

[4]CIS stands for Commonwealth of Independent States, the loose organisation that includes most of the countries form the former Soviet Union, bar the Baltic States that became members of the EU in 2004 (namely, its members are Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan: one must note that Turkmenistan discontinued its permanent membership of the CIS as of 26 August 2005, and is now an "associate member", that Ukraine never actually ratified the CIS Treaty and that on 12 August 2008, the Georgian Government announced it would leave the CIS, a decision later approved by the Georgian Parliament). I use here the aggregate CIS-11, i.e., without Russia, as otherwise Russia's performance – roughly 75% of the CIS' GDP– would dominate the dynamics of the CIS aggregate.

[5]BRIC stands for Brazil, Russia, India and China. One must note that, as China and India have much lower GDP *per capita* levels than Brazil or Russia, their long-term growth rates are necessarily higher. Also, similarly to the situation of Russia in the CIS, China, by the end of the sample used in Figure 1, had come to dominate the BRIC aggregate, with around 50% of its GDP.

[6]This stands for the set of ten formerly planned economies that entered the EU in 2004 and 2007, namely Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia and Romania.

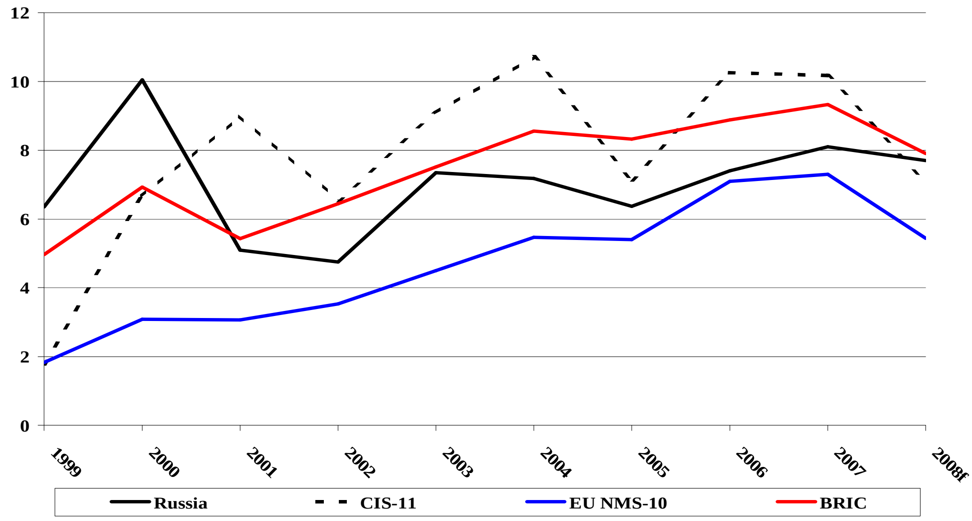

Fig. 1. **Comparative Weighted GDP Growth Rates (%)**

Source: ECFIN, UNECE, IMF.

My choices of benchmarks in Figure 1 obviously define both the NMS and especially the CIS (as the NMS, contrary to Russia and the CIS, experienced much less time under the planned economy system and benefited from the reform "anchoring" provided by the EU Accession process and related financial and technical support) as adequate references for the Russian performance, as both are sets of countries that experienced a similar process of transformation from planned to market economy. Additionally, the BRIC provides another benchmark, that of a set of large emerging economies like Russia. I chose 1999 as the year to start the comparison in Figure 1 as it excludes both the distortions caused by the initial period of 'transition recession'[7] and the 1998 Crisis. One must remember that, on average, the 'transition recession' in the NMS occurred *before* that in the CIS countries, as they began their reforms earlier than the CIS did – some as early as in the 1980s. This reveals another problem when comparing growth performance (or indeed, progress in reforms) between the CIS and other regions, *the time reference sample*. Some works adjust the comparison by basing series on the year reforms started (termed 'transition time').

The same conclusion holds true for other traditional measures of macroeconomic stabilisation (a necessary precondition for sustainable growth) like inflation and external balance

[7]As a rule, *all* 'transition' countries experienced several years of negative growth, referred to in the literature as the 'transition recession'. This period of negative GDP growth is linked to the necessary time to reorganise the existing factors of production according to their marginal productivities and the international comparative advantage of the individual countries (see Vinhas de Souza & Havrylyshyn, 2006). It is also related to the *depth* of accumulated distortions: as the Soviet Union had been under a planned economic system for a generation longer than Eastern Europe, the distortions there (for instance, the degree of over-industrialisation) were more serious.

(see Figure 2): not only Russia is not an underperfomer in those (and other) criteria, but it frequently surpasses the comparator groups.

Also, and again contrary to widespread perception, over 70% of Russian growth in the post 1998 period is not *directly* related to natural resources (see Ahrend, 2006), as there has been strong growth in some manufacturing and services sectors. Therefore, growth performance in Russia is linked, to a very considerable degree, to the effects of liberalisation reforms in the non-commodity parts of the economy.

Additionally, in principle there are no real reasons for a relatively robust growth performance not to remain for the long-term, as any catching-up economy –as Russia undeniably still is– *by definition* will have higher sustainable long-term growth rates than mature economic areas like the EU.[8]

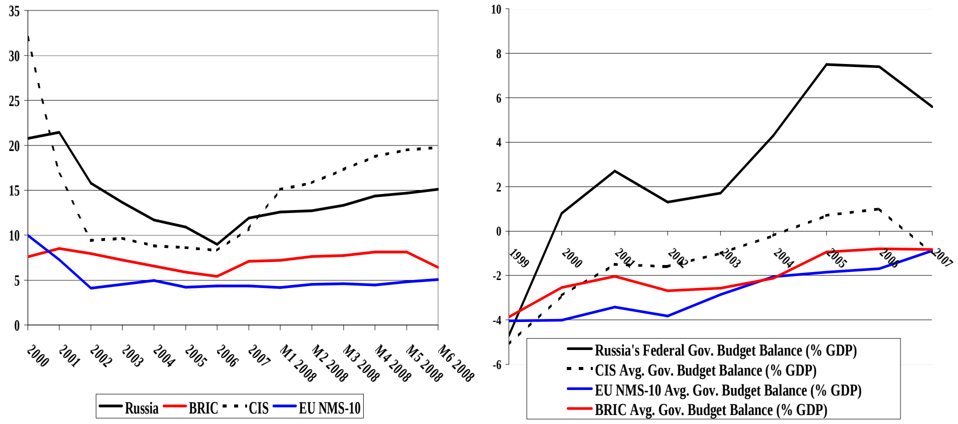

Fig. 2. **CPI* (left pane) and Budget Balance (right pane)**

Source: ECFIN, UNECE, IMF.*HIPC for the NMS-10.

Finally, beyond sheer catching-up dynamics, Russia could be on the verge of switching to a more sustainable growth model, driven by higher domestic investment and FDI inflows (see Vinhas de Souza, 2008b).[9] To take full advantage of this situation, making growth truly sustainable in the long run, the *necessary macroeconomic frameworks and structural reforms* have to be in place. These are dealt with in the next sections.

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[8]Beck, Kamps and Mileva (2007) estimate the current (i.e., without any additional growth-enhancing structural reform) long-term growth potential of Russia to be within the 4-6% *per annum* interval.

[9]One could also point out that the high endowment of human capital in Russia is potentially supportive of that: the secondary and tertiary enrolment rates are very similar to high-income countries and far above the rate in the BRIC countries. On the other hand, indicators of spending on education remain below the BRIC average. Russia also produces a much greater share of graduates in science and engineering subjects than higher-income countries. The number of persons in R&D per million of population is comparable to Germany and much higher than in the BRICs: in 2005, Russia had almost 1 million persons engaged in R&D activities. This figure is similar to China's, and about half of the EU 27 figure.

2. Russia's Incomplete Reform Agenda

As exemplified in the previous section concerning growth, when evaluating Russia's overall performance in economic reform, it is essential to use adequate benchmarks. A simple comparison with the NMS is not fully correct, as the EU Accession both implied and anchored *binding* structural reforms. For the CIS, no such strong external anchor exists. Therefore, Russia's reform process is better compared with clusters of countries that do not benefit from such external constraints, like the CIS.

Using a traditional index of reform –the *Transition Indicator*, or TI, of the European Bank for Reconstruction and Development (EBRD)[10]– to compare Russia with clusters of other "transition" countries reveals several things (see Figure 3).

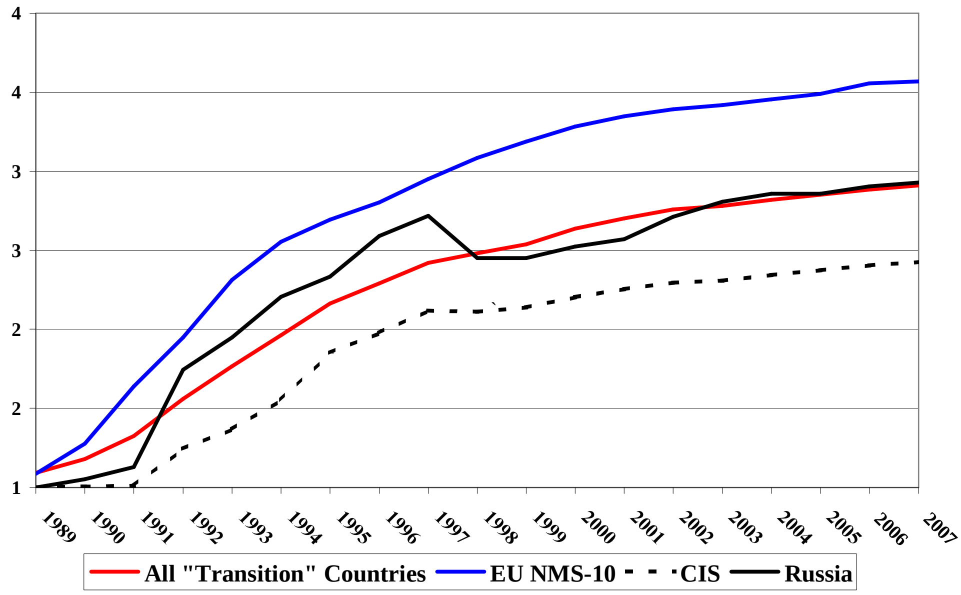

***Fig. 3.* EBRD Transition Indicators for Russia and Regional Groups**

Source: EBRD.

First, Russia outperforms the CIS average and since the early 2000s with increasing distance (in other words, Russia is reforming faster than the CIS –here non-GDP weighted– average, which includes some very slow reformers). Second, Russia is very close to the average

[10]For a description of the indicator, see EBRD (several issues). The choice to present here first the TI does not imply any preference for this indicator, or any belief in its superiority: it merely has the longest consistent homogeneous series available for Russia and the chosen comparator countries. *All* indexes of reform imply a degree of subjective judgement and a not necessarily transparent aggregation and weighting procedures by its producers (as this Author, who has build reform indexes before in his life, can personally attest to: see Vinhas de Souza, 2004).

of all so-called "transition countries". [11] Third, progress in structural reform in Russia as measured by the Transition Indicator resumed in 2006-07 after a hiatus in 2004–05.[12] Finally, the NMS-10 clearly outperforms all the other groupings, as one should expect. It is possible to identify the specific reform areas in which Russia underperforms (not shown in Figure 3 above): these are *competition policy, corporate governance* and *enterprise restructuring* (i.e. microeconomic and structural areas, arguably more difficult to reform; conversely, Russia performs better in macro areas of reform).

Using other indicators that cover these "transition countries", Russia also shows a mixed performance in improving its business environment (equally a microeconomic/structural concern). For instance, according to the results of the EBRD–World Bank *Business Environment and Enterprise Performance Survey* (BEEPS), between 2002 and 2005, private sector perceptions of the *level of effectiveness of the judiciary, the extent of corruption* and *labour regulation* worsened – substantially in the case of corruption. At the same time, the perceptions concerning *customs and trade regulations, business licensing and permits,* and *tax administration* improved. Significantly, Russia is below the CIS average in *all* these latter categories, but tellingly its performance there is strikingly similar to the other resource-rich CIS economies, Azerbaijan and Kazakhstan.

Going beyond the set of "transition economies", how does Russia compare with other large emerging markets? This question has particular relevance given that, for instance, when a foreign investor is evaluating the decision to engage in an FDI operation in Russia, his or her comparator country will not necessarily be Estonia, Slovenia or even Poland, but rather other resource/endowment-rich BRIC giants like Brazil, China or India.

One can do that sort of comparison using the global World Bank survey of business regulations and their enforcement, entitled *Doing Business 2008* (which refers to 2007 data: see Figure 4). There, Russia ranks 106th out of 178 countries, above countries such as Brazil and India but behind China (this is a relative deterioration compared with its 2006 ranking of 96th out of 175 countries, although the changes in the index methodology and in the sample of countries it covers make inter-year comparisons rather difficult: this last point is valid for most indexes bar the EBRD's TI). Russia is close to the average rank of the CIS countries, and above EU-leaning countries like Ukraine.

[11] An increasingly outdated concept, in spite of the efforts of some international institutions to keep it alive.

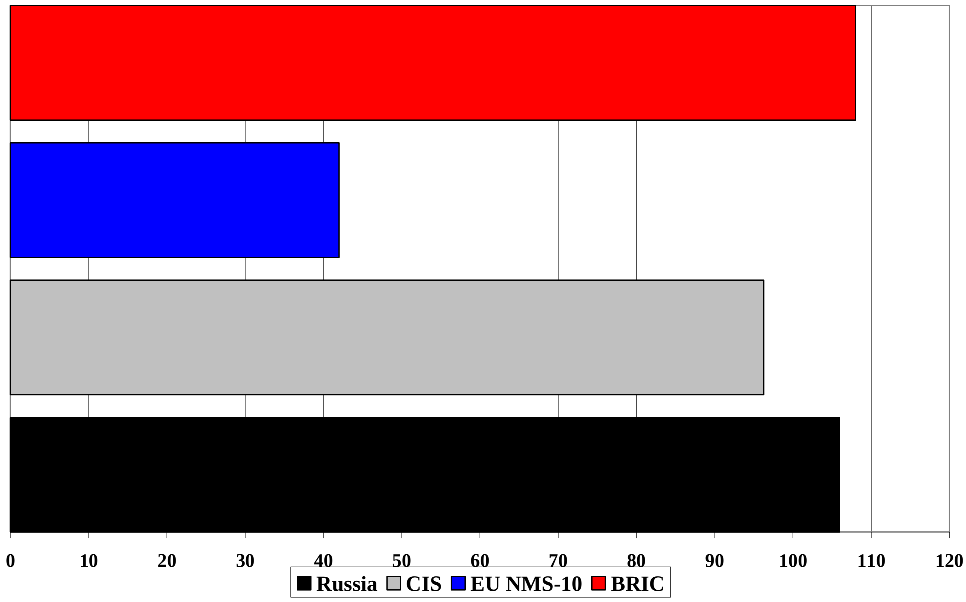

Fig. 4. **Doing Business 2008 Rankings for Russia and Others**

Source: World Bank.

The areas in which Russia performs worst when compared with the CIS average are *licensing requirements*, *dealing with workers* (its stands at roughly the EU and OECD averages in the latter) and *trading across borders* (export and import costs are comparatively high in Russia, which is *partially* related to the sheer size of the country). On the other hand, it ranks *above* the OECD and the EU on items like *enforcing contracts* (19th),[13] *registering property* (45th) and *starting a business* (50th).

According to another set of global World Bank indexes, its so-called *Governance Indicators*, between 2006 and 2007, Russia improved in half of its six criteria, namely, in *political stability*, *government effectiveness* and *regulatory quality*, whereas *voice and accountability*, *rule of law* and *control of corruption* worsened. Using the average of the six Governance Indicators, Russia is exactly at the CIS average, but slightly below the BRIC average –which is due to the focus of this particular index, as it excludes macroeconomic components– and, as one should expect, far below the EU's NMS 10 average.

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[12]This hiatus was linked to an expansion of the role of the state in the economy, as demonstrated by the takeover of Yukos. That move led to a reduction of the private sector share in GDP from 70% to 65% between 2004 and 2005. In 2006, the share stabilised at 65%. This figure still puts Russia above the CIS average of 56%, and at the same level of other large CIS economies such as Kazakhstan and Ukraine, and just above the South-Eastern European and overall transition economy average of 64% (but considerably below the NMS average of 73%).

[13]This ranking admittedly may come as a surprise to TNK-BP, BP, Shell or Yukos investors. On the other hand, a recent survey of foreign investors *in Russia* indicates that the country, as a market, is considerably more profitable for FDI than the other BRICs (see FIAC, 2008).

On the other hand, when one uses the World Economic Forum's *Global Competitiveness Report,* another global benchmarking index, Russia ranks in 2008 as 58th out of 131 countries, which is the highest rank of all CIS countries covered[14] and slightly below the EU's NMS and BRIC averages. Russia's main weaknesses here are *institutions* (it fares close to the bottom in 'usual suspect' categories like *protection of minority shareholders* and *property rights*) and in *goods market efficiency* (where it ranks much lower on some items related to FDI).

Another indicator, the *Bertelsmann Transformation Index,* this one a benchmark for "emerging economies" in general, places Russia 59th out of 125 countries in 2008, comfortably above the CIS average in both the "economic" and "political" components of this index, but below the NMS and BRIC averages (for the BRICs, the bulk of the difference arises from the "political" items of the index[15]).

The overall conclusion from this section is that Russia, albeit far from being a model reformer, does not necessarily do badly when compared with adequate benchmarks. Furthermore, the perception of an overall slowdown or even stagnation in reforms is not necessarily accurate, at least not in all areas. It also shows that the reform areas in which Russia lags are mostly, albeit not exclusively, microeconomic and structural ones, related to business climate, rule of the law and competition policy. Therefore, the following section will look at those remaining specific components of the reform process in the Russian Federation.

3. Remaining Reform Challenges

Macroeconomic Institutions

On one hand, Russia has clearly significantly improved the overall robustness of its macroeconomic framework, and especially of its *fiscal component* (see Figure 2, right pane). 2007 saw another important development in this process, in the form of the decisions taken in April 2007. The Russian Oil Stabilisation Fund (StabFund), having been established in 2003 and which remains the main fiscal restraint framework in Russia, was divided in February 2008 into a fiscal stabilisation (so called "Reserve Fund") and an investment component (so called "Welfare Fund"). The fiscal stabilisation part will perform the current StabFund functions (i.e. to shelter fiscal policy from swings in oil prices) and will be fixed at 10% of GDP, while the investment component is *expected* to have some functions akin to a Sovereign Wealth Fund

[14]This index does not cover Belarus and Turkmenistan, but one can safely assume Russia would outperform those two countries too.
[15]Those are: 1) Stateness, 2) Political Participation, 3) Rule of Law, 4) Stability of Democratic Institutions and 5) Political and Social Integration.

(SWF). A medium-term expenditure framework was also formally introduced by the April 2007 reforms. This three-year budgetary framework additionally encompasses separate oil and non-oil budgetary systems (to be phased in progressively), which include a cap on the transfers from the oil to the non-oil budget, and a limit for the non-oil deficit.[16] Moreover, in a gradual move towards performance budgeting, the government has decided to start including performance indicators that will cover an estimated 70% of the expenditure in the federal budget. This last change is especially relevant given the traditionally low effectiveness of public spending in Russia.

On the other hand, the recent inflationary spike (see Figure 2, left pane) –even if it is part of a worldwide trend[17] largely outside the direct control of the Russian monetary authorities and even if the Russian inflation is below the CIS average (and below the one in some NMS too)– shows the limitations of the current and still largely accommodative Russian *monetary policy*. Of course, this policy was accommodative mostly due to the very large trade surplus –admittedly largely sterilised by the fiscal framework– and perhaps also to the pre-emptive policy reactions to the instability in global financial markets initiated in the summer of 2007. Additionally, the limited effect of the several increases in the Central Bank of Russia's reference interest rate during the first half of 2008 also show the problems associated with the implementation of a monetary policy based on interest rates (for more on that, see Esanov, Merkl and Vinhas de Souza, 2005 and Vinhas de Souza, 2007).

Nevertheless, this inflationary spike is likely a short-term concern, and as indicated above, largely outside of the direct control of policy makers. How to cope with the *reduction and eventual disappearance of the budget and current account surpluses* are likely the most important medium-term macroeconomic policy challenges. These changes, which are part of the medium-term scenarios of the Russian Government itself, will necessarily imply a *need for continued positive net capital inflows*, and the only way to assure that is to create a *truly reliable investment climate*,[18] which is a structural reform challenge.

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[16]In mid-August 2008 the Russian Finance Ministry, as part of the draft "Fiscal Strategy to 2023" *proposed* to raise social security taxes and further reform Russia's oil and wealth funds, essentially to support the pension system. According to this draft, the Reserve Fund will fall to 6% of GDP from its current 10%, with this difference being transferred to the Welfare Fund, the main function of which will be to shore up the Russian pension system: under the "Fiscal Strategy", the Welfare Fund will contribute 0.6 % of the GDP per year towards the pension system, with this amount to be partly covered by the returns on the fund's SWF-like investments.

[17]An upcoming ECFIN paper looks at the ongoing inflationary upsurge in Russia, placing it within a global commodities-related trend (see Peeters and Strahilov, 2008). Another upcoming ECFIN paper (see Vinhas de Souza, 2008a) questions the claim that Russia might have been "overheating" in 2007-early 2008, which would be another inflationary factor.

[18]Vinhas de Souza, 2008a and 2008b look at the 2006-2007 increase in foreign investment and, more importantly, *net* positive foreign investment into Russia, but the fall in inflows observed during the first half of 2008 and the

Microeconomic and Structural Reforms

Microeconomic and structural reforms are not only important in and of themselves, but given the systemic nature of many of the outstanding questions, the deficiencies in those also affect areas in which Russia's performance is recognised as having been largely successful, notably in the macroeconomic sphere.

Part of the strategy to address the remaining shortcomings includes the definition of a comprehensive economic strategy that sets an overall direction to the long-term reform process, similarly to what the "Gref Plan" did in the early 2000s, as this will anchor the expectations of economic agents. The "Long Term Concept for Social and Economic Development of the Russian Federation", know as "Russia 2020 Strategy" or "Concept", published in August 2008 and updated with comments from the Russian cabinet in October 2008, has exactly such function (see Ministry of Economic Development, 2008). This Strategy openly recognises many of the weaknesses that may prevent Russian growth from becoming sustainable and proposes clear policies and aims to overcome them.[19]

Those weaknesses include how to address the undeniable *shortcomings of the legal system and of the broader state apparatus in Russia*. There is a widespread perception that the courts provides only a limited protection of property rights, and that the checks and balances among institutions in Russia needs strengthening.[20] Russia clearly requires both a more efficient and truly independent legal system and a qualified and professional civil service capable of delivering the services that its population and economic agents need.

Russia also needs to *strengthen its competition framework*. The relatively limited overall degree of competition in Russia has some structural causes (the sectoral composition of the economy, with a significant share of industries that are monopolistic in nature, the sheer size of the country, which makes some firms enjoy close to virtual regional monopolies), but there are also other reasons related to past choices that are amenable to corrective policies. Those include strengthening the legal and institutional frameworks that deal with anti-competitive behaviour and by a further multi-vector (i.e., geographically differentiated) integration of the Russian

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return of net negative foreign investment show how fragile that development is, and how sensitive to negative shocks in investment climate.

[19]Albeit some analysts may question the achievability of the Concept's focus on a growth model driven by "knowledge economy" sectors for Russia. In any case, its underlying logic of a diversification of the Russian economy away from natural resources is clearly desirable.

[20]Famously, even the Russian President, Dmitry Medvedev, called Russia a "country of legal nihilism" in a speech in January 2008.

economy into the World economy,[21] thereby opening-up the country to a greater degree of external competition.[22] Greater competition (both from domestic and external economic agents) also speeds-up and increases the degree of adoption of new technologies, thereby enhancing the overall competitiveness and growth potential of the Russian economy. The same is true for a policy that explicitly supports small and medium enterprises, underrepresented in Russia's economy. The recent strengthening of the Federal Antimonopoly Service (FAS), and the greater opening-up of some sectors of the Russian economy –for instance, the financial industry– to foreign participation, are positive signs that such a policy is being at least partially pursued in some areas.

Even if the current strategy seems to be one of strengthening *the role of the state* in some sectors of the economy, there are ways to limit the potentially negative effects of this policy. For instance, by opening up the governance structure of those state-owned or participated companies (SOE), which can be done by the increasing the capacity and independency of regulatory bodies (like the FAS itself), by listing those companies in stock markets, and also by bringing external members to their boards and professional managers to run the companies themselves, therefore incorporating private sector governance elements into those SOEs. As a stated intention from the Russian Government is an *eventual* (re)privatisation of some of those companies, this will also have the effect of facilitating such a future strategy.

Clearly, the *natural resources sector* will remain for the short-and medium terms one of the most important drivers of Russian growth, and it can also provide resources to fund an economic diversification strategy. Therefore, its legal framework is of particular importance. Unfortunately, some *further* recent episodes, plus some features of the "Strategic Sectors Law", which incorporates the relatively restrictive "Subsoil Law", may cast doubts on the current willingness of the Russian Government to open up and liberalize this sector, even in the face of reduced output levels of oil and gas and the related clear need for more (productive) investment.[23]

This recognition of the importance of the primary sector does not in any way negates the potential benefits of an *economic diversification strategy*, including into higher technology areas, but any successful diversification of the Russian economy will have to be based on a clear

[21]Also necessary simply because the financing needs for Russia's development cannot be fully met neither by the domestic financial system nor by the Russian Government (nor by both together), even under the still rather benign (for Russia at least) current environment.

[22]Investing in upgrading and expansion of the physical infrastructure that links Russian regions would also be a part of this strategy (beyond, of course, the sheer growth effects of investment in infrastructure), but this is a more long-term policy.

understanding of the true potential strengths of the country, and not merely rely on the allocation of large amounts of public resources into a few pre-selected industries (some even of unknown economic potential). Those strengths include a large domestic market, a highly educated population, an extensive network of (mostly government funded) research institutes,[24] and many unexplored possibilities for the creation of companies' clusters among the country's extensive industrial basis (and not only in higher technology but also in traditional and natural resources-based sectors, see Porter *et al*, 2007).

Another truly fundamental structural challenge for Russia is its current *demographic trend*: the Russian *official* resident population continues to age and shrink,[25] although life expectancy seems to have started to increase again, as has fertility. Mortality rates are still very high in Russia, particularly among working-age men. The rate of population increase in Russia is the world's second lowest: -0.6%, just above Ukraine's -0.8%. In order to fully compensate for this decline, a very significant annual inflow of working-age migrants would be necessary, with all the known challenges related to the integration of such large immigrant populations. The further reduction of working-age men mortality rates shall play a role too, with measures like an increased investment in health being part of the solution (an increase in birth rates may be less amenable to direct policy measures –including taxation ones– but sheer macro economic stabilisation and growth resumption may naturally also play a role in changing this trend). In any case, even if a deliberate policy to enhance immigration is chosen, the question of *increasing the labour productivity* of the domestic Russian labour force will also have to be addressed, and this passes through a reform of the educational system.

Related to this is the question of *inequality*: albeit growth resumption has very significantly reduced poverty, income inequality seems to have increased, especially in older segments of the population. A *reform of the pensions system* that both address the inequality question while at the same time assuring its long-term financial sustainability is also necessary (see Gurvich, 2007), and this lies behind the reforms of the fiscal framework proposed in August 2008.

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[23]For an extensive analysis of the economic structure of the energy sector in Russian and in the other CIS countries, see ECFIN, 2008.

[24]The main weakness of the Russian R&D complex seems to lie in the rather weak linkages between Russian industries and these government-funded research centres (peculiarly, foreign companies seem to use more the domestic Russian R&D capabilities –as measured by the number of patents– than Russian companies themselves).

[25]Russia's official resident population fell to 142.2 million in 2007, from 148.5 million in 1993, but some estimates of immigration (official and unofficial) put the figure as high as 14 million. Nevertheless, it is not clear how much of this is permanent or merely temporary/seasonal migration, which is aided by the lack of visa controls between Russia and most of the other CIS countries.

The enhanced episode of financial instability started during the summer of 2008, which, contrary to what happened in the summer of 2007, quickly spread to emerging markets like Russia, also point out to another weakness, the *financial sector*: the (net) reliance of the Russian banking system on foreign finance, which, at around 13% of assets at the latest available data, is still relatively limited and concentrated is a sub-set of banks,[26] but which grew 4 fold between 2003 and the first half of 2008. This indicates that robust deposit growth has been insufficient to fund the very significant lending expansion observed in Russia in the past few years: the average nominal deposit growth rate since between 2003 and the mid of 2008 was 44%, but the equivalent value for loans was 47%, and the imbalance has been growing 2006. This reliance on foreign resources is apparent too in the country's stock markets, and together with the worldwide shock to investor confidence largely explains their very significant falls during 2008. This points out to the need of reforming the supervisory structure of the Russian financial system, and to a larger mobilisation of domestic resources (especially longer-term ones) to finance investment in Russia.

It must be pointed out that the use of external anchors for reform (WTO accession, OECD membership, the future EU–Russia "New Agreement") is a necessary and important part of this overall reform process, and that this is also recognized by the long-term development strategy of the Russian government itself (see Ministry of Economic Development, 2008).

4. Conclusions

This brief paper has shown that Russia's macro performance does not underperform that of other genuinely similar countries. The length and intensity of its "transitional recession" during the early to mid-1990s was related to the later start of reforms in the CIS countries, the depth of distortions accumulated by the three generations of a centrally planned economy and the lack of a binding external anchor, such as the EU accession process. Even in terms of structural reform, when benchmarked against broadly similar economies (either other CIS countries or the other emerging giants of the BRICS), Russia's performance is respectable. All the fundamental structures of a market economy have been established –frequently at considerable social and economic cost– and the macroeconomic framework is clearly much more robust than it was in

[26] Namely, they are largely concentrated in the foreign banks in Russia, who have a share of foreign liabilities, which is twice as high as their share of assets, and also in some state-owned banks (who seem to have used the opportunity to exploit an implicit or explicit sovereign guarantee to attract foreign funding at lower rates) with the very significant exception of *the* systemically important –and conservatively run– Sberbank: there they are estimated to be as low as 2% of assets.

the mid-1990s. Additionally, despite the perception conveyed by some analyses, structural reform –albeit slower in certain areas– has not stopped.

That is not to say that a substantial, unfinished reform agenda does not remain: it does, and it includes some macro components, but mostly microeconomic and structural ones.

In terms of the macro challenges, how to cope with the inflationary spike and the reduction and eventual disappearance of the budget and current account surpluses are the most important matters for medium-term policy. These changes will imply a need for continued positive net capital inflows, and the only way to assure that is to create a reliable investment climate. The renewed financial instability and capital outflows over the summer of 2008 also shows the clear need for reform in this area.

These issues are tightly linked to the wider reform of the Russian state institutions and policies. I single out here the (interdependent) areas that are more pressing: those include reforming the legal system ("rule of the law" versus "legal nihilism") and the civil service, strengthening the competition framework while modifying the role of the state in the economy and changing the framework of the energy sector, supporting a sustainable economic diversification strategy, deepening and diversifying integration into the world economy while increasing the overall competitiveness of the country, and finally dealing with the current demography trends and related budgetary consequences. This is a long and challenging, but nevertheless necessary, reform agenda.

As a final remark, to assure the consistent and successful implementation of those reforms it is essential to make a clear, coherent and convincing case demonstrating that they will be beneficial for Russia and its population.

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